Internal Revenue
bulletin

Bulletin No. 2007-15
April 9, 2007

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.

SPECIAL ANNOUNCEMENT

Announcement 2007–39, page 954.

This announcement publishes a copy of the news release issued by the Office of the Deputy Commissioner, International, on March 22, 2007. It provides a further extension, until June 30, 2007, of the deadline for current and former U.S.-based employees of foreign embassies, consular offices and missions, and international organizations to participate in a one-time settlement initiative to resolve outstanding tax matters related to their employment.

INCOME TAX

Rev. Rul. 2007–23, page 889.

Federal rates; adjusted federal rates; adjusted federal long-term rate and the long-term exempt rate. For purposes of sections 382, 642, 1274, 1288, and other sections of the Code, tables set forth the rates for April 2007.

T.D. 9315, page 891.

Final regulations under section 1503 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. Notice 2006–13 obsoleted. Rev. Proc. 2000–42 obsoleted in part.

Notice 2007–35, page 940.

This notice alerts taxpayers to common mistakes made on individual income tax returns.

Announcement 2007–35, page 949.

Escrow accounts, trusts, and other funds used during deferred exchanges of like-kind property. A revised initial regulatory flexibility analysis discusses the impact on small businesses of proposed regulations (REG–113365–04, 2006–10 I.R.B. 580) relating to the current taxation of qualified escrow accounts, qualified trusts, and other escrow accounts, trusts, and funds used during deferred exchanges of like-kind property. The proposed regulations were published in the Federal Register on February 6, 2006.

Announcement 2007–39, page 954.

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(Continued on the next page)

Finding Lists begin on page ii.

Department of the Treasury
Internal Revenue Service

EXEMPT ORGANIZATIONS

Announcement 2007–38, page 954.
The IRS has revoked its determination that Quality Industrial Services of Snohomish, WA; Nazareth, Inc., of Cleveland Heights, OH; One Step Ahead Daycare, Inc., of Racine, WI; Gift America Program of Rockville, MD; The Patrick and Janet Hayes Charitable Supporting Organization of Houston, TX; 10th Life Foundation of Santa Barbara, CA; San Francisco Neighbors Resource Center of San Francisco, CA; Emerald Foundation, Inc., of Ojai, CA; and Osterville Village Association of Osterville, MA, qualify as organizations described in sections 501(c)(3) and 170(c)(2) of the Code.

ADMINISTRATIVE

REG–153037–01, page 942.
Proposed regulations under sections 7603 and 7609 of the Code provide guidance relating to the manner in which summonses may be served on third-party recordkeepers, the expanded class of third-party summonses subject to notice requirements and other procedures, and the suspension of periods of limitation if a court proceeding is brought involving a challenge to a third-party summons, or if a third party's response to a summons is not finally resolved within six months after service.

Notice 2007–35, page 940.
This notice alerts taxpayers to common mistakes made on individual income tax returns.

Announcement 2007–36, page 953.
This document contains corrections to proposed regulations (REG–139059–02, 2006–24 I.R.B. 1052) that conform the rules relating to the child and dependent care credit to statutory changes including amendments under the Working Families Tax Relief Act of 2004.

Announcement 2007–37, page 954.
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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 42.—Low-Income Housing Credit

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of April 2007. See Rev. Rul. 2007-23, page 889.

Section 280G.—Golden Parachute Payments

Federal short-term, mid-term, and long-term rates are set forth for the month of April 2007. See Rev. Rul. 2007-23, page 889.

Section 382.—Limitation on Net Operating Loss Carryforwards and Certain Built-In Losses Following Ownership Change

The adjusted applicable federal long-term rate is set forth for the month of April 2007. See Rev. Rul. 2007-23, page 889.

Section 412.—Minimum Funding Standards

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of April 2007. See Rev. Rul. 2007-23, page 889.

Section 467.—Certain Payments for the Use of Property or Services

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of April 2007. See Rev. Rul. 2007-23, page 889.

Section 468.—Special Rules for Mining and Solid Waste Reclamation and Closing Costs

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of April 2007. See Rev. Rul. 2007-23, page 889.

Section 468B.—Special Rules for Designated Settlement Funds

A revised Initial Regulatory Flexibility Analysis discusses the impact on small businesses of proposed regulations relating to the current taxation of qualified escrow accounts, qualified trusts, and other escrow accounts, trusts, and funds used during deferred exchanges of like-kind property. The proposed regulations were published on February 6, 2006. See Announcement 2007-35, page 949.

Section 482.—Allocation of Income and Deductions Among Taxpayers

Federal short-term, mid-term, and long-term rates are set forth for the month of April 2007. See Rev. Rul. 2007-23, page 889.

Section 483.—Interest on Certain Deferred Payments

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of April 2007. See Rev. Rul. 2007-23, page 889.

Section 642.—Special Rules for Credits and Deductions

Federal short-term, mid-term, and long-term rates are set forth for the month of April 2007. See Rev. Rul. 2007-23, page 889.

Section 807.—Rules for Certain Reserves

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of April 2007. See Rev. Rul. 2007-23, page 889.

Section 846.—Discounted Unpaid Losses Defined

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of April 2007. See Rev. Rul. 2007-23, page 889.

Section 1031.—Exchange of Property Held for Productive Use or Investment

26 CFR 1.1031(k)–1: Treatment of deferred exchanges.

A revised Initial Regulatory Flexibility Analysis discusses the impact on small businesses of proposed regulations relating to the current taxation of qualified escrow accounts, qualified trusts, and other escrow accounts, trusts, and funds used during deferred exchanges of like-kind property. The proposed regulations were published on February 6, 2006. See Announcement 2007-35, page 949.

Section 1274.—Determination of Issue Price in the Case of Certain Debt Instruments Issued for Property

(Also Sections 42, 280G, 382, 412, 467, 468, 482, 483, 642, 807, 846, 1288, 7520, 7872.)

Federal rates; adjusted federal rates; adjusted federal long-term rate and the long-term exempt rate. For purposes of sections 382, 642, 1274, 1288, and other sections of the Code, tables set forth the rates for April 2007.

Rev. Rul. 2007–23

This revenue ruling provides various prescribed rates for federal income tax purposes for April 2007 (the current month). Table 1 contains the short-term, mid-term, and long-term applicable federal rates (AFR) for the current month for purposes of section 1274(d) of the Internal Revenue Code. Table 2 contains the short-term, mid-term, and long-term adjusted applicable federal rates (adjusted AFR) for the current month for purposes of section 1288(b). Table 3 sets forth the adjusted federal long-term rate and the long-term tax-exempt rate described in section 382(f). Table 4 contains the appropriate percentages for determining the low-income housing credit described in section 42(b)(2) for buildings placed in service during the current month. Finally, Table 5 contains the federal rate for determining the present value of an annuity, an interest for life or for a term of years, or a remainder or a reversionary interest for purposes of section 7520.

REV. RUL. 2007–23 TABLE 1

Applicable Federal Rates (AFR) for April 2007

	Period for Compounding			
	Annual	*Semiannual*	*Quarterly*	*Monthly*
Short-term				
AFR	4.90%	4.84%	4.81%	4.79%
110% AFR	5.39%	5.32%	5.29%	5.26%
120% AFR	5.89%	5.81%	5.77%	5.74%
130% AFR	6.39%	6.29%	6.24%	6.21%
Mid-term				
AFR	4.61%	4.56%	4.53%	4.52%
110% AFR	5.08%	5.02%	4.99%	4.97%
120% AFR	5.54%	5.47%	5.43%	5.41%
130% AFR	6.02%	5.93%	5.89%	5.86%
150% AFR	6.96%	6.84%	6.78%	6.74%
175% AFR	8.14%	7.98%	7.90%	7.85%
Long-term				
AFR	4.81%	4.75%	4.72%	4.70%
110% AFR	5.30%	5.23%	5.20%	5.17%
120% AFR	5.78%	5.70%	5.66%	5.63%
130% AFR	6.28%	6.18%	6.13%	6.10%

REV. RUL. 2007–23 TABLE 2

Adjusted AFR for April 2007

	Period for Compounding			
	Annual	*Semiannual*	*Quarterly*	*Monthly*
Short-term adjusted AFR	3.50%	3.47%	3.46%	3.45%
Mid-term adjusted AFR	3.65%	3.62%	3.60%	3.59%
Long-term adjusted AFR	4.04%	4.00%	3.98%	3.97%

REV. RUL. 2007–23 TABLE 3

Rates Under Section 382 for April 2007

Adjusted federal long-term rate for the current month	4.04%
Long-term tax-exempt rate for ownership changes during the current month (the highest of the adjusted federal long-term rates for the current month and the prior two months.)	4.18%

REV. RUL. 2007–23 TABLE 4

Appropriate Percentages Under Section 42(b)(2) for April 2007

Appropriate percentage for the 70% present value low-income housing credit	8.10%
Appropriate percentage for the 30% present value low-income housing credit	3.47%

REV. RUL. 2007–23 TABLE 5

Rate Under Section 7520 for April 2007

Applicable federal rate for determining the present value of an annuity, an interest for life or a term of years, or a remainder or reversionary interest	5.6%

Section 1288.—Treatment of Original Issue Discount on Tax-Exempt Obligations

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of April 2007. See Rev. Rul. 2007-23, page 889.

Section 1503.—Computation and Payment of Tax

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

T.D. 9315

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

Dual Consolidated Loss Regulations

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final 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, the loss does not offset the income of any foreign corporation. Similar rules apply to losses of separate units of domestic corporations. These final 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: *Effective Date:* These regulations are effective on March 19, 2007.

Applicability Dates: For dates of applicability, see §1.1503(d)–8.

FOR FURTHER INFORMATION CONTACT: Jeffrey P. Cowan, (202) 622–3860 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information contained in these final regulations has been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)) under control number 1545–1946.

The collections of information in these final regulations are in §§1.1503(d)–1(c), 1.1503(d)–3(e), 1.1503(d)–4(e), 1.1503(d)–6(c), 1.1503(d)–6(d), 1.1503(d)–6(e), 1.1503(d)–6(f), 1.1503(d)–6(g), 1.1503(d)–6(h), and 1.1503(d)–6(j). This information is required for various reasons. The information under §1.1503(d)–1(c) notifies the IRS when a taxpayer asserts that it had reasonable cause for failing to comply with certain filing requirements under the regulations. The information under §1.1503(d)–4(e) indicates when the taxpayer attempts to rebut the amount of presumed tainted income. The information under the other provisions provides the IRS with various information regarding domestic use elections, exceptions to the domestic use limitation, triggering events, new domestic use agreements, original elector statements, annual certifications, and terminations of existing domestic use elections.

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.

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

Background

Congress enacted section 1503(d), as part of the Tax Reform Act of 1986, to prevent a dual resident corporation from using a single economic loss 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). In 1988, Congress extended the application of section 1503(d), by adding section 1503(d)(3) and (4), to apply the provisions to separate units of domestic corporations and to grant the Secretary authority to promulgate regulations to prevent the avoidance of section 1503(d) through the contribution of assets to a corporation with a dual consolidated loss after the loss was sustained. The IRS and Treasury Department issued temporary regulations under section 1503(d) in 1989 (T.D. 8261, 1989–2 C.B. 220) and final regulations in 1992 (T.D. 8434, 1992–2 C.B. 240), see §601.601(d)(2)(ii)(*b*). These final regulations were updated and amended over the next 11 years (current regulations).

On May 24, 2005, the IRS and Treasury Department published in the **Federal Register** a notice of proposed rulemaking (REG–102144–04, 2005–1 C.B. 1297 [70 FR 29868]). The proposed regulations addressed the following fundamental concerns arising under the current regulations: (1) the potential over- and under-application of the current regulations; (2) various issues arising in the application of the current regulations, particularly in light of the adoption of the entity classification regulations under §§301.7701–1 through 301.7701–3 (check-the-box regulations); and (3) the administrative burden of the current regulations. The public hearing with respect to the 2005 proposed regulations was cancelled because no request to speak was received. However, the IRS and Treasury Department received a number of

written comments which are discussed in this preamble.

Summary of Comments and Explanation of Provisions

A. *Application of Section 1503(d) to Regulated Investment Companies and Real Estate Investment Trusts*

Under the current regulations, a dual resident corporation is a domestic corporation that is subject to an income tax of a foreign country on its worldwide income or on a residence basis. As a result, unless specifically exempted, certain entities that are domestic corporations, but not generally taxed at the entity level, may be subject to the current regulations. The current regulations provide that an S corporation, which is a domestic corporation, is not treated as a dual resident corporation. The proposed regulations, and these final regulations, provide that an S corporation is not treated as a domestic corporation and thus cannot be a dual resident corporation or own a separate unit.

Under the current regulations, as a domestic corporation, a regulated investment company (as defined in section 851) or a real estate investment trust (as defined in section 856) could be a dual resident corporation or own a separate unit. In the preamble to the proposed regulations, however, the IRS and Treasury Department requested comments as to whether regulated investment companies or real estate investment trusts should, like S corporations, be excluded from the application of the dual consolidated loss rules. One commentator suggested that regulated investment companies and real estate investment trusts should be subject to the dual consolidated loss rules, but would limit recapture pursuant to a domestic use agreement to situations where there was a foreign use and a section 381 transaction occurred.

The IRS and Treasury Department believe that subjecting regulated investment companies and real estate investment trusts to the dual consolidated loss rules is inappropriate. Section 1503(d) was intended to apply to domestic corporations that are subject to entity-level tax. Although regulated investment companies and real estate investment trusts are domestic corporations under the Code, unlike most domestic corporations these entities often do not pay tax at the entity level because they may deduct the amount of dividends paid to their shareholders from their own taxable income. Thus, under the final regulations regulated investment companies and real estate investment trusts are excluded from the definition of a domestic corporation and, as a result, are not subject to the dual consolidated loss rules.

B. *Separate Units*

(1) *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 available to offset the income of the other branches under the tax laws of the foreign country, then the branches are treated as a single separate unit.

In response to comments that the current combination rule was unnecessarily limited and did not appropriately address the check-the-box regulations, the proposed regulations adopt a broader combination rule that, subject to certain requirements, combines all separate units of a single domestic corporation. One requirement for combining separate units, both under the current regulations and the proposed regulations, is that the losses of each separate unit are made available to offset the income of the other separate units under the tax laws of a single foreign country.

The combination rule in the proposed regulations does not combine dual resident corporations that are members of the same consolidated group, or separate units of multiple domestic corporations that are members of the same consolidated group. However, in the preamble to the proposed regulations, the IRS and Treasury Department requested comments as to whether combination was appropriate in these cases.

Numerous comments were received on the scope and application of the combination rule. Commentators uniformly recommended that the combination rule be expanded to include separate units that are located in or subject to tax in the same foreign country (same-country separate units) and that are owned by multiple domestic corporations that are members of the same consolidated group. The IRS and Treasury Department believe that combining same-country separate units of domestic corporations that are members of the same consolidated group is consistent with the policies underlying section 1503(d) because, in general, all of the items of income, gain, deduction, and loss of such combined separate units are taken into account in both the United States and the foreign country. Therefore, these final regulations expand the combination rule to apply to same-country separate units of multiple domestic corporations that are members of the same consolidated group.

Two commentators recommended that the combination rule be expanded to combine dual resident corporations that are members of the same consolidated group. The IRS and Treasury Department do not believe that Congress intended that multiple dual resident corporations be treated as a single domestic corporation for purposes of section 1503(d). Combining dual resident corporations and separate units would also add complexity because certain rules apply differently to dual resident corporations and separate units. As a result, the combination rule in these final regulations does not apply to dual resident corporations.

Nevertheless, it is important to note that a dual resident corporation will often carry on its activities through a foreign branch (as defined in §1.367(a)–6T(g)(1)) and, as a result, will be a domestic owner of a foreign branch separate unit. In these cases, the foreign branch separate unit through which it carries on its activities in the foreign country will be eligible for combination. In addition, in many cases, a significant number of the items of income, gain, deduction, and loss of a dual resident corporation that owns a foreign branch separate unit will be attributable to the foreign branch separate unit (and therefore will not be items of the dual resident corporation itself). As a result, not extending the combination rule to dual resident corporations should, as a practical matter, have limited effect.

One commentator recommended eliminating the proposed regulations' requirement that losses of each separate unit must be available to offset the income of other separate units under the tax laws of a single foreign country in order for them to com-

bine. The IRS and Treasury Department believe that it is appropriate to remove this requirement, provided that the individual separate units are located, or subject to income tax on a worldwide or residence basis, in the same foreign country. This is the case because it is likely that all of the items of the combined separate unit will be recognized in both the United States and the foreign jurisdiction, without regard to whether such items are available for offset under the income tax laws of the foreign country. In addition, the IRS and Treasury Department believe that eliminating this requirement will reduce complexity, and will further refine the application of the rules. As a result, these final regulations eliminate this requirement from the combination rule.

Commentators also recommended making combination elective in certain situations. The IRS and Treasury Department believe that elective combination would add complexity and create administrative burdens. Therefore, this comment is not adopted.

The IRS and Treasury Department recognize that the expanded combination rule may necessitate that the basis of the stock of multiple domestic corporations, which are members of the same consolidated group, be adjusted to reflect the items of income, gain, deduction, and loss entering into the computation of the dual consolidated loss of a combined separate unit. These regulations provide guidance on the manner of such basis adjustments.

These final regulations also clarify that the separate unit combination rule generally applies for all purposes of section 1503(d). As a result, except as specifically provided in these regulations, any individual separate unit composing a combined separate unit loses its character as an individual separate unit. For example, in determining whether there is a triggering event as a result of the transfer of the assets of a combined separate unit, all of the assets of the combined separate unit are taken into account (rather than only the assets of any individual separate unit within the combined separate unit).

(2) *Definition of a foreign branch by reference to §1.367(a)–6T(g)*

One commentator stated that the reference in the current and proposed regulations to §1.367(a)–6T(g) for the definition of a foreign branch, which implicitly includes references to §1.367(a)–6T(g)(1) through (3), creates needless complexity. The IRS and Treasury Department generally agree with this comment. Accordingly, these final regulations clarify that a foreign branch is defined, in part, by reference to §1.367(a)–6T(g)(1), rather than by reference to §1.367(a)–6T(g).

(3) *Treaty exception to the definition of a foreign branch separate unit*

One commentator suggested that the definition of a foreign branch separate unit should not include a branch that would not be subject to income tax in a foreign jurisdiction either as a result of an income tax convention or because of the passive nature of the activities. This commentator explained that such an exclusion is appropriate because in these cases there would be no potential use of a branch loss for foreign tax purposes.

The IRS and Treasury Department agree that it is appropriate to exclude from the definition of a foreign branch separate unit certain business operations that, under an applicable income tax convention, would not be considered a permanent establishment. As a result, these final regulations include an exception to the definition of a foreign branch separate unit. The IRS and Treasury Department do not, however, believe an exception is appropriate where the business operations are not subject to tax in the foreign jurisdiction because of the passive nature of the activities. Such an exception would require the analysis of foreign law which, to the extent possible, should not be required under these rules.

(4) *Activities owned by a dual resident corporation or a hybrid entity*

One commentator requested clarification that home-country activities of a dual resident corporation or hybrid entity separate unit can qualify as a foreign branch separate unit. The IRS and Treasury Department agree that this clarification is warranted and these final regulations are modified accordingly.

C. *Elimination of the Consistency Rule*

As a result of the expansion of the separate unit combination rule in these final regulations, the IRS and Treasury Department believe that the consistency rule would have only limited application. Therefore, the consistency rule has been eliminated from these final regulations. The IRS and Treasury Department believe that eliminating the consistency rule will simplify the application of the dual consolidated loss rules and will eliminate various issues that arise under the rule.

D. *Domestic Reverse Hybrid Entities*

One commentator noted that the application of the current and proposed regulations to certain structures involving domestic reverse hybrid entities appears inconsistent with the underlying policies of section 1503(d). In a typical structure, a foreign corporation owns the majority of the interests in a partnership or limited liability company that elects to be treated as a corporation for U.S. tax purposes and, therefore, is subject to tax on its worldwide income in the United States, but is treated as a pass-through entity under foreign law (domestic reverse hybrid). The domestic reverse hybrid is the parent of a consolidated group, is the obligor on group indebtedness, and holds stock of other group members. This structure allows the interest expense of the domestic reverse hybrid to offset income of the foreign corporation, which is not subject to U.S. tax, and to offset income of the other members of the consolidated group, which is not subject to foreign tax.

The commentator noted that because the domestic reverse hybrid is neither a dual resident corporation (because it is not subject to tax on a residence basis or on its worldwide income in the foreign country, but is instead treated as a pass-through entity) nor a separate unit of a domestic corporation, the current and proposed regulations do not apply to the losses of the domestic reverse hybrid. The commentator asserted that this result is inconsistent with the policies underlying section 1503(d), which was adopted, in part, to ensure that domestic corporations were not put at a competitive disadvantage as compared to foreign corporations through the use of certain inbound acquisition structures. See

S. Rep. No. 99–313, 1986–3 C.B. Vol. 3 at 420, see §601.601(d)(2)(ii)(*b*). The commentator suggested that the scope of the final regulations be broadened to treat such entities as separate units, the losses of which are subject to the restrictions of section 1503(d). This change would, in effect, apply the provisions of section 1503(d) to a separate unit of a foreign corporation.

The IRS and Treasury Department recognize that this type of structure results in a double dip similar to that which Congress intended to prevent through the adoption of section 1503(d). However, the IRS and Treasury Department believe that a domestic reverse hybrid is neither a dual resident corporation nor a separate unit and, therefore, is not subject to section 1503(d). As a result, this comment is not adopted. However, the IRS and Treasury Department continue to study these and similar structures.

E. *Transparent Entities*

Section 1.1503–2(c)(3) and 1.1503–2(c)(4) of the current regulations define a separate unit of a domestic corporation as a foreign branch (within the meaning of §1.367(a)–6T(g)), and an interest in a partnership, trust, or hybrid entity. As a result, the current regulations potentially apply not only to entities that are subject to tax in a foreign country (for example, hybrid entities), but also to entities that are not subject to tax in a foreign country, and otherwise have no connection to a foreign jurisdiction (for example, a domestic partnership engaged in a U.S. trade or business).

The proposed regulations modify the definition of a separate unit to exclude interests in non-hybrid entity partnerships and non-hybrid entity grantor trusts. These interests were excluded because the IRS and Treasury Department believe that it is unlikely that losses and deductions attributable to these interests could be put to a foreign use (as that term is defined in the proposed regulations). However, the proposed regulations retain the rule that a domestic corporation can own a separate unit through a non-hybrid entity partnership or non-hybrid entity grantor trust.

Commentators noted that, as a result of this change, the proposed regulations may not sufficiently and consistently address the treatment of certain entities. Such an entity is a pass-through entity for U.S. tax purposes (for example, a disregarded entity, a partnership or a grantor trust), but is not a hybrid entity because it is not subject to tax on its worldwide income or on a residence basis in a foreign country. In addition, the entity would not be treated as a pass-through entity under the laws of the applicable foreign country. One example of such an entity (transparent entity) is a limited liability company organized in the United States that for U.S. tax purposes is a partnership or disregarded entity, but, for purposes of the applicable foreign country, is not viewed as a pass-through entity. Another example is a foreign entity that is a pass-through entity for U.S. tax purposes, is not subject to income tax in a foreign country as a corporation (or otherwise at the entity level) either on its worldwide income or on a residence basis (because, for example, it is organized in a foreign country that does not impose an income tax), and is not treated as a pass-through entity under the laws of the applicable foreign country.

The commentators noted that under the proposed regulations items of income, gain, deduction, and loss of a transparent entity that is a partnership for U.S. tax purposes would be taken into account in computing the dual consolidated loss of a dual resident corporation or hybrid entity separate unit that owns an interest in such entity, even though it is unlikely that the items are taken into account by the jurisdiction in which the dual resident corporation or hybrid entity is subject to tax. As a result, items of deduction or loss which are unlikely to be available for a double dip (because they are not taken into account by the foreign country in which the dual resident corporation or hybrid entity is subject to tax) could inappropriately result in a dual consolidated loss. The commentators further noted that items of income or gain which are unlikely to be taken into account by the foreign country could inappropriately reduce (or eliminate) a dual consolidated loss of the dual resident corporation or hybrid entity separate unit that owns an interest in such entity.

The IRS and Treasury Department believe that losses attributable to interests in transparent entities should not be subject to section 1503(d), but also believe that items attributable to these interests should not influence the calculation or use of a dual consolidated loss of a dual resident corporation or separate unit in a manner that is inconsistent with the purposes of section 1503(d). Accordingly, these final regulations provide four new rules that address transparent entities (and interests therein).

First, these final regulations provide a definition of a transparent entity that is consistent with the description and examples in the preceding discussion.

Second, rules are provided for attributing items of income, gain, deduction, and loss to interests in transparent entities. The rules applicable for attributing items to these interests are consistent with the rules for attributing items to hybrid entity separate units.

Third, these final regulations provide that items of income, gain, deduction, and loss attributable to interests in transparent entities are not considered when calculating whether a dual resident corporation that holds an interest in such entity has income or a dual consolidated loss. This modification ensures that in cases where the foreign country in which the dual resident corporation is subject to tax is unlikely to take into account items of the transparent entity, such items do not inappropriately affect the computation of income or a dual consolidated loss of the dual resident corporation. Similar rules apply for purposes of calculating the income or dual consolidated loss of a separate unit through which an interest in a transparent entity is owned (directly or indirectly).

Finally, an interest in a transparent entity will be treated as a domestic affiliate for purposes of determining whether there is a domestic use of a dual consolidated loss. This change prevents a dual consolidated loss from being used to offset the income of a transparent entity such that there is no inappropriate domestic use of the loss.

These final regulations do not treat transparent entities, or interests therein, as dual resident corporations or separate units and, as a result, do not cause such entities (or interests therein) to be subject to the limitations of section 1503(d). Instead, the rules aim to appropriately take into account such entities when applying the dual consolidated loss rules to dual resident corporations and separate units.

F. *Reasonable Cause Exception*

The current regulations require various filings to be included on a timely filed income tax return. In addition, taxpayers that fail to include these filings must request an extension of time to file under §§301.9100–1 through 301.9100–3. The proposed regulations eliminate the requirement that a taxpayer obtain an extension of time under §§301.9100–1 through 301.9100–3 and instead adopt a reasonable cause standard.

On January 31, 2006, the IRS and Treasury Department published Notice 2006–13, 2006–8 I.R.B. 496, see §601.601(d)(2)(ii)(*b*), announcing that taxpayers that must file agreements, statements, and other information under section 1503(d) may cure any late filings by applying a reasonable cause exception similar to the standard contained in the proposed regulations, until such time as the proposed regulations become final. In addition to allowing the use of the reasonable cause exception prior to the proposed regulations being published as final regulations in the **Federal Register**, the notice modifies the procedures for obtaining reasonable cause relief to ensure that requests for reasonable cause relief are handled in a timely and efficient manner.

These final regulations adopt the reasonable cause standard contained in the proposed regulations and Notice 2006–13, with certain modifications. See paragraph S(3) of this preamble for the application of the reasonable cause exception to losses that are subject to the current regulations.

G. *Foreign Use*

(1) *In general*

Section 1.1503–2(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 ((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 proposed regulations modify the definition of "use" and provide a rule based on "foreign use" in order to minimize the potential over- and under-application of the current regulations. 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 deduction or loss 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 these items are recognized under U.S. tax principles. 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.

(2) *Indirect foreign use*

As noted, the proposed regulations provide that a foreign use of a dual consolidated loss will occur when any item of deduction or loss, entering into the computation of the dual consolidated loss, is made available, directly or indirectly, to offset under foreign law, income of a foreign corporation or an owner of an interest in a hybrid entity that is not a separate unit. The proposed regulations do not provide comprehensive examples illustrating when an indirect use of a dual consolidated loss occurs. However, the provision was included in the proposed regulations to address transactions that are structured to avoid the application of section 1503(d) through, for example, the use of a back-to-back lending or conduit financing-type arrangements, or through the use of one or more hybrid instruments.

Commentators requested additional guidance regarding an indirect foreign use. In response to these comments, these final regulations clarify when an indirect foreign use is deemed to occur, include an exception to the general indirect foreign use rule for certain ordinary course transactions, and provide related examples.

The indirect foreign use rules are designed to limit an indirect use to situations in which taxpayers have engaged in transactions which have the effect of transferring an item of deduction or loss composing a dual consolidated loss to another entity for foreign tax purposes, so that it is made available to offset the income of a foreign corporation or the owner of an interest in an entity which is not a separate unit. In general, these rules are intended to target structured transactions that are designed to achieve a double dip that is contrary to the policies of section 1503(d), and are not intended to apply to ordinary business transactions.

(3) *Exceptions to foreign use*

The proposed regulations contain three exceptions to the definition of a foreign use, including an exception where there is no dilution of an interest in a separate unit. In the preamble to the proposed regulations, the IRS and Treasury Department request comments as to whether a *de minimis* exception should be provided to the dilution limitation. The preamble also states that a revenue procedure would be issued, in conjunction with the proposed regulations being published as final regulations in the **Federal Register**, that would provide additional exceptions (safe harbors) under which a triggering event would be deemed rebutted if various conditions were satisfied, including, in certain cases, a demonstration that there can be no foreign use of a significant portion of the dual consolidated loss.

The IRS and Treasury Department received a number of comments on transactions and situations that could be included in the list of safe harbors. One commentator suggested an exception whereby recapture would not be required following transactions outside the taxpayer's control. For example, this commentator suggested that a recapture of a dual consolidated loss should not occur following the conveyance or relinquishment of assets of a separate unit, or interests in a separate unit, to a foreign government.

Commentators also suggested that relief should be provided following certain

transactions, similar to those mentioned in the preamble to the proposed regulations, where there is a *de minimis* potential for foreign use, a *de minimis* carryover of asset basis, and for which rebuttal would otherwise be difficult or impossible. According to these commentators, this safe harbor would apply to many common business transactions in which the policies underlying section 1503(d) would not be violated because of only a *de minimis* potential for foreign use.

Another commentator stated that an exception to foreign use would be appropriate where the taxpayer enters into a binding and irrevocable agreement with the tax authorities of a foreign country which ensures that no portion of the dual consolidated loss can be put to a foreign use in the foreign country. The commentator explained that, pursuant to such an arrangement, the taxpayer and the foreign tax authorities would agree that the foreign tax attributes of a dual resident corporation or separate unit (for example, loss carryforwards and asset basis) would be eliminated such that there would be no opportunity for a foreign use.

After considering these comments, the IRS and Treasury Department believe that it is appropriate to include certain safe harbors where a foreign use will be deemed not to occur. As a result, these final regulations (rather than a revenue procedure) set forth additional exceptions to the definition of a foreign use. These exceptions generally apply in cases where the potential for foreign use is *de minimis*, or where the transaction giving rise to a foreign use occurs as a result of events largely outside of the taxpayer's control.

These new exceptions to foreign use include a *de minimis* rule and rules that apply to certain transactions involving the carry over of asset basis and the assumption of liabilities. Another new exception applies to a transaction that qualifies for the multiple-party event exception to a triggering event (referred to as successor elector events under the proposed regulations) where the acquiring unaffiliated domestic owner or consolidated group owns, immediately after the transaction, less than 100 percent of the acquired assets or interests. Without this exception to foreign use, many transactions that would qualify for the multiple-party event exception would immediately result in a foreign use triggering event when the unaffiliated domestic corporation or consolidated group acquires between 90 and 100 percent of the assets or interests. Finally, these regulations modify the "no dilution" exception contained in the proposed regulations to, among other things, incorporate a *de minimis* exception.

These final regulations provide that the exceptions may be supplemented through subsequent guidance published in the Internal Revenue Bulletin, as appropriate. As a result, the IRS and Treasury Department request comments on additional transactions or situations that should be added as safe harbors. For example, additional comments are requested on arrangements with foreign tax authorities whereby foreign tax attributes could be eliminated to ensure that no portion of the dual consolidated loss can be put to a foreign use.

(4) *Ordering rules for determining a foreign use*

The current and proposed regulations provide rules for determining the order in which dual consolidated losses are used in cases where the laws of a foreign country provide for the foreign use of such loss, but do not provide applicable rules for determining the order in which these losses are used in a taxable year.

A commentator noted that in certain cases involving dual consolidated losses incurred in different taxable years, the ordering rules may result in losses being deemed to be made available for a foreign use resulting in recapture, even though there are other losses which, if deemed to be used, would not result in recapture. This commentator recommended that in these situations the losses be deemed to first be used in a manner that will not result in the recapture of a dual consolidated loss. The commentator also noted that this approach is consistent with the exception to foreign use contained in §1.1503(d)–1(b)(14)(iii)(B) of the proposed regulations where there is no foreign country rule for determining use. Finally, the commentator stated that losses that do give rise to a foreign use should be deemed to be used on a "last-in/first-out" basis. The IRS and Treasury Department believe these rules are appropriate and, as a result, these comments are adopted.

(5) *Mirror legislation*

The current regulations contain a mirror legislation rule that denies a taxpayer the ability to make an election to use a dual consolidated loss to offset the income of a domestic affiliate where the foreign country has enacted legislation that operates in a manner similar to section 1503(d), and, as a result, prohibits the taxpayer from claiming the dual consolidated loss in the foreign country. The mirror legislation rule was designed to prevent the revenue gain resulting from the disallowance of a double dip from inuring solely to the foreign country. Staff of the Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1986, at 1065 - 66 (J. Comm. Print 1987), see §601.601(d)(2)(ii)(*b*); see also *British Car Auctions, Inc. v. United States*, 35 Fed. Cl. 123 (1996), *aff'd without op.*, 116 F.3d 1497 (Fed. Cir. 1997) (upholding the validity of the mirror legislation rule). The effect of the mirror legislation rule is that a dual consolidated loss may be disallowed in the United States and in the foreign country. In such cases, Congress intended for the Treasury Department to pursue a bilateral agreement with the foreign jurisdiction so that the loss could offset income of an affiliate in only one country.

The proposed regulations retain the mirror legislation rule and modify it to better take into account the policies underlying its adoption.

A number of comments were received on the scope and utility of the mirror legislation rule. Several commentators encouraged the IRS and the Treasury Department to pursue bilateral agreements where the dual consolidated loss is disallowed in both the United States and the foreign country.

The IRS and Treasury Department agree that such agreements are necessary and recently concluded a competent authority agreement on such matters with the United Kingdom on October 6, 2006 (the Agreement). For the text of the Agreement, see Announcement 2006–86, 2006–45 I.R.B. 842; see §601.601(d)(2)(ii)(*b*). The Agreement applies to dual consolidated losses attributable to certain UK permanent establishments that are otherwise subject to both section 1503(d) and mirror legislation enacted by the United Kingdom. In general,

the Agreement provides that taxpayers can elect to use or relieve the loss in either the United Kingdom or the United States, but not both.

The IRS and Treasury Department believe that these final regulations and the Agreement appropriately refine and limit the scope of the mirror rule. In addition, the IRS and Treasury Department believe that the provisions of the Agreement can serve as a model for future competent authority agreements, if necessary, between the United States and its treaty partners which would further the Congressional intent with respect to the application of the mirror legislation rule. Accordingly, comments are requested on the provisions of the Agreement and on specific jurisdictions and considerations that should be taken into account in future agreements.

Commentators also suggested that a "stand-alone" exception to the mirror legislation rule be adopted. This exception would apply where filing a domestic use election with respect to a dual consolidated loss otherwise subject to the mirror legislation rule would not violate the policies of section 1503(d). According to the commentators, this is the case because the mirror legislation in the foreign country would not have the effect of forcing taxpayers to use the losses in the United States. The commentators suggested that the mirror legislation rule would not apply provided there is not a foreign affiliate to which the separate unit or dual resident corporation could put the dual consolidated loss to a foreign use. The commentators noted that in these situations, the mirror legislation does not result in the revenue loss inuring solely to the United States, because it is factually impossible for the loss to offset taxable income in the foreign country that is not also taken into account in the United States.

The IRS and Treasury Department generally agree with this comment. As a result, these final regulations contain a stand-alone exception to the mirror legislation rule.

H. *Elimination of a Dual Consolidated Loss After Certain Transactions*

Both the current and proposed regulations contain rules that eliminate a dual consolidated loss that is subject to the general restrictions under section 1503(d)(1) following certain transactions. In the case of a dual resident corporation, the dual consolidated loss is generally eliminated in transactions described in section 381(a) because the dual resident corporation ceases to exist. In the case of a separate unit, the dual consolidated loss is generally eliminated in transactions where the separate unit ceases to be a separate unit of its domestic owner (either through a transaction described in section 381(a) or otherwise). In these cases, and subject to the exceptions discussed in this preamble, after the transaction it is no longer possible for the dual resident corporation or separate unit to generate income that can be offset by the dual consolidated loss. As a result, any unused dual consolidated loss is eliminated.

Both the current and the proposed regulations provide exceptions to the general elimination rule in the case of certain transactions to which section 381(a) applies. These exceptions generally apply in cases where it is possible that income that is generated by the transferee corporation after the transaction is subject to tax in both the United States and the foreign country such that it is appropriate for the income to be offset by the dual consolidated loss that carries over to the transferee.

These final regulations make certain modifications to the elimination rules. For example, the rules are modified to reflect the expansion of the separate unit combination rule. Thus, these final regulations take into account transactions involving combined separate units that have more than one domestic owner. For example, a dual consolidated loss of a domestic owner that is attributable to a separate unit will not be eliminated under these final regulations if the separate unit continues to be a separate unit of any member of its domestic owner's consolidated group.

I. *Application of SRLY Limitation to a Former Dual Resident Corporation*

Section 1.1503(d)–3(c)(3) of the proposed regulations provides that a dual consolidated loss is treated as a loss incurred by a dual resident corporation or separate unit in a separate return limitation year (SRLY) and is generally subject to all the limitations of §1.1502–21(c). The proposed regulations provide that when determining the general SRLY limitation with respect to a dual resident corporation, the calculation of aggregate consolidated taxable income only includes income, gain, deduction, and loss generated in years in which the dual resident corporation is a resident (or is taxed on its worldwide income) in the same foreign country in which it was a resident (or was taxed on its worldwide income) during the year in which the dual consolidated loss was generated. See proposed §1.1503(d)–3(c)(3)(iii).

One commentator noted that this rule prevents the dual consolidated loss of a dual resident corporation from being taken into account by its consolidated group after the dual resident corporation ceases to be subject to tax on a residence basis (or on its worldwide income), regardless of whether the former dual resident corporation contributes taxable income to the consolidated taxable income of the group. The commentator stated that this result is inappropriate because it does not merely limit the use of a dual consolidated loss from offsetting the income of a domestic affiliate, but has the effect of limiting the use of a dual consolidated loss from offsetting the domestic corporation's own taxable income.

The IRS and Treasury Department agree with this comment. Section 1503(d)(1) provides that a dual consolidated loss of a corporation shall not reduce the taxable income of any other member of the affiliated group for the taxable year or for any other taxable year. However, the limitations of section 1503(d)(1) do not prevent the use of a dual consolidated loss to offset the income of the dual resident corporation that incurred the loss, even where the dual resident corporation ceases to be subject to tax in the foreign country. As a result, this rule is not contained in these final regulations. But see section 1503(d)(4) (relating to tainted assets contributed to a dual resident corporation).

J. *Effect of Section 1503(d) on Foreign Tax Credits*

Section 1503(d)(2) generally defines a dual consolidated loss to mean any net operating loss of a dual resident corporation or a separate unit. Section 172(c) generally defines a net operating loss as the excess of deductions over gross income. Section 164(a)(3) generally provides that foreign taxes are allowed as a deduction for

the taxable year in which paid or accrued. However, section 275(a)(4) provides that no deduction is allowed for any such taxes, to the extent the taxpayer chooses to take to any extent the benefits of section 901 (which permits taxpayers to claim a credit for certain taxes paid or accrued during the taxable year to any foreign country or any possession of the United States).

Commentators asked whether a creditable foreign tax expenditure incurred by a dual resident corporation or separate unit, for which an election is made to claim a credit pursuant to section 901, may be subject to the limitations of section 1503(d)(1).

The IRS and Treasury Department recognize that policy concerns arise in certain transactions in which two or more parties claim a credit for the same foreign taxes. Although these policy concerns are similar to those arising under section 1503(d), the IRS and Treasury Department do not believe that Congress intended the limitations of section 1503(d) to apply to foreign taxes, so long as the foreign taxes do not enter into the computation of a net operating loss (that is, so long as an election is made to claim a credit for such taxes, in lieu of deducting them). As a result, under the terms of the statute, the limitations of section 1503(d) do not apply to creditable foreign tax expenditures incurred by a dual resident corporation or a separate unit, provided an election is made to claim a credit with respect to such expenditures in accordance with section 901 and the related regulations.

Even though section 1503(d) does not apply to foreign tax credits that are claimed by more than one person, the IRS and Treasury Department continue to study these transactions and, as appropriate, intend to address them in future published guidance under other provisions.

K. *Tainted Income Rule*

Section 1503(d)(4) grants the Secretary authority to prescribe such regulations as may be necessary or appropriate to prevent the avoidance of the purposes of section 1503(d) by contributing assets to the corporation with the dual consolidated loss after such loss is incurred. 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 the income from assets that are acquired by the dual resident corporation in a nonrecognition transaction, or 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 any time thereafter. The proposed regulations retained the tainted income rule, with certain modifications.

One commentator noted that the tainted income rule of the current and proposed regulations applies with respect to assets acquired by a dual resident corporation, regardless of whether such tainted assets were received from a member of the dual resident corporation's affiliated group. According to this commentator, because section 1503(d) was intended to prevent the use of a dual consolidated loss from offsetting the taxable income of any other member of the affiliated group, applying the tainted income rule where the tainted assets were not received from a member of the dual resident corporation's affiliated group is inconsistent with the policies underlying section 1503(d).

Section 1503(d)(4) grants the Secretary broad regulatory authority to implement the tainted income rule. In addition, the IRS and Treasury Department believe that adopting the rule suggested by the commentator would require the IRS to trace the source of tainted assets received (for example, to ensure that the rule cannot be avoided through the imposition of an intermediary entity, such as a partnership, or through indirect transfers of assets). Moreover, such a rule would be difficult for both taxpayers and the IRS to apply, and would increase complexity. Accordingly, the IRS and Treasury Department believe that the tainted income rule should continue to apply without regard to the source of the tainted assets. As a result, this comment is not adopted.

L. *Items Taken into Account in Computing Income or a Dual Consolidated Loss*

(1) *In general*

Section 1503(d)(2)(A) generally defines a dual consolidated loss to mean any net operating loss of a domestic corporation which is subject to an income tax of a foreign country on its income without regard to whether such income is from sources inside or outside such foreign country, or is subject to such a tax on a residence basis. Section 1503(d)(3) grants the Secretary broad authority to subject any loss of a separate unit of a domestic corporation to the limitations of section 1503(d). Because separate units are not themselves taxpayers, it is necessary to determine which items of income, gain, deduction, and loss of the domestic owner of the separate unit should be taken into account for purposes of calculating a dual consolidated loss.

Section 1.1503–2(d)(1)(ii) of the current regulations provides a limited rule for attributing items of a domestic owner to a separate unit. Under this rule, a separate unit must compute its income as if it were a separate domestic corporation that is a dual resident corporation, using only those items of income, expense, deduction, and loss that are otherwise attributable to such separate unit. For this purpose, only items of the domestic owner that are recognized for U.S. tax purposes are taken into account.

In response to requests for additional guidance in this area, the proposed regulations provide more detailed rules for determining the amount of income or dual consolidated loss of a separate unit. This determination depends on various factors, including the type of separate unit, the ownership structure, and the nature of the item. The determination generally turns on whether it is likely that the relevant foreign country would take into account the item (assuming the item is recognized) for tax purposes. This determination is solely for purposes of section 1503(d) and does not apply for any other purpose, such as attributing items under an applicable income tax treaty or under other Code sections such as section 884 or 987.

These final regulations adopt the attribution rules contained in the proposed regulations, with modifications.

(2) *Books and records*

The proposed regulations provide that, in general, the items of income, gain, deduction, and loss that are attributable to a hybrid entity (and, therefore, attributable to interests in the hybrid entity) are those that are properly reflected on its books and records, as adjusted to conform to

U.S. tax principles. The proposed regulations further provide that the principles of §1.988–4(b)(2) apply for purposes of making this determination.

One commentator asked whether §1.988–4(b)(2) is a strict booking rule, or whether it would instead permit taxpayers to take positions contrary to how items are reflected on the books and records if, under the facts and circumstances, the items were not appropriately reflected on the books and records. Another commentator stated that the clause "to the extent consistent with U.S. tax principles" in the proposed regulations created uncertainty.

In response to these comments, the final regulations clarify that only the Commissioner, and not the taxpayer, may make adjustments to the books and records where the booking practices are employed with a principle purpose of avoiding the principles of section 1503(d), including inconsistently treating the same or similar items of income, gain, deduction, and loss. In addition, these final regulations clarify that, in general, a domestic owner's items of income, gain, deduction, and loss are attributable to the domestic owner's hybrid entity separate unit, or interest in a transparent entity, to the extent such items are reflected on the hybrid entity or transparent entity's books and records (as defined in §1.989(a)–1(d)), as adjusted to conform to U.S. tax principles.

The books and records standard set forth in these final regulations is intended to be consistent with the more detailed approach for attributing items that was adopted in proposed §1.987–2(b) that was published on September 7, 2006 (REG–208270–86, 2006–42 I.R.B. 698 [71 FR 52875]). It is anticipated that when those regulations are published as final regulations in the **Federal Register**, that approach will, as appropriate, be incorporated into these regulations. The IRS and Treasury Department believe that applying consistent standards under these two provisions, where appropriate, would make the rules more administrable. Comments are requested as to whether the standard contained in the section 987 proposed regulations is appropriate for purposes of section 1503(d).

(3) *Attributing interest expense under the principles of §1.882–5*

The proposed regulations provide that the principles of §1.882–5, as modified, apply for purposes of determining the interest expense that is attributable to a foreign branch separate unit. In making this determination, and solely for this purpose, the domestic owner 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.

Two comments were received on the application of this rule. First, commentators stated that adopting the principles of §1.882–5 results in unnecessary complexity. These commentators suggested that, in lieu of using the principles of §1.882–5, the interest expense of a foreign branch separate unit be determined by reference to its books and records. Another commentator noted the rationale of using the principles of §1.882–5 as a general matter, but suggested that where the foreign country looks to the books and records of the foreign branch separate unit for purposes of computing the interest expense of the separate unit, it would be appropriate to use the books and records for purposes of section 1503(d).

The IRS and Treasury Department continue to believe that the principles of §1.882–5, as modified, serve as a reasonable proxy for determining the items of interest expense recognized for U.S. tax purposes that, if recognized by the foreign country, would be taken into account by the foreign country. Therefore, the principles of §1.882–5, as modified, are retained as the general rule for purposes of determining the interest expense that is attributable to a foreign branch separate unit.

However, to minimize complexity, the IRS and Treasury Department believe it is appropriate to use a books and records approach, where possible. Therefore, these final regulations provide an exception to the general rule such that interest expense is attributable to a foreign branch separate unit to the extent it is reflected on its books and records. This exception only applies if the foreign country in which the foreign branch is located determines, for purposes of computing the taxable income (or loss) under the laws of the foreign country, the interest expense of the foreign branch separate unit by taking into account only the items of interest expense reflected on the foreign branch separate unit's books and records. This rule will not apply, however, in cases where the foreign country does not use a strict booking approach for interest expense.

Finally, it is important to note that in all cases only items of interest expense, as determined for U.S. tax purposes, are taken into account. The treatment of interest expense in the foreign country is only relevant for purposes of determining the method under which items of interest expense (determined for U.S. tax purposes) is attributed to the foreign branch separate unit.

(4) *Treaty-based methods*

The proposed regulations provide that 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 sections 864(c)(2) and (c)(4) as set forth in §§1.864–4(c) and 1.864–6 shall apply.

One commentator stated that domestic corporations operating foreign branch separate units should be allowed to attribute items to the foreign branch separate unit based on the method provided under an income tax treaty between the United States and the foreign country (or between two foreign countries if foreign branch operations are conducted by a hybrid entity outside its home country). The IRS and Treasury Department believe that this approach is inappropriate for two reasons. First, it would have the effect of attributing items recognized by the foreign jurisdiction, which may not be recognized as items for U.S. tax purposes. This would be inconsistent with section 1503(d), which defines a dual consolidated loss solely based on U.S. tax rules. Second, this approach would require the interpretation of foreign law, which the IRS and Treasury Department believe should be avoided, to the extent possible. Accordingly, this comment is not adopted.

(5) *Gain or loss recognized under section 987*

The proposed regulations do not provide whether gain or loss of a domestic owner recognized under section 987 as a result of a remittance or transfer is attributable to a separate unit for purposes of calculating income or dual consolidated loss, but instead request comments.

Commentators stated that gain or loss recognized under section 987 should not be attributable to a separate unit because in most cases the foreign country would not recognize such items since the income of the separate unit will be computed in the local currency. The IRS and Treasury Department agree with this comment. As a result, these final regulations provide that gain or loss recognized under section 987, as a result of a remittance or transfer, will not be taken into account for purposes of computing the income or dual consolidated loss of a separate unit.

(6) *Attributable to or taken into account*

The proposed regulations generally provide that items are attributable to a hybrid entity separate unit, but are taken into account by a foreign branch separate unit. The IRS and Treasury Department believe that the use of these different terms is unnecessary and may lead to confusion. As a result, these final regulations provide that items are attributable to a separate unit, regardless of whether the separate unit is a foreign branch separate unit or a hybrid entity separate unit.

M. *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 and affiliated domestic owners owned by other members of the consolidated group. Similar rules apply to separate units arising from the ownership of an interest in a partnership. These special basis adjustment rules were included in the current regulations to prevent the indirect deduction of a dual consolidated loss. Although the proposed regulations retain these rules, the IRS and Treasury Department requested comments on whether the special basis adjustment rules should be retained.

A number of commentators recommended that the special basis adjustment rules be removed for several reasons. For example, the commentators noted that an indirect use, which the special basis rules were intended to prevent, may not occur for many years after the dual consolidated loss was incurred. In response to these comments, the special basis rules are not contained in these final regulations. Thus, the basis adjustment rules under §1.1502–32 shall apply without modification for purposes of determining the adjusted basis in the stock of a dual resident corporation or the stock of an affiliated domestic owner owned by other members of the consolidated group. These final regulations also contain rules to ensure consistent treatment for a partner's basis in a partnership interest that is a separate unit, or through which a separate unit is owned indirectly.

N. *Losses of a Foreign Insurance Company Treated as a Domestic Corporation*

(1) *In general*

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) company). Section 953(d)(3) provides that if a section 953(d) company 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).

The current regulations do not address the application of section 953(d)(3). In the proposed regulations, however, the definition of a dual resident corporation includes a section 953(d) company that is a member of an affiliated group. In addition, the proposed regulations clarify that a section 953(d) company may not make a domestic use election. These rules are consistent with section 953(d)(3).

In response to comments, these final regulations provide additional guidance on the application of the dual consolidated loss rules to section 953(d)(3) companies, including the treatment of separate units owned by such companies.

(2) *Transactions intended to avoid the limitations of sections 953(d)(3) and 1503(d)*

The IRS and Treasury Department understand that taxpayers may be implementing structures that result in the same overall tax consequences as structures that Congress intended to be subject to the loss limitation rules provided under sections 953(d)(3) and 1503(d). However, taxpayers may be taking the position that the structures are not subject to these loss limitation rules. For example, a foreign insurance company may, in lieu of making an election under section 953(d) and thus being subject to the limitations of sections 953(d)(3) and 1503(d), file a certificate of domestication in a state as a limited liability company. As a business entity with multiple charters, this entity would be treated as a domestic corporation for U.S. tax purposes under §301.7701–2(b)(9). Taxpayers may take the position that this entity would be entitled to the same benefits of a company that makes an election under section 953(d), without being subject to the limitations on the use of its losses that are imposed under sections 953(d)(3) and 1503(d).

The IRS and Treasury Department disagree with the taxpayer's characterization of these structures under current law. In addition, the IRS and Treasury Department believe the taxpayers' characterization of the structures is contrary to the policies underlying section 953(d). Accordingly, the IRS and Treasury Department are considering issuing regulations, which may be retroactive, that would clarify the application of section 953(d)(3) to these structures. These regulations would provide that if a foreign insurance company is eligible to make an election to be treated as a domestic corporation pursuant to section 953(d), but in lieu of making such election becomes a domestic corporation through other means (for example, by filing a certificate of domestication in a state as a limited liability company), then such company shall be subject to the limitations under sections 953(d)(3) and 1503(d) (without regard to paragraph (2)(B) thereof).

The IRS and Treasury Department request comments regarding appropriate rules to address these structures and other structures that are intended to avoid the purposes of section 953(d)(3).

O. *All or Nothing Rule*

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

The proposed regulations retain this so-called all or nothing principle because the IRS and Treasury Department recognize that departing from it would lead to significant administrative burdens for the Commissioner and taxpayers. Although the all or nothing principle was retained, the IRS and Treasury Department requested comments regarding administrable alternatives that would not involve substantial analysis of foreign law.

Several comments were received with respect to this issue. A number of commentators stated that the final regulations should remove the all or nothing principle and allow for a *pro-rata* recapture such that, for example, the disposition of an individual separate unit, which is part of a combined separate unit, would not result in the entire recapture of the combined separate unit's dual consolidated loss, but only the portion of the loss attributable to the individual separate unit. Another commentator suggested removing the all or nothing rule and allowing a taxpayer to establish that the losses otherwise subject to recapture were not, in fact, used under foreign law. The commentator suggested that any concerns regarding an analysis of foreign law could be mitigated by requiring the taxpayer to provide certified copies of foreign tax returns and, in addition, where the foreign tax base differs substantially from the U.S. tax base, by adopting an apportionment methodology.

The IRS and Treasury Department continue to believe that, even under the approaches suggested by these commentators, departing from the all or nothing principle would lead to substantial administrative complexity. As a result, these comments are not adopted.

Another commentator suggested that the final regulations include a general *de minimis* rule for purposes of applying the triggering and recapture provisions. Under this approach, if a taxpayer could establish that less than a specific percentage of the dual consolidated loss is available for a foreign use, the taxpayer could avoid recapture altogether. However, in situations where the potential loss available for a foreign use exceeds the *de minimis* amount, the dual consolidated loss would be recaptured to the extent it was actually put to a foreign use.

The IRS and Treasury Department do not believe that a *de minimis* rule as described would be meaningful given that the Commissioner and taxpayers would be required to determine the actual amount of the dual consolidated loss available for foreign use, which poses the same administrative concerns as generally departing from the all or nothing principle (that is, a complex analysis of foreign law or complicated ordering, stacking, or tracing rules). As a result, this suggestion is not adopted.

Finally, commentators suggested that following certain events otherwise requiring recapture, a taxpayer should be allowed to reduce the amount of recapture by establishing that a portion of the dual consolidated loss is attributable to items of deduction or loss that, due to permanent differences between the U.S. and foreign tax law, do not give rise to a corresponding item of deduction or loss in the foreign country. The commentators cited items of deduction or loss composing the dual consolidated loss attributable to a basis step-up following a section 338 election, or attributable to a deduction arising from the amortization of goodwill or certain intangibles under section 197, as examples of such items.

The IRS and Treasury Department recognize that items of deduction or loss that are never taken into account in the foreign country cannot be put to a foreign use. However, the IRS and Treasury Department believe that the suggested approach would, in most situations, involve many items of deduction and loss and, as a result, would present the same concerns as are present in the other approaches discussed above. For example, if the deductions giving rise to a dual consolidated loss were the result of a step-up in basis following a section 338 election, but the various assets to which such basis attached had, prior to the election, a basis for foreign tax purposes, complex ordering and stacking rules would be required to determine that, in fact, no portion of the dual consolidated loss is attributable to the pre-existing foreign tax basis. In addition, this approach would require rules to distinguish a permanent (or base) difference from a timing difference, in order to ensure that the portion of the dual consolidated loss that is not being recaptured would not be available for a foreign use at some point in the future. As a result, such rules would add complexity and would be administratively burdensome. Accordingly, this comment is not adopted.

Although these comments are not adopted in the final regulations, the IRS and Treasury Department believe that the application of the all or nothing rule will be significantly reduced under these regulations as a result of the new exceptions to foreign use and the further reduction of the term of the certification period.

P. *Triggering Events and Related Rules*

(1) *Modification of exceptions to triggering events*

The proposed regulations contain exceptions to triggering events that generally apply where assets or interests sold or disposed of are acquired, directly or through certain wholly-owned pass-through entities, by members of the consolidated group that includes the dual resident corporation or separate unit, or by the unaffiliated domestic owner.

The final regulations generally retain these exceptions, but modify them to take into account the new exceptions to foreign use. For example, the exceptions are modified to include certain acquisitions by pass-through entities that are more than 90-percent owned (rather than wholly owned) by the consolidated group or unaffiliated domestic owner. These rules also address certain deemed transactions (for example, pursuant to Rev. Rul. 99–5, 1999–1 C.B. 434) to minimize the likelihood that they result in triggering events, where appropriate, see §601.601(d)(2)(ii)(*b*).

Finally, in response to comments discussed in section G(3) of this preamble, these regulations contain a new exception to triggering events that occur as a result of certain compulsory transfers.

(2) *Rebuttal*

Under the current regulations, taxpayers may rebut all but two of the triggering events such that there is no recapture of a certified dual consolidated loss (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). See §1.1503–2(g)(2)(iii)(A)(*2*) through 1.1503–2(g)(2)(iii)(A)(*7*). 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 proposed regulations generally 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. However, 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).

One commentator noted that the rebuttal standard of the proposed regulations is unnecessarily broad with respect to certain asset transfers. For example, according to this commentator, a triggering event cannot be rebutted under this standard where a separate unit transfers over 50 percent of its assets in a transaction that does not result in a loss carryover to the transferee under foreign law. This is the case because the separate unit would not be able to establish that the dual consolidated loss, which did not carry over to the transferee, could never be put to a foreign use. Accordingly, this commentator requested that the rebuttal standard for asset transfers contained in the current regulations be adopted in the final regulations.

The IRS and Treasury Department agree with this comment and these final regulations are modified accordingly.

Another commentator noted that neither the proposed nor current regulations specify how taxpayers must demonstrate that there can be no foreign use during the remaining certification period by any means. The commentator stated that this lack of specificity creates uncertainty and, as a result, requested additional guidance as to how the determination is to be made.

The IRS and Treasury Department believe that this demonstration can be made in a number of ways, including based on the taxpayer's interpretation of foreign law, on an opinion from local advisors, or on assurance from the local country tax authorities. In all cases, however, the determination must be made to the satisfaction of the Commissioner. These final regulations are modified accordingly.

(3) *Reduction of recapture amount*

The proposed regulations permit the elector to reduce the amount of the dual consolidated loss that must be recaptured upon a triggering event. The recapture amount can be reduced to the extent the elector demonstrates that the dual consolidated loss would have offset other income of the dual resident corporation or separate unit 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 limitation under §1.1503(d)–2(b) of the proposed regulations.

Commentators questioned the requirements for the reduction of the recapture amount. One commentator suggested that recapture should be reduced by the amount of subsequent income attributable to the dual resident corporation or separate unit, irrespective of the income or loss of other group members.

The IRS and Treasury Department recognize that the policies underlying the SRLY rules differ from those underlying section 1503(d). Although the SRLY rules do not provide for a reduction in recapture in all cases consistent with the views of this commentator, the IRS and Treasury Department continue to believe that the SRLY rules are a reasonable and appropriate mechanism for implementing the restrictions of section 1503(d)(1) in the vast majority of cases. Further, the IRS and Treasury Department believe that deviating from the SRLY mechanism would add considerable complexity to the rules and could lead to unintended consequences. As a result, this comment is not adopted. The IRS and Treasury Department will consider addressing the interaction of the SRLY rules with the recapture provisions in future guidance. Comments are requested as to alternative mechanisms that are more consistent with dual consolidated loss policy and that are not unduly complicated.

(4) *Interest due on recapture*

Under both the current regulations and these final regulations, taxpayers must pay an interest charge in connection with recapture that is computed under the rules of section 6601. In response to comments, these final regulations clarify that this interest charge is deductible to the same extent as interest under section 6601.

(5) *Treatment of recapture income under section 384*

One commentator requested clarification regarding a subsequent elector's agreement to treat potential recapture amounts as unrealized built-in gain for purposes of section 384(a). The commentator stated that it may be unclear as to whether section 384 must otherwise apply to the transaction, whether the thresholds of section 384 apply, and whether potential recapture income treated as unrealized built-in gain is subject to reduction for income earned by a separate unit or dual resident corporation.

The IRS and Treasury Department believe that potential recapture amounts should be treated as unrealized built-in gains for purposes of determining whether section 384 applies, but that the requirements and exceptions of section 384 otherwise apply. In addition, the potential

recapture amount treated as unrealized built-in gain may be reduced by potential offset, as permitted under the regulations. These final regulations have been modified accordingly.

(6) *Reconstituted dual consolidated loss*

Both the current and proposed regulations contain a reconstituted loss provision. This rule generally provides that if a dual consolidated loss is recaptured as a result of a triggering event, the dual resident corporation or separate unit that incurred the loss is treated as having a net operating loss in an amount equal to the amount recaptured. The loss is reconstituted in the taxable year immediately following the year of the recapture and is subject to the general restrictions of section 1503(d). This rule is intended to put the taxpayer in the same approximate position it would have been in had it never made an election to use the dual consolidated loss.

These final regulations modify the proposed regulations' reconstituted loss rule to reflect the expansion of the separate unit combination rule and the rules that eliminate dual consolidated losses following certain transactions. In addition, the rule was modified to better take into account the interaction of the dual consolidated loss rules with the general loss carryover rules. For example, these final regulations provide that, other than with respect to the multiple-party event exception, a transfer of an interest in a separate unit by its domestic owner to another corporation cannot cause all or a portion of the dual consolidated loss of such separate unit to carry over to the acquiring corporation, absent the application of section 381.

Q. *Certification Period*

Section 1.1503–2(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 15 year certification period. This filing permits the dual consolidated loss to be used in the United States to offset the income of a domestic affiliate but 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 current regulations do not require annual certifications for (g)(2)(i) agreements entered into with respect to dual consolidated losses of foreign branch separate units. The current regulations also provide 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. §1.1503–2(g)(2)(iii)(A).

The proposed regulations reduce the certification period from 15 years to seven years, and expand the annual certification requirement to include dual consolidated losses of foreign branch separate units.

Commentators recommended that the certification period in the proposed regulations be further reduced to five years, because such five-year period would be sufficient to deter the types of double dips with which section 1503(d) is concerned, and would be consistent with time periods used under similar provisions (for example, the term of gain recognition agreements entered into under section 367(a)). The IRS and Treasury Department agree with this comment, and, as a result, the certification period in these final regulations is five years.

Another commentator asserted that extending the annual certification requirement to foreign branch separate units is both unnecessary and administratively burdensome and, as a result, such certification should not be included in these final regulations.

The IRS and Treasury Department continue to believe that the annual certification requirement improves taxpayer compliance and is beneficial in monitoring and deterring inappropriate double dips. In addition, the IRS and Treasury Department believe that, where appropriate, treating foreign branch separate units, hybrid entity separate units, and dual resident corporations consistently for purposes of section 1503(d) will reduce the administrative complexity of these regulations. As a result, this comment is not adopted.

R. *Other Comments and Modifications*

(1) *Information provided with domestic use election*

One commentator recommended that certain information provided with the domestic use election should not bind a taxpayer if the information is provided in good faith, but subsequently is determined to be erroneous. The IRS and Treasury Department believe that adopting this recommendation would be administratively burdensome. Accordingly, this comment is not adopted.

(2) *No possibility of foreign use*

One commentator noted that taxpayers may be eligible to demonstrate no possibility of foreign use, but still choose to enter into a domestic use agreement. The commentator explained that taxpayers may do so to avoid the cost and effort required to satisfy the no possibility of foreign use standard, recognizing that this demonstration would only be beneficial if there is a triggering event during the certification period. The commentator further stated that the taxpayer should nonetheless retain the ability to argue at a later time, when a foreign use may occur after a change in foreign law, that no dual consolidated loss existed in the year in which the loss was actually incurred. Thus, if there was a change in foreign law, taxpayers would not be penalized for being unable to rebut the triggering event in the current year (due to a change in foreign law) but could instead rely on the foreign law in effect for the year in which the loss was incurred.

The IRS and Treasury Department recognize that taxpayers may simply choose to file a domestic use election, rather than engage in additional efforts to demonstrate no possibility of foreign use. The IRS and Treasury Department believe that these final regulations provide ample opportunities for taxpayers willing to demonstrate no possibility of foreign use. Taxpayers have three opportunities to demonstrate no possibility of foreign use under the final regulations: first under §1.1503(d)–6(c) to be excepted from the domestic use limitation, second under §1.1503(d)–6(e)(2) to rebut a triggering event, and third under §1.1503(d)–6(j)(2) to terminate a domestic use agreement. Because of these opportunities and the administrative burdens

that would ensue from taking into account changes in foreign law, this comment is not adopted.

S. *Effective Dates*

(1) *General rule*

Except as provided in this preamble, these final regulations apply to dual consolidated losses incurred in taxable years beginning on or after April 18, 2007. However, a taxpayer may apply these regulations, in their entirety, to dual consolidated losses incurred in taxable years beginning on or after January 1, 2007.

(2) *Certification period*

A number of commentators requested that the reduced certification period of these final regulations apply with respect to dual consolidated losses that are subject to the current regulations. The commentators asserted that the policies underlying the reduced certification period should apply equally to dual consolidated losses that are subject to the current regulations. Commentators also recommended that the reduced certification period contained in these final regulations apply to closing agreements entered into between taxpayers and the IRS pursuant to §1.1503–2(g)(2)(iv)(B)(*3*)(*i*) and Rev. Proc. 2000–42, 2000–2 C.B. 394, see §601.601(d)(2)(ii)(*b*).

The IRS and Treasury Department generally agree with these comments and these final regulations are modified accordingly.

(3) *Reasonable cause exception*

These final regulations adopt the reasonable cause procedure for purposes of curing all late filings as introduced in the proposed regulations, and subsequently modified by Notice 2006–13, 2006–8 I.R.B. 496, see §601.601(d)(2)(ii)(*b*). Moreover, these final regulations provide that the reasonable cause procedures supplant the current procedures for all untimely filings with respect to dual consolidated losses incurred under the current regulations as well, except with respect to requests for closing agreements. Taxpayers requiring relief to cure a late request for a closing agreement must continue to seek extensions of time under §§301.9100–1 through 301.9100–3 and Rev. Proc. 2000–42, 2000–2 C.B. 394, see §601.601(d)(2)(ii)(*b*). Taxpayers seeking relief for other late filings required in connection with such closing agreements must, however, use the reasonable cause procedure of these final regulations. Therefore, as a result of these changes, untimely filings under section 1503(d) and these regulations will no longer be eligible for the relief provided by §§301.9100–1 through 301.9100–3, regardless of whether such filings were required under the current regulations (except for certain closing agreements) or these final regulations.

(4) *Multiple-party event exception to triggering events*

These final regulations provide an exception to certain triggering events involving multiple parties. In general, the exceptions provided under these final regulations with respect to multiple-party events are similar to those provided under §1.1503–2(g)(2)(iv)(B)(*1*). The procedures required to satisfy these multiple-party event exceptions are also similar to those found in §1.1503–2(g)(2)(iv)(B)(*3*). One important difference is that these final regulations do not require (or permit) taxpayers to obtain closing agreements. These final regulations also provide a special effective date provision with respect to events described in §1.1503–2(g)(2)(iv)(B)(*1*) that occur after April 18, 2007, that are with respect to dual consolidated losses subject to the current regulations. Such events are not eligible for the exception described in §1.1503–2(g)(2)(iv)(B)(*1*) and thus are not eligible for a closing agreement as described in §1.1503–2(g)(2)(iv)(B)(*3*)(*i*). Instead, such events are eligible for the multiple-party event exception described in these final regulations and as modified by the special effective date provision of §1.1503(d)–8(b)(4). Taxpayers may, however, choose to apply the multiple-party exception to events described in §1.1503–2(g)(2)(iv)(B)(*1*)(*i*) through (*iii*) that occur after March 19, 2007 and on or before April 18, 2007.

(5) *Basis adjustments*

One commentator requested that the elimination of the special basis adjustments described in paragraph M of this preamble be applied retroactively. The commentator further requested that such retroactive application apply to adjustments that occurred in closed taxable years if the basis of the stock is relevant in an open taxable year.

The IRS and Treasury Department agree with this comment. As a result, these regulations provide that taxpayers may apply the basis adjustment rules of these final regulations for all taxable years if such adjustments affected tax basis that is relevant in an open taxable year.

(6) *Other provisions*

A number of commentators requested that the IRS and Treasury Department provide that taxpayers be allowed to electively apply other provisions of these regulations to dual consolidated losses that are subject to the current regulations.

The IRS and Treasury Department do not believe that it would be appropriate to allow taxpayers to selectively apply provisions of these regulations (other than those that the IRS and Treasury Department view as clarifications) retroactively, because it would lead to administrative complexity for the IRS and could lead to unintended results.

Effect on Other Documents

These final regulations obsolete Notice 2006–13, 2006–8 I.R.B. 496, see §601.601(d)(2)(ii)(*b*). These final regulations also obsolete Rev. Proc. 2000–42, 2000–2 C.B. 394, see §601.601(d)(2)(ii)(*b*), with respect to triggering events occurring after April 18, 2007.

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 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 Internal Revenue Code, the notice of proposed rulemaking preceding this regulation was submitted to the Chief Counsel for Advocacy of the Small Business for comment on its impact on small business.

Drafting Information

The principal authors of these regulations are Jeffrey P. Cowan, of the Office of the Associate Chief Counsel (International), and Christopher L. Trump, formerly of the Office of the Associate Chief Counsel (International). However, other personnel from the IRS and Treasury Department participated in their development.

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Adoption of 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 is amended by adding an entry in numerical order to read in part as follows:

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

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

§1.1502–21 [Amended]

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)–8" in its place.

§1.1503–2A [Removed]

Par. 3. Section 1.1503–2A is removed.

Par. 4. New §§1.1503(d)–0 through 1.1503(d)–8 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)–8.

§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) Business operations that do not constitute a permanent establishment.
(iv) Foreign branch separate units held by dual resident corporations or hybrid entities in the same foreign country.
(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.
(15) Grantor trust.
(16) Transparent entity.
(i) In general.
(ii) Example.
(17) Disregarded entity.
(18) Partnership.
(19) Indirectly.
(20) Certification period.
(c) Special rules for filings under section 1503(d).
(1) Reasonable cause exception.
(2) Requirements for reasonable cause relief.
(i) Time of submission.
(ii) Notice requirement.
(3) Signature requirement.

§1.1503(d)–2 Domestic use.

§1.1503(d)–3 Foreign use.

(a) Foreign use.
(1) In general.
(2) Indirect use.
(i) General rule.
(ii) Exception.
(iii) Examples.
(3) Deemed use.
(b) Available for use.
(c) Exceptions.
(1) In general.
(2) Election or merger required to enable foreign use.
(3) Presumed use where no foreign country rule for determining use.
(4) Certain interests in partnerships or grantor trusts.
(i) General rule.
(ii) Combined separate unit.
(iii) Reduction in interest.
(5) *De minimis* reduction of an interest in a separate unit.
(i) General rule.
(ii) Limitations.
(iii) Reduction in interest.
(iv) Examples and coordination with exceptions to other triggering events.
(6) Certain asset basis carryovers.
(7) Assumption of certain liabilities.
(i) In general.
(ii) Ordinary course limitation.
(8) Multiple-party events.
(9) Additional guidance.
(d) Ordering rules for determining the foreign use of losses.
(e) Mirror legislation rule.
(1) In general.
(2) Stand-alone exception.
(i) In general.
(ii) Stand-alone domestic use agreement.
(iii) Termination of stand-alone domestic use agreement.

§1.1503(d)–4 Domestic use limitation and related operating rules.

(a) Scope.
(b) Limitation on domestic use of a dual consolidated loss.
(c) Effect of a dual consolidated loss on a consolidated group, unaffiliated dual resident corporation, or unaffiliated domestic owner.
(1) Dual resident corporation.
(2) Separate unit.
(3) SRLY limitation.
(4) Items of a dual consolidated loss used in other taxable years.
(5) Reconstituted net operating losses.
(d) Elimination of a dual consolidated loss after certain transactions.
(1) General rule.
(i) Transactions described in section 381(a).
(ii) Cessation of separate unit status.
(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.

(A) Acquisition by a corporation that is not a member of the same consolidated group.

(B) Acquisition by a member of the same consolidated group.

(iv) Special rules for foreign insurance companies.

(e) 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.

(f) Computation of foreign tax credit limitation.

§1.1503(d)–5 Attribution of items and basis adjustments.

(a) In general.

(b) Determination of amount of income or dual consolidated loss of a dual resident corporation.

(1) In general.

(2) Exceptions.

(c) Determination of amount of income or dual consolidated loss attributable to a separate unit, and income or loss attributable to an interest in a transparent entity.

(1) In general.

(i) Scope and purpose.

(ii) Only items of domestic owner taken into account.

(iii) Separate application.

(2) Foreign branch separate unit.

(i) In general.

(ii) Principles of §1.882–5.

(iii) Exception where foreign country attributes interest expense solely by reference to books and records.

(3) Hybrid entity separate unit and an interest in a transparent entity.

(i) General rule.

(ii) Interests in certain disregarded entities, partnerships, and grantor trusts owned by a hybrid entity or transparent entity.

(4) Special rules.

(i) Allocation of items between certain tiered separate units and interests in transparent entities.

(A) Foreign branch separate unit.

(B) Hybrid entity separate unit or interest in a transparent entity.

(ii) Combined separate unit.

(iii) Gain or loss on the direct or indirect disposition of a separate unit or an interest in a transparent entity.

(A) In general.

(B) Multiple separate units or interests in transparent entities.

(iv) Inclusions on stock.

(v) Foreign currency gain or loss recognized under section 987.

(vi) Recapture of dual consolidated loss.

(d) Foreign tax treatment disregarded.

(e) Items generated or incurred while a dual resident corporation, a separate unit, or a transparent entity.

(f) Assets and liabilities of a separate unit or an interest in a transparent entity.

(g) Basis adjustments.

(1) Affiliated dual resident corporation or affiliated domestic owner.

(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.

(3) Combined separate units.

§1.1503(d)–6 Exceptions to the domestic use limitation rule.

(a) In general.

(1) Scope and purpose.

(2) Absence of foreign affiliate or foreign consolidation regime.

(3) Foreign insurance companies treated as domestic corporations.

(b) Elective agreement in place between the United States and a foreign country.

(1) In general.

(2) Application to combined separate units.

(c) No possibility of foreign use.

(1) In general.

(2) Statement.

(d) Domestic use election.

(1) In general.

(2) No domestic use election available if there is a triggering event in the year the dual consolidated loss is incurred.

(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 a regulated investment company, a real estate investment trust, or an S corporation.

(viii) Failure to certify.

(ix) Cessation of stand-alone status.

(2) Rebuttal.

(i) General rule.

(ii) Certain asset transfers.

(iii) Reporting.

(iv) Examples.

(f) Triggering event exceptions.

(1) Continuing ownership of assets or interests.

(i) Disaffiliation as a result of a transaction described in section 381.

(ii) Continuing ownership by consolidated group.

(iii) Continuing ownership by unaffiliated dual resident corporation or unaffiliated domestic owner.

(2) Transactions requiring a new domestic use agreement.

(i) Multiple-party events.

(ii) Events resulting in a single consolidated group.

(iii) Requirements.

(A) New domestic use agreement.

(B) Statement filed by original elector.

(3) Certain transfers qualifying for the *de minimis* exception to foreign use.

(4) Deemed transactions as a result of certain transfers that do not result in a foreign use.

(5) Compulsory transfers.

(6) 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 multiple-party event exceptions to triggering events.

(i) Scope.

(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.

(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) Exception to presumptive rule.

(5) Character and source of recapture income.

(6) Reconstituted net operating loss.

(i) General rule.

(ii) Exception.

(iii) Special rule for recapture following multiple-party event exception to a triggering event.

(i) [Reserved].

(j) Termination of domestic use agreement and annual certifications.

(1) Rebuttals, exceptions to triggering events, and recapture.

(2) Termination of ability for foreign use.

(i) In general.

(ii) Statement.

(3) Agreements filed in connection with stand-alone exception.

§1.1503(d)–7 Examples.

(a) In general.

(b) Presumed facts for examples.

(c) Examples.

§1.1503(d)–8 Effective dates.

(a) General rule.

(b) Special rules.

(1) Reduction of term of agreements filed under §§1.1503–2(g)(2)(i) or 1.1503–2T(g)(2)(i).

(2) Reduction of term of closing agreements entered into pursuant to §1.1503–2(g)(2)(iv)(B)(*3*)(*i*).

(3) Relief for untimely filings.

(i) General rule.

(ii) Closing agreements.

(iii) Pending requests for relief.

(4) Multiple-party event exception to triggering events.

(5) Basis adjustment rules.

§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)–8 provide rules concerning the determination and use of dual consolidated losses pursuant to section 1503(d). Paragraph (b) of this section provides definitions that apply for purposes of this section and §§1.1503(d)–2 through 1.1503(d)–8. Paragraph (c) of this section provides a reasonable cause exception and a signature requirement for filings.

(b) *Definitions.* The following definitions apply for purposes of this section and §§1.1503(d)–2 through 1.1503(d)–8:

(1) *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), 1504(d), and 7874. However, solely for purposes of section 1503(d), the term domestic corporation shall not include a regulated investment company as defined in section 851, a real estate investment trust as defined in section 856, or an S corporation as defined in section 1361.

(2) *Dual resident corporation* means—

(i) 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; and

(ii) 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* means an entity that is not taxable as an association for Federal 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 carried on or owned, as applicable, directly or indirectly, by a domestic corporation (including a dual resident corporation):

(A) Except to the extent provided in paragraph (b)(4)(iii) of this section, a business operation outside the United States that, if carried on by a U.S. person, would constitute a foreign branch as defined in §1.367(a)–6T(g)(1) (foreign branch separate unit).

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

(ii) *Separate unit combination rule.* Except as otherwise provided in this paragraph, if a domestic owner, or two or more domestic owners that are members of the same consolidated group, have two or more separate units (individual separate units), then all such individual separate units that are located (in the case of a foreign branch separate unit) or subject to an income tax either on their worldwide income or on a residence basis (in the case of a hybrid entity an interest in which is a hybrid entity separate unit) in the same foreign country shall be treated as one separate unit (combined separate unit). See §1.1503(d)–7(c) *Example 1.* Separate units of a foreign insurance company that is a dual resident corporation under paragraph (b)(2)(ii) of this section, however, shall not be combined with separate units of any other domestic corporation. Except as specifically provided in this section or §§1.1503(d)–2 through 1.1503(d)–8, any individual separate unit composing a combined separate unit loses its character as an individual separate unit.

(iii) *Business operations that do not constitute a permanent establishment.* A business operation carried on by a domestic corporation that is not a dual resident corporation shall not constitute a foreign branch separate unit, provided the business operation:

(A) Is not carried on indirectly through a hybrid entity or a transparent entity; and

(B) Is conducted in a country with which the United States has entered into

an income tax convention and is not treated as a permanent establishment pursuant to that convention, or is not otherwise subject to tax on a net basis under that convention. See §1.1503(d)–7(c) *Example 2*.

(iv) *Foreign branch separate units held by dual resident corporations or hybrid entities in the same foreign country*. A foreign branch separate unit may be owned by a dual resident corporation, or through a hybrid entity (an interest in which is a separate unit), even where the foreign branch is located in the same foreign country that subjects such dual resident corporation or hybrid entity to tax on its worldwide income or on a residence basis. But see the rule under paragraph (b)(4)(ii) of this section that combines certain same-country hybrid entity separate units and foreign branch separate units. See also §1.1503(d)–7(c) *Example 1*.

(5) *Dual consolidated loss* means—

(i) In the case of a dual resident corporation, and except to the extent provided in §1.1503(d)–5(b), the net operating loss (as defined in section 172(c) and the related regulations) 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 the separate unit under §1.1503(d)–5(c) through (e).

(6) *Subject to tax*. For purposes of determining whether a domestic corporation or another 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* includes any possession of the United States.

(8) *Consolidated group* has the meaning provided in §1.1502–1(h).

(9) *Domestic owner* means—

(i) A domestic corporation (including a dual resident corporation) that has one or more separate units or interests in a transparent entity; and

(ii) In the case of a combined separate unit, a domestic corporation (including a dual resident corporation) that has one or more individual separate units that are treated as part of the combined separate unit under paragraph (b)(4)(ii) of this section.

(10) *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* mean a dual resident corporation, domestic corporation, and domestic owner, respectively, that is not a member of a consolidated group.

(12) *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;

(iii) A separate unit; or

(iv) An interest in a transparent entity, as defined in paragraph (b)(16) of this section.

(13) *Domestic use*. See §1.1503(d)–2.

(14) *Foreign use*. See §1.1503(d)–3.

(15) *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.

(16) *Transparent entity*—(i) *In general*. The term *transparent entity* means an entity described in this paragraph (b)(16) where all or a portion of its interests are owned, directly or indirectly, by a domestic corporation. An entity is described in this paragraph (b)(16) if the entity—

(A) Is not taxable as an association for Federal tax purposes;

(B) Is not subject to income tax in a foreign country as a corporation (or otherwise at the entity level) either on its worldwide income or on a residence basis; and

(C) Is not a pass-through entity under the laws of the applicable foreign country. For purposes of applying the preceding sentence, the applicable foreign country is the foreign country in which the relevant foreign branch separate unit is located, or the foreign country that subjects the relevant hybrid entity (an interest in which is a separate unit) or dual resident corporation to an income tax either on its worldwide income or on a residence basis.

(ii) *Example*. A U.S. limited liability company (LLC) does not elect to be taxed as an association for Federal tax purposes and is not subject to income tax in a foreign country as a corporation (or otherwise at the entity level) either on its worldwide income or on a residence basis. The LLC is owned by a hybrid entity (an interest in which is a separate unit) that is the relevant hybrid entity. Provided the LLC is not treated as a pass-through entity by the applicable foreign country that subjects the relevant hybrid entity to an income tax either on its worldwide income or on a residence basis, the LLC would qualify as a transparent entity. See also §1.1503(d)–7(c) *Example 26*.

(17) *Disregarded entity* means an entity that is disregarded as an entity separate from its owner, under §§301.7701–1 through 301.7701–3 of this chapter, for Federal tax purposes.

(18) *Partnership* means an entity that is classified as a partnership, under §§301.7701–1 through 301.7701–3 of this chapter, for Federal tax purposes.

(19) *Indirectly*, when used in reference to ownership, means ownership through a partnership, a disregarded entity, or a grantor trust, regardless of whether the partnership, disregarded entity, or grantor trust is a U.S. person.

(20) *Certification period* means the period of time up to and including the fifth taxable year following the year in which the dual consolidated loss that is the subject of a domestic use agreement (as described in §1.1503(d)–6(d)(1)) was incurred.

(c) *Special rules for filings under section 1503(d)*—(1) *Reasonable cause exception*. A person that is permitted or required to file an election, agreement, statement, rebuttal, computation, or other information pursuant to section 1503(d) and these regulations, 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 Area Director, Field Examination, Small Business/Self Employed or the Director of Field Operations, Large and Mid-Size Business (Director) having jurisdiction of the taxpayer's tax return for the taxable year, that such failure was due to reasonable cause and not willful neglect. In determining whether the taxpayer has reasonable cause, the Director shall consider whether the taxpayer acted reasonably and in good faith. In general, the taxpayer must demonstrate that it exercised ordinary care and prudence in meeting its tax obligations but nonetheless did not comply with the prescribed duty within the prescribed time. Whether the taxpayer acted reasonably and in good faith will be determined after considering all the facts and circumstances. The Director 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. For this purpose, the 120-day period shall begin on the date the taxpayer is notified in writing that the request has been received and assigned for review. If, once such period commences, the taxpayer is not again notified within 120 days, then the taxpayer shall be deemed to have established reasonable cause. The reasonable cause exception of this paragraph (c) shall only apply if, once the person becomes aware of its failure to file the election, agreement, statement, rebuttal, computation or other information in a timely manner, the person complies with the requirements of paragraph (c)(2) of this section.

(2) *Requirements for reasonable cause relief*—(i) *Time of submission*. Requests for reasonable cause relief will only be considered if once the person becomes aware of the failure to file the election, agreement, statement, rebuttal, computation or other information, the person attaches all the documents that should have been filed, as well as a written statement setting forth the reasons for the failure to timely comply, to an amended return that amends the return to which the documents should have been attached pursuant to the rules of section 1503(d) and these regulations.

(ii) *Notice requirement*. In addition to the requirements of paragraph (c)(2)(i) of this section, the taxpayer must provide a copy of the amended return and all required attachments to the Director as follows:

(A) If the taxpayer is under examination for any taxable year when the taxpayer requests relief, the taxpayer must provide a copy of the amended return and attachments to the personnel conducting the examination.

(B) If the taxpayer is not under examination for any taxable year when the taxpayer requests relief, the taxpayer must provide a copy of the amended return and attachments to the Director having jurisdiction of the taxpayer's return.

(3) *Signature requirement*. When an election, agreement, statement, rebuttal, computation, or other information is required pursuant to section 1503(d) and these regulations 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 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 income of a domestic affiliate (other than the dual resident corporation or separate unit that, in each case, incurred the dual consolidated loss) in the taxable year in which the dual consolidated loss is recognized, or in any other taxable year, 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, unaffiliated dual resident corporation, or an unaffiliated domestic owner, as applicable, even if no tax benefit results from such inclusion in that year. See §1.1503(d)–7(c) *Examples 2* through *4*.

§1.1503(d)–3 Foreign use.

(a) *Foreign use*—(1) *In general*. Except as provided in paragraph (c) of this section, a *foreign use* of a dual consolidated loss shall be deemed to occur when any portion of a deduction or loss 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, or would be, considered under U.S. tax principles to be an item of—

(i) A foreign corporation as defined in section 7701(a)(3) and (a)(5); or

(ii) A direct or indirect owner of an interest in a hybrid entity, provided such interest is not a separate unit. See §1.1503(d)–7(c) *Examples 5* through *10* and *37*.

(2) *Indirect use*—(i) *General rule*. Except to the extent provided in paragraph (a)(2)(ii) of this section, an item of deduction or loss shall be deemed to be made available indirectly if—

(A) One or more items are taken into account as deductions or losses for foreign tax purposes, but do not give rise to corresponding items of income or gain for U.S. tax purposes; and

(B) The item or items described in paragraph (a)(2)(i)(A) of this section have the effect of making an item of deduction or loss composing the dual consolidated loss available for a foreign use as described in paragraph (a)(1) of this section.

(ii) *Exception*. The general rule provided in paragraph (a)(2)(i) of this section shall not apply if the consolidated group, unaffiliated domestic owner, or unaffiliated dual resident corporation demonstrates, to the satisfaction of the Commissioner, that the item or items described in paragraph (a)(2)(i)(A) of this section that gave rise to the indirect foreign use—

(A) Were not incurred, or taken into account, with a principal purpose of avoiding the provisions of section 1503(d). For purposes of this paragraph (a)(2)(ii), an item incurred or taken into account as interest for foreign tax purposes, but disregarded for U.S. tax purposes, shall be deemed to have been incurred, or taken into account, with a principal purpose of avoiding the provisions of section 1503(d). Similarly, for purposes of this paragraph (a)(2)(ii), an item incurred or taken into account as the result of an instrument that is treated as debt for foreign tax purposes and equity for U.S. tax purposes, shall be deemed to have been incurred, or taken into account, with a principal purpose of avoiding the provisions of section 1503(d); and

(B) Were incurred, or taken into account, in the ordinary course of the dual resident corporation's or separate unit's trade or business.

(iii) *Examples*. See §1.1503(d)–7(c) *Examples 6* through *8*.

(3) *Deemed use*. See paragraph (e) of this section for a deemed foreign use pursuant to the mirror legislation rule.

(b) *Available for use*. A foreign use shall be deemed to occur in the year in which any portion of a deduction or loss taken into account in computing the dual consolidated loss is made available for an offset described in paragraph (a) 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.

(c) *Exceptions*—(1) *In general*. Paragraphs (c)(2) through (9) of this section provide exceptions to the general definition of foreign use set forth in paragraphs (a) and (b) of this section. These exceptions only apply to a foreign use that occurs solely as a result of the conditions or circumstances described therein, and do not apply if a foreign use occurs in any other case or by any other means. For example, the exception under paragraph (c)(4) of this section (regarding certain interests in partnerships or grantor trusts) shall not apply where the item of deduction or loss is made available through a foreign consolidation regime (or similar method). In addition, these exceptions do not apply when attempting to demonstrate that no foreign use of a dual consolidated loss can occur in any other year by any means under §1.1503(d)–6(c), (e)(2)(i), or (j)(2). But see §1.1503(d)–6(e)(2)(ii), which takes into account the exception under paragraph (c)(7) of this section for purposes of rebutting certain asset transfers.

(2) *Election or merger required 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. Similarly, where the laws of a foreign country would enable a foreign use through a sale, merger, or similar transaction, a foreign use shall be considered to occur only if the sale, merger, or similar transaction occurs.

(3) *Presumed use where no foreign country rule for determining use*. This paragraph (c)(3) applies 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. In such a case, the losses or deductions shall be deemed to be made available to offset the 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)–7(c) *Example 11*.

(4) *Certain interests in partnerships or grantor trusts*—(i) *General rule*. Except to the extent provided in paragraph (c)(4)(iii) of this section, this paragraph (c)(4)(i) applies to a dual consolidated loss attributable to an interest in a hybrid entity partnership or a hybrid entity grantor trust, or to a separate unit owned indirectly through a partnership or grantor trust. In such a case, a foreign use will not be considered to occur if the foreign use is solely the result of another person's ownership of an interest in the partnership or grantor trust, as applicable, and the allocation or carry forward of an item of deduction or loss composing such dual consolidated loss as a result of such ownership. See §1.1503(d)–7(c) *Example 13*.

(ii) *Combined separate unit*. This paragraph applies to a dual consolidated loss attributable to a combined separate unit that includes an individual separate unit to which paragraph (c)(4)(i) of this section would apply, but for the application of the separate unit combination rule provided under §1.1503(d)–1(b)(4)(ii). In such a case, paragraph (c)(4)(i) of this section shall apply to the portion of the dual consolidated loss of such combined separate unit that is attributable, as provided under §1.1503(d)–5(c) through (e), to the individual separate unit (otherwise described in paragraph (c)(4)(i) of this section) that is a component of the combined separate unit. See §1.1503(d)–7(c) *Example 14*.

(iii) *Reduction in interest*. The exception under paragraph (c)(4)(i) of this section shall not apply if, at any time following the year in which the dual consolidated loss is incurred, there is more than a *de minimis* reduction in the domestic owner's percentage interest in the partnership or grantor trust, as applicable, as described in paragraph (c)(5) of this section. In such a case, a foreign use shall be deemed to occur at the time the reduction in interest exceeds the *de minimis* amount. See §1.1503(d)–7(c) *Example 13*.

(5) *De minimis reduction of an interest in a separate unit*—(i) *General rule*. This paragraph applies to a *de minimis* reduction of a domestic owner's interest in a separate unit (including an interest described in paragraph (c)(4)(i) of this section). Except to the extent provided in paragraph (c)(5)(ii) of this section, no foreign use shall be considered to occur with respect to a dual consolidated loss as a result of an item of deduction or loss composing such dual consolidated loss being made available solely as a result of a reduction in the domestic owner's interest in the separate unit, as provided under paragraph (c)(5)(iii) of this section. See §1.1503(d)–7(c) *Example 5*.

(ii) *Limitations*. The exception provided in paragraph (c)(5)(i) of this section shall not apply if—

(A) During any 12-month period the domestic owner's percentage interest in the separate unit is reduced by 10 percent or more, as determined by reference to the domestic owner's interest at the beginning of the 12-month period; or

(B) At any time the domestic owner's percentage interest in the separate unit is reduced by 30 percent or more, as determined by reference to the domestic owner's interest at the end of the taxable year in which the dual consolidated loss was incurred.

(iii) *Reduction in interest*. The following rules apply for purposes of paragraphs (c)(4) and (5) of this section. A reduction of a domestic owner's interest in a separate unit shall include a reduction resulting from another person acquiring through sale, exchange, contribution, or other means, an interest in the foreign branch or hybrid entity, as applicable. A reduction may occur either directly or indirectly, including through an interest in a partnership, a disregarded entity, or a grantor trust through which a separate unit is carried on or owned. In the case of an interest in a hybrid entity partnership or a separate unit all or a portion of which is carried on or owned through a partnership, an interest in such separate unit (or portion of such separate unit) is determined by reference to the owner's interest in the profits or the capital in the separate unit. In the case of an interest in a hybrid entity grantor trust or a separate unit all or a portion of which is carried on or owned through a grantor trust, an interest in such separate unit (or portion of such separate unit) is determined by reference to the domestic owner's share of the assets and liabilities of the separate unit.

(iv) *Examples and coordination with exceptions to other triggering events*. See

§1.1503(d)–7(c) *Examples 5*, *13*, and *14*. See also §1.1503(d)–6(f)(3) and (f)(5) for rules that coordinate the *de minimis* exception to foreign use with exceptions to other triggering events described in §1.1503(d)–6(e)(1), and provide an exception to foreign use following certain compulsory transfers.

(6) *Certain asset basis carryovers*. No foreign use shall be considered to occur with respect to a dual consolidated loss solely as a result of items of deduction or loss composing such dual consolidated loss being made available as a result of the transfer of assets of a dual resident corporation or separate unit, provided—

(i) Such items of loss and deduction are made available solely as a result of the basis of the transferred assets being determined, under foreign law, in whole or in part by reference to the basis of the assets in the hands of the dual resident corporation or separate unit;

(ii) The aggregate adjusted basis, as determined under U.S. tax principles, of all the assets so transferred during any 12-month period is less than 10 percent of the aggregate adjusted basis, as determined under U.S. tax principles, of all the dual resident corporation's or separate unit's assets, determined by reference to the assets held at the beginning of such 12-month period; and

(iii) The aggregate adjusted basis, as determined under U.S. tax principles, of all the assets so transferred at any time is less than 30 percent of the aggregate adjusted basis, as determined under U.S. tax principles, of all the dual resident corporation's or separate unit's assets, determined by reference to the assets held at the end of the taxable year in which the dual consolidated loss was generated. See §1.1503(d)–7(c) *Example 15*.

(7) *Assumption of certain liabilities*—(i) *In general*. Except to the extent provided in paragraph (c)(7)(ii) of this section, no foreign use shall be considered to occur with respect to any dual consolidated loss solely as a result of an item of deduction or loss composing such dual consolidated loss being made available following the assumption of liabilities of a dual resident corporation or separate unit, provided such availability arises solely as the result of an item of deduction or loss incurred with respect to, or as a result of, such liabilities. See §1.1503(d)–7(c) *Example 16*.

(ii) *Ordinary course limitation*. Paragraph (c)(7)(i) of this section shall apply only to the extent the liabilities assumed were incurred in the ordinary course of the dual resident corporation's, or separate unit's, trade or business. For purposes of this paragraph, liabilities incurred in the ordinary course of a trade or business shall include debt incurred to finance the trade or business of the dual resident corporation or separate unit.

(8) *Multiple-party events*. This paragraph applies to a transaction that qualifies for the triggering event exception described in §1.1503(d)–6(f)(2)(i)(B) where the acquiring unaffiliated domestic corporation or consolidated group owns, directly or indirectly, more than 90 percent, but less than 100 percent, of the transferred assets or interests immediately after the transaction. In such a case, no foreign use shall be considered to occur with respect to a dual consolidated loss of the dual resident corporation or separate unit whose assets or interests were acquired, solely as a result of the less than 10 percent direct or indirect ownership of the acquired assets or interests by persons other than the acquiring unaffiliated domestic corporation or consolidated group, as applicable, immediately after the transaction. See §1.1503(d)–7(c) *Example 37*.

(9) *Additional guidance*. The Commissioner may provide, by guidance published in the Internal Revenue Bulletin, that certain events or transactions do or do not result in a foreign use. Such guidance may also modify the triggering events and rebuttals described in §1.1503(d)–6(e), and the exceptions thereto under §1.1503(d)–6(f), as appropriate.

(d) *Ordering rules for determining the foreign use of losses*. If the laws of a foreign country provide for the foreign use of losses of a dual resident corporation or a separate unit, but do not provide applicable rules for determining the order in which such losses are used in a taxable year, the following rules shall apply:

(1) 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 carry over of its losses is considered to be used to offset any income from the taxable year.

(2) 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 which would not constitute a triggering event that would result in the recapture of a dual consolidated loss pursuant to §1.1503(d)–6(h). Thereafter, it shall be deemed to use first the losses from the most recent taxable year from which a loss may be carried forward or back for foreign law purposes.

(3) 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)–7(c) *Example 12*.

(e) *Mirror legislation rule*—(1) *In general*. Except as provided in paragraph (e)(2) of this section and §1.1503(d)–6(b) (relating to agreements entered into between the United States and a foreign country), a foreign use shall be deemed to occur if the income tax laws of a foreign country would deny any opportunity for the foreign use of the dual consolidated loss in the year in which the dual consolidated loss is incurred (mirror legislation), determined by assuming that such foreign country had recognized the dual consolidated loss in such year, for any of the following reasons:

(i) The dual resident corporation or separate unit that incurred the loss is subject to income taxation by another country (for example, the United States) on its worldwide income or on a residence basis.

(ii) 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 (for example, the United States).

(iii) The deductibility of any portion of a deduction or loss taken into account in computing the dual consolidated loss depends on whether such amount is deductible under the laws of another country (for example, the United States). See §1.1503(d)–7(c) *Examples 17* through *19*.

(2) *Stand-alone exception*—(i) *In general*. This paragraph (e)(2) applies if, in the absence of the mirror legislation described in paragraph (e)(1) of this section,

no item of deduction or loss composing the dual consolidated loss of such dual resident corporation or separate unit would otherwise be available for a foreign use in the taxable year in which such dual consolidated loss is incurred. This determination is made without regard to whether such availability is limited by election (or other similar procedure). However, for purposes of this paragraph (e)(2)(i), no item of deduction or loss composing the dual consolidated loss of a dual resident corporation or separate unit is considered to be made available for foreign use solely because the laws of a foreign country would enable a foreign use through a sale, merger, or similar transaction (provided no such sale, merger, or similar transaction actually occurs). In such a case, no foreign use shall be considered to occur pursuant to paragraph (e)(1) of this section with respect to the dual consolidated loss, provided the requirements of paragraph (e)(2)(ii) of this section are satisfied. See §1.1503(d)–7(c) *Examples 17* through *19*.

(ii) *Stand-alone domestic use agreement*. In order to qualify for the exception under paragraph (e)(2)(i) of this section, the consolidated group, unaffiliated dual resident corporation, or unaffiliated domestic owner, as the case may be, must enter into a domestic use agreement in accordance with the provisions of §1.1503(d)–6(d) and, in addition, must include the following items in such domestic use agreement:

(A) A statement that the document is also being submitted under the provisions of paragraph (e)(2) of this section.

(B) A certification that the conditions of paragraph (e)(2)(i) of this section are satisfied during the taxable year in which the dual consolidated loss is incurred.

(C) An agreement to include with each annual certification required under §1.1503(d)–6(g), a certification that the conditions described in paragraph (e)(2)(i) of this section are satisfied during the taxable year of each such certification.

(iii) *Termination of stand-alone domestic use agreement*. This paragraph (e)(2)(iii) applies to a consolidated group, unaffiliated dual resident corporation, or unaffiliated domestic owner, as the case may be, that entered into a domestic use agreement pursuant to paragraph (e)(2)(ii) of this section, with respect to a dual consolidated loss, and which subsequently makes an election pursuant to §1.1503(d)–6(b) (relating to agreements entered into between the United States and a foreign country) with respect to such dual consolidated loss. In such a case, the dual consolidated loss shall be subject to the election under §1.1503(d)–6(b) (and any related agreements, representations and conditions), and the domestic use agreement entered into pursuant to paragraph (e)(2)(ii) of this section shall terminate and have no further effect.

§1.1503(d)–4 Domestic use limitation and related operating rules.

(a) *Scope*. This section prescribes rules that apply when the general limitation on the domestic use of a dual consolidated loss under paragraph (b) of this section applies. Thus, the rules of this section do not apply when an exception to the domestic use limitation applies (for example, as a result of a domestic use election under §1.1503(d)–6(d)). In general, when the domestic use limitation applies, the dual consolidated loss of a dual resident corporation or separate unit is subject to the separate return limitation year (SRLY) provisions of §1.1502–21(c), as modified under this section. Paragraph (c) of this section provides rules that determine the effect of a dual consolidated loss on a consolidated group, an unaffiliated dual resident corporation, or an unaffiliated domestic owner. Paragraph (d) of this section provides rules that eliminate dual consolidated losses following certain transactions or events. Paragraph (e) of this section contains provisions that prevent dual consolidated losses from offsetting tainted income. Finally, paragraph (f) of this section provides rules for computing foreign tax credits.

(b) *Limitation on domestic use of a dual consolidated loss*. Except as provided in §1.1503(d)–6, the domestic use of a dual consolidated loss is not permitted. See §1.1503(d)–2 for the definition of a domestic use. See also §1.1503(d)–7(c) *Examples 2* through *4*.

(c) *Effect of a dual consolidated loss on a consolidated group, unaffiliated dual resident corporation, or unaffiliated domestic owner*. For any taxable year in which a dual resident corporation or separate unit has a dual consolidated loss that is subject to the domestic use limitation of paragraph (b) of this section, the following rules shall apply:

(1) *Dual resident corporation*. This paragraph (c)(1) applies to a dual consolidated loss of a dual resident corporation. The unaffiliated dual resident corporation, or consolidated group that includes the dual resident corporation, shall compute its taxable income (or loss), or consolidated taxable income (or loss), respectively, without taking into account those items of deduction and loss that compose the dual resident corporation's dual consolidated loss. For this purpose, 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 limitations, 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. If the dual resident corporation owns a separate unit or an interest in a transparent entity, the limitations contained in paragraph (c)(3) of this section shall apply to the dual resident corporation as if the separate unit or interest in a transparent entity were a separate domestic corporation that filed a consolidated return with the unaffiliated dual resident corporation, or with the consolidated group of the affiliated dual resident corporation, as applicable.

(2) *Separate unit*. This paragraph (c)(2) applies to a dual consolidated loss that is attributable to a 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) or consolidated taxable income (or loss), respectively, without taking into account those items of deduction and loss that compose the separate unit's dual consolidated loss. For this purpose, 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 to which the dual consolidated loss is attributable

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, as applicable. Subject to such limitations, 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. See §1.1503(d)–7(c) *Examples 29* and *38*.

(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 modifications—

(i) Notwithstanding §1.1502–1(f)(2)(i), the SRLY limitation is applied to any dual consolidated loss of a common parent that is a dual resident corporation, or any dual consolidated loss attributable to a separate unit 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, and loss generated—

(A) In the case of a hybrid entity separate unit, in years in which the hybrid entity (an interest in which is a separate unit) is taxed as a corporation (or otherwise at the entity level) either on its worldwide income or as a resident in the same foreign country in which it was so taxed during the year in which the dual consolidated loss was generated; and

(B) In the case of a foreign branch separate unit, in years in which the foreign branch qualified as a separate unit in the same foreign country in which it so qualified during the year in which the dual consolidated loss was generated.

(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)–6(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)–7(c) *Examples 29* and *38*.

(5) *Reconstituted net operating losses*. For additional rules and limitations that apply to reconstituted net operating losses, see §1.1503(d)–6(h)(6).

(d) *Elimination of a dual consolidated loss after certain transactions*—(1) *General rule*. In general, a dual resident corporation has a net operating loss (and, therefore, a dual consolidated loss) only if it sustains such loss, or succeeds to such loss as a result of acquiring the assets of a corporation that sustained the loss in a transaction described in section 381(a). Similarly, a net loss generally is attributable to a separate unit of a domestic owner (and therefore is a dual consolidated loss) only if the domestic owner incurs the deductions or losses, or succeeds to such deductions or losses in a transaction described in section 381(a). Except as provided in §1.1503(d)–6(h)(6)(iii), section 1503(d) and these regulations do not alter these general rules. Thus, the provisions of §§1.1503(d)–1 through 1.1503(d)–8 generally do not cause a corporation to have a dual consolidated loss if it did not sustain (or inherit) the loss. Instead, these regulations either eliminate a dual consolidated loss that a corporation sustained (or inherited), or prevent the carryover of a dual consolidated loss under section 381 that would ordinarily occur, as a result of certain transactions.

(i) *Transactions described in section 381(a)*. This paragraph (d)(1)(i) applies to a dual consolidated loss of a dual resident corporation, or of a domestic owner attributable to a separate unit, that is subject to the domestic use limitation rule of paragraph (b) of this section. In such a case, and except as provided in paragraph (d)(2) of this section, the dual consolidated loss 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)–7(c) *Example 20*.

(ii) *Cessation of separate unit status*. This paragraph (d)(1)(ii) applies when a separate unit of an unaffiliated domestic owner ceases to be a separate unit of its domestic owner, or when a separate unit of an affiliated domestic owner ceases to be a separate unit with respect to its domestic owner and all other members of the affiliated domestic owner's consolidated group. In such a case, and except as provided in paragraph (d)(2)(iii) of this section, a dual consolidated loss of the domestic owner attributable to such separate unit, that is subject to the domestic use limitation of paragraph (b) of this section, shall be eliminated. For purposes of this paragraph (d)(1)(ii), a separate unit may cease to be a separate unit if, for example, such separate unit is terminated, dissolved, liquidated, sold, or otherwise disposed of. See §1.1503(d)–7(c) *Example 21*.

(2) *Exceptions*—(i) *Certain section 368(a)(1)(F) reorganizations*. Paragraph (d)(1)(i) of this section (relating to transactions described in section 381(a)) shall not apply to a dual consolidated loss of a dual resident corporation that undergoes a reorganization described in section 368(a)(1)(F) in which the resulting corporation is a domestic corporation. In such a case, the dual consolidated loss of the resulting corporation continues to be subject to the limitations of paragraphs (b) and (c) of this section, applied as if the resulting corporation incurred the dual consolidated loss.

(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 paragraph (d)(1)(i) of this section shall not apply with respect to dual consolidated losses of the dual resident corporation, and income generated by the transferee may be offset by the carryover dual consolidated losses of the transferor, subject to the limitations of paragraphs (b) and (c) of this section applied as if the transferee incurred the dual consolidated loss. Dual consolidated losses of the transferor dual resident corporation may not, however, be used to offset income attributable to separate units or interests in transparent entities owned by the transferee because they constitute domestic af-

filiates under §1.1503(d)–1(b)(12)(iii) and (iv), respectively.

(iii) *Acquisition of a separate unit by a domestic corporation*. This paragraph (d)(2)(iii) provides exceptions to the general rules in paragraphs (d)(1)(i) and (ii) of this section that eliminate the dual consolidated loss of a domestic owner that is attributable to a separate unit following certain transactions or events. The exceptions set forth in this paragraph (d)(2)(iii) shall only apply where a domestic owner transfers its assets to a domestic corporation (transferee corporation) in a transaction described in section 381(a).

(A) *Acquisition by a corporation that is not a member of the same consolidated group—(1) General rule*. If a domestic owner transfers either an individual separate unit or a combined separate unit to a transferee corporation that is not a member of its consolidated group in a transaction described in section 381(a), and the transferee corporation, or a member of the transferee's consolidated group, is a domestic owner of the transferred separate unit immediately after the transaction, then paragraphs (d)(1)(i) and (ii) of this section shall not apply to such transfer. In addition, income of the transferee, or a member of the transferee's consolidated group, that is attributable to the transferred separate unit may be offset by the carryover dual consolidated losses of the transferor domestic owner that were attributable to the transferred separate unit, subject to the limitations of paragraphs (b) and (c) of this section applied as if the transferee incurred the dual consolidated losses and such losses were attributable to the separate unit. See §1.1503(d)–7(c) *Example 21*.

(*2*) *Combination with separate units of the transferee*. This paragraph (d)(2)(iii)(A)(*2*) applies to a transaction described in paragraph (d)(2)(iii)(A)(*1*) of this section where the transferred separate unit is combined with another separate unit of the transferee, or another member of the transferee's consolidated group, immediately after the transfer as provided under §1.1503(d)–1(b)(4)(ii). In such a case, income generated by the transferee, or another member of the transferee's consolidated group, that is attributable to the combined separate unit may be offset by the carryover dual consolidated losses that were attributable to the transferred separate unit, subject to the limitations of paragraphs (b) and (c) of this section, applied as if the transferee incurred the dual consolidated losses and such losses were attributable to the combined separate unit.

(B) *Acquisition by a member of the same consolidated group*. If an affiliated domestic owner transfers its assets to another member of its consolidated group in a transaction described in section 381(a), and the transferee corporation or another member of such consolidated group is a domestic owner of the separate unit to which the dual consolidated loss was attributable, then paragraphs (d)(1)(i) and (ii) of this section shall not apply. In addition, income generated by the transferee that is attributable to the transferred separate unit may be offset by the carryover dual consolidated losses that were attributable to the transferred separate unit, subject to the limitations of paragraphs (b) and (c) of this section, applied as if the transferee incurred the dual consolidated losses and such losses were attributable to the separate unit. See §1.1503(d)–7(c) *Example 21*.

(iv) *Special rules for foreign insurance companies*. See §1.1503(d)–6(a) for additional limitations that apply where the transferor is a foreign insurance company that is a dual resident corporation under §1.1503(d)–1(b)(2)(ii).

(e) *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 that are subject to the domestic use limitation rule under paragraph (b) of this section 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 (e)(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 (e)(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)–7(c) *Example 22*.

(3) *Tainted assets defined*. For purposes of paragraph (e)(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), any assets otherwise transferred to the corporation as a contribution to capital, or any assets otherwise received from a separate unit or a transparent entity owned by such domestic corporation, at any time during the three taxable years immediately 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 (e)(1) of this section, and in addition shall not be treated as tainted assets as defined in paragraph (e)(3) 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.

(f) *Computation of foreign tax credit limitation*. If a dual consolidated loss is subject to the domestic use limitation rule under paragraph (b) of this section, the consolidated group, unaffiliated dual resident corporation, or unaffiliated domestic owner shall compute its foreign tax credit

limitation by applying the limitations of paragraph (c) of this section. 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)–5 Attribution of items and basis adjustments.

(a) *In general*. This section provides rules for determining the amount of income or dual consolidated loss of a dual resident corporation. This section also provides rules for determining the income or dual consolidated loss attributable to a separate unit, as well as the income or loss attributable to an interest in a transparent entity. Paragraph (b) of this section provides rules with respect to dual resident corporations. Paragraph (c) of this section provides rules with respect to separate units and interests in transparent entities. These determinations are required for various purposes under section 1503(d). For example, it is necessary for purposes of applying the domestic use limitation rule under §1.1503(d)–4(b) to a dual consolidated loss, and for determining the extent to which a dual consolidated loss is available to offset income as provided under §1.1503(d)–4(c). These determinations are also necessary for purposes of determining whether the amount subject to recapture may be reduced pursuant to §1.1503(d)–6(h)(2). Paragraph (d) of this section provides rules with respect to the foreign tax treatment of items. Paragraph (e) of this section provides rules regarding the treatment of items where a dual resident corporation, separate unit, or transparent entity only qualified as such during a portion of a taxable year. Paragraph (f) of this section provides rules for determining the assets and liabilities of a separate unit. Finally, paragraph (g) of this section provides rules for making basis adjustments to stock of certain members of a consolidated group and to certain interests in partnerships. The rules in this section apply for purposes of §§1.1503(d)–1 through 1.1503(d)–7.

(b) *Determination of amount of income or dual consolidated loss of a dual resident corporation*—(1) *In general*. For purposes of determining whether a dual resident corporation has income or a dual consolidated loss for the taxable year, and except as provided in paragraph (b)(2) of this section, the dual resident corporation shall compute its income or dual consolidated loss taking into account only those items of income, gain, deduction, and loss from such year (including any items recognized by such corporation as a result of an election under section 338). In the case of an affiliated dual resident corporation, such calculation shall be made in accordance with the rules set forth in the regulations under section 1502 governing the computation of consolidated taxable income. See also paragraphs (d) and (e) of this section.

(2) *Exceptions*. For purposes of determining the income or dual consolidated loss of a dual resident corporation, the following shall not be taken into account—

(i) Any net capital loss of the dual resident corporation;

(ii) Any carryover or carryback losses; or

(iii) Any items of income, gain, deduction, and loss that are attributable to a separate unit or an interest in a transparent entity of the dual resident corporation.

(c) *Determination of amount of income or dual consolidated loss attributable to a separate unit, and income or loss attributable to an interest in a transparent entity*—(1) *In general*—(i) *Scope and purpose*. Paragraphs (c) through (e) of this section apply for purposes of determining the income or dual consolidated loss attributable to a separate unit, and the income or loss attributable to an interest in a transparent entity, for the taxable year. In the case of an affiliated domestic owner, this determination shall be made in accordance with the rules set forth in the regulations under section 1502 governing the computation of consolidated taxable income. These rules apply solely for purposes of section 1503(d).

(ii) *Only items of domestic owner taken into account*. The computation made under paragraphs (c) through (e) of this section shall be made using only those existing items of income, gain, deduction, and loss of the separate unit's or transparent entity's domestic owner (or owners, in the case of certain combined separate units), as determined for U.S. tax purposes. These items must be translated into U.S. dollars (if necessary) at the appropriate exchange rate provided under section 989(b), as modified by regulations. The computation shall be made as if the separate unit or interest in a transparent entity were a domestic corporation, using items that are attributable to the separate unit or interest in a transparent entity. However, for purposes of making this computation, net capital losses, and carryover or carryback losses, of the domestic owner shall not be taken into account. Items of income, gain, deduction, and loss that are otherwise disregarded for U.S. tax purposes shall not be regarded or taken into account for purposes of this section. See §1.1503(d)–7(c) *Examples 6* and *23* through *25*.

(iii) *Separate application*. The attribution rules of this section shall apply separately to each separate unit or interest in a transparent entity. Thus, an item of income, gain, deduction, or loss shall not be considered attributable to more than one separate unit or interest in a transparent entity. In addition, for purposes of this section items of income, gain, deduction, and loss attributable to a separate unit or an interest in a transparent entity shall not offset items of income, gain, deduction, and loss of another separate unit or interest in a transparent entity. See §1.1503(d)–7(c) *Example 24*. See also the separate unit combination rule in §1.1503(d)–1(b)(4)(ii).

(2) *Foreign branch separate unit*—(i) *In general*. Except to the extent provided in paragraph (c)(4) of this section, for purposes of determining the items of income, gain, deduction (other than interest), and loss of a domestic owner that are attributable to the domestic owner's foreign branch separate unit, the principles of section 864(c)(2), (c)(4), and (c)(5), as set forth in §1.864–4(c), and §§1.864–5 through 1.864–7, 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). Except as provided in paragraph (c)(2)(iii) of this section, for purposes of determining the domestic owner's interest expense that is attributable to a foreign branch separate unit, the principles of §1.882–5, as modified in paragraph (c)(2)(ii) of this section, shall apply. When applying the principles of section 864(c) (as modified by this paragraph) and §1.882–5 (as modified in paragraph (c)(2)(ii) of this section), the foreign branch separate unit's domestic

owner 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 owner shall be treated as assets that are not U.S. assets.

(ii) *Principles of §1.882–5*. For purposes of paragraph (c)(2)(i) of this section, the principles of §1.882–5 shall be applied, subject to the following modifications—

(A) 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;

(B) Except as provided under paragraph (c)(2)(ii)(C) of this section, a taxpayer may use the alternative tax book value method under §1.861–9(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);

(C) 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 expense for the taxable year under section 864(e);

(D) Asset values shall be determined pursuant to §1.861–9T(g)(2); and

(E) 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) *Exception where foreign country attributes interest expense solely by reference to books and records*. The principles of §1.882–5 shall not apply if the foreign country in which the foreign branch separate unit is located determines, for purposes of computing taxable income (or loss) of a permanent establishment or branch of a nonresident corporation under the laws of the foreign country, the interest expense of the foreign branch separate unit by taking into account only the items of interest expense reflected on the foreign branch separate unit's books and records. In such a case, only those items of the domestic owner's interest expense reflected on the foreign branch separate unit's books and records (as provided in paragraph (c)(3)(i) of this section), adjusted to conform to U.S. tax principles, shall be attributable to the foreign branch separate unit. This paragraph shall not apply where the foreign country does not use a method of attributing interest based solely on the interest that is reflected on the books and records. For example, this paragraph does not apply if the foreign country uses a method for attributing interest expense similar to §1.882–5 or that set forth in the Organization for Economic Co-operation and Development Report on the Attribution of Profits to Permanent Establishments, Part II (Banks), December 2006. See *www.oecd.org*.

(3) *Hybrid entity separate unit and an interest in a transparent entity*—(i) *General rule*. This paragraph (c)(3) applies to determine the items of income, gain, deduction, and loss of a domestic owner that are attributable to a hybrid entity separate unit, or an interest in a transparent entity, of such domestic owner. Except to the extent provided in paragraph (c)(4) of this section, the domestic owner's items of income, gain, deduction, and loss are attributable to the extent they are reflected on the books and records of the hybrid entity or transparent entity, as applicable, as adjusted to conform to U.S. tax principles. See §1.1503(d)–7(c) *Examples 23* through *26*. For purposes of this paragraph (c)(3), the term "books and records" has the meaning provided under §1.989(a)–1(d). The treatment of items for foreign tax purposes, including under any type of foreign anti-deferral regime, is not relevant for purposes of determining whether items are reflected on the books and records of the entity, or for purposes of making adjustments to such items to conform to U.S. tax principles. The method described in the second sentence of this paragraph shall not apply to the extent that the Commissioner determines that booking practices are employed with a principal purpose of avoiding the principles of section 1503(d), including inconsistently treating the same or similar items of income, gain, deduction, and loss. In such a case, the Commissioner may reallocate the items of income, gain, deduction, and loss between or among a domestic owner, its hybrid entities, its transparent entities (and interests therein), its separate units, or any other entity, as applicable, in a manner consistent with the principles of section 1503(d) and which properly reflects income (or loss).

(ii) *Interests in certain disregarded entities, partnerships, and grantor trusts owned by a hybrid entity or transparent entity*. This paragraph (c)(3)(ii) applies if a hybrid entity or transparent entity to which paragraph (c)(3)(i) of this section applies owns, directly or indirectly (other than through a hybrid entity or transparent entity), an interest in an entity that is treated as a disregarded entity, partnership, or grantor trust for U.S. tax purposes, but is not a hybrid entity or a transparent entity. For example, the rules of this paragraph would apply when a hybrid entity holds an interest in a limited partnership created in the United States and, for both U.S. and foreign tax purposes the entity is considered a partnership. In such a case, and except to the extent provided in paragraph (c)(4) of this section, items of income, gain, deduction, and loss that are reflected on the books and records of such disregarded entity, partnership or grantor trust, as determined under paragraph (c)(3)(i) of this section, shall be treated as being reflected on the books and records of the hybrid entity or transparent entity for purposes of applying paragraph (c)(3)(i) of this section. See §1.1503(d)–7(c) *Example 26*.

(4) *Special rules*. The following special rules shall apply for purposes of attributing items to separate units or interests in transparent entities under this section:

(i) *Allocation of items between certain tiered separate units and interests in transparent entities*—(A) *Foreign branch separate unit*. This paragraph (c)(4)(i) applies where a hybrid entity or transparent entity owns directly or indirectly (other than through a hybrid entity or a transparent entity), a foreign branch separate unit. For purposes of determining items of income, gain, deduction, and loss of the domestic owner that are attributable to the domestic owner's foreign branch separate unit described in the preceding sentence, only items of income, gain, deduction, and loss that are attributable to the domestic owner's interest in the hybrid entity, or transparent entity, as provided in paragraph (c)(3) of this section, shall be taken into account. Further, only assets, liabilities, and activities of the domes-

tic owner's interest in the hybrid entity or the transparent entity shall be taken into account under paragraph (c)(2) of this section when applying the principles of 864(c)(2), (c)(4), (c)(5) (as set forth in §1.864–4(c), and §§1.864–5 through 1.864–7), and §1.882–5 (as modified in paragraph (c)(2)(ii) of this section). See §1.1503(d)–7(c) *Examples 25* and *26*.

(B) *Hybrid entity separate unit or interest in a transparent entity*. For purposes of determining items of income, gain, deduction, and loss that are attributable to a hybrid entity separate unit or an interest in a transparent entity described in paragraph (c)(3) of this section, such items shall not be taken into account to the extent they are attributable to a foreign branch separate unit pursuant to paragraph (c)(4)(i)(A) of this section. See §1.1503(d)–7(c) *Examples 25* and *26*.

(ii) *Combined separate unit*. If two or more individual 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 the combined separate unit shall be determined as follows:

(A) Items of income, gain, deduction, and loss are first attributed to each individual separate unit without regard to §1.1503(d)–1(b)(4)(ii), pursuant to the rules of paragraphs (c) through (e) of this section.

(B) The combined separate unit then takes into account all of the items of income, gain, deduction, and loss attributable to its individual separate units pursuant to paragraph (c)(4)(ii)(A) of this section. See §1.1503(d)–7(c) *Examples 25* and *26*.

(iii) *Gain or loss on the direct or indirect disposition of a separate unit or an interest in a transparent entity*—(A) *In general*. This paragraph (c)(4)(iii) applies for purposes of attributing items of income, gain, deduction, and loss that are recognized on the sale, exchange, or other disposition of a separate unit or an interest in a transparent entity (or an interest in a disregarded entity, partnership, or grantor trust that owns, directly or indirectly, a separate unit or an interest in a transparent entity). For purposes of this paragraph (c)(4)(iii), items taken into account on the sale, exchange, or other disposition include loss recapture income or gain under section 367(a)(3)(C) or 904(f)(3), and gain or loss recognized by the domestic owner as the result of an election under section 338. In cases where this paragraph (c)(4)(iii)(A) applies, items taken into account on the sale, exchange, or other disposition shall be attributable to the separate unit or the interest in the transparent entity to the extent of gain or loss that would have been recognized had the separate unit or transparent entity sold all its assets (as determined in paragraph (f) of this section) in a taxable exchange, immediately before the sale, exchange, or other disposition (deemed sale). For purposes of a deemed sale described in this paragraph (c)(4)(iii), the assets are treated as being sold for an amount equal to their fair market value, plus the assumption of the liabilities of the separate unit or interest in a transparent entity (as determined in paragraph (f) of this section). See §1.1503(d)–7(c) *Example 27*.

(B) *Multiple separate units or interests in transparent entities*. This paragraph (c)(4)(iii)(B) applies to a sale, exchange, or other disposition described in paragraph (c)(4)(iii)(A) of this section that results in more than one separate unit or interest in a transparent entity being, directly or indirectly, disposed of. In such a case, items of income, gain, deduction, and loss recognized on such sale, exchange, or other disposition are allocated and attributed to each separate unit or interest in a transparent entity, based on the relative gain or loss that would have been recognized by each separate unit or interest in a transparent entity pursuant to a deemed sale of their assets. See §1.1503(d)–7(c) *Example 28*.

(iv) *Inclusions on stock*. Any amount included in income of a domestic owner arising from ownership of stock in a foreign corporation (for example, under sections 78, 951, or 986(c)) through a separate unit, or interest in a transparent entity, shall be attributable to the separate unit or interest in a transparent entity, if an actual dividend from such foreign corporation would have been so attributed. See §1.1503(d)–7(c) *Example 24*.

(v) *Foreign currency gain or loss recognized under section 987*. Foreign currency gain or loss of a domestic owner recognized under section 987 as a result of a transfer or remittance shall not be attributable to a separate unit or an interest in a transparent entity.

(vi) *Recapture of dual consolidated loss*. If all or a portion of a dual consolidated loss that was attributable to a separate unit is included in the gross income of a domestic owner under the recapture provisions of §1.1503(d)–6(h), such amount shall be attributable to the separate unit that incurred the dual consolidated loss being recaptured. See §1.1503(d)–7(c) *Examples 38* and *40*.

(d) *Foreign tax treatment disregarded*. The fact that a particular item taken into account in computing the income or dual consolidated loss of a dual resident corporation or a separate unit, or the income or loss of an interest in a transparent entity, is not taken into account in computing income (or loss) subject to a foreign country's income tax shall not cause such item to be excluded from being taken into account under paragraph (b), (c), or (e) of this section.

(e) *Items generated or incurred while a dual resident corporation, a separate unit, or a transparent entity*. For purposes of determining the amount of the dual consolidated loss of a dual resident corporation for the taxable year, only the items of income, gain, deduction, and loss generated or incurred during the period the dual resident corporation qualified as such shall be taken into account. For purposes of determining the amount of income of a dual resident corporation for the taxable year, all the items of income, gain, deduction, and loss generated or incurred during the year shall be taken into account. For purposes of determining the amount of the income or dual consolidated loss attributable to a separate unit, or the income or loss attributable to an interest in a transparent entity, for the taxable year, only the items of income, gain, deduction, and loss generated or incurred during the period the separate unit or the interest in the transparent entity qualified as such shall be taken into account. For purposes of this paragraph (e), the allocation of items to periods shall be made under the principles of §1.1502–76(b).

(f) *Assets and liabilities of a separate unit or an interest in a transparent entity*. A separate unit or an interest in a transparent entity shall be treated as owning assets to the extent items of income, gain, deduction, and loss from such assets would be attributable to the separate unit or interest in the transparent entity under paragraphs

(c) through (e) of this section. Similarly, liabilities shall be treated as liabilities of a separate unit, or an interest in a transparent entity, to the extent interest expense incurred on such liabilities would be attributable to the separate unit, or the interest in a transparent entity, under paragraphs (c) through (e) of this section.

(g) *Basis adjustments*—(1) *Affiliated dual resident corporation or affiliated domestic owner*. If a member of a consolidated group owns stock in an affiliated dual resident corporation or an affiliated domestic owner that is a member of the same consolidated group, the member shall adjust the basis of the stock in accordance with the provisions of §1.1502–32. Corresponding adjustments shall be made to the stock of other members in accordance with the provisions of §1.1502–32. In the case where two or more individual separate units are treated as a combined separate unit pursuant to §1.1503(d)–1(b)(4)(ii), see paragraph (g)(3) of this section.

(2) *Interests in hybrid entities that are partnerships or interests in partnerships through which a separate unit is owned indirectly*—(i) *Scope*. This paragraph (g)(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 described in paragraph (g)(2)(i) of this section shall be adjusted in accordance with section 705 and this paragraph (g)(2). The adjusted basis shall not be decreased for any amount of a dual consolidated loss that is attributable to the partnership interest, or separate unit owned indirectly through the partnership interest, as applicable, that is not absorbed as a result of the application of §1.1503(d)–4(b) and (c). The adjusted basis shall, however, be decreased for the amount of such dual consolidated loss that is absorbed in a carryover or carryback taxable year. The adjusted basis shall be increased for any amount included in income pursuant to §1.1503(d)–6(h) as a result of the recapture of a dual consolidated loss that was attributable to the interest in the hybrid partnership, or separate unit owned indirectly through the partnership interest, as applicable.

(3) *Combined separate units*. This paragraph (g)(3) applies where two or more individual separate units of one or more affiliated domestic owners are treated as one combined separate unit pursuant to §1.1503(d)–1(b)(4)(ii). In such a case, a member owning stock in an affiliated domestic owner of the combined separate unit shall adjust the basis in the stock of such domestic owner as provided in paragraph (g)(1) of this section, and an affiliated domestic owner shall adjust its basis in a partnership, as provided in paragraph (g)(2) of this section, taking into account only those items of income, gain, deduction, or loss attributable to each individual separate unit, prior to combination. For purposes of this rule, if the dual consolidated loss attributable to a combined separate unit is subject to the domestic use limitation of §1.1503(d)–4(b), then for purposes of this paragraph (g) and §1.1502–32, the dual consolidated loss shall be allocated to an individual separate unit to the extent such individual separate unit contributed items of deduction or loss giving rise to the dual consolidated loss. In addition, if one or more affiliated domestic owners are required to recapture all or a portion of a dual consolidated loss pursuant to paragraph (h) of this section, such recapture amount shall be allocated to the affiliated domestic owner of the individual separate units composing the combined separate unit, to the extent such individual separate units contributed items of deduction or loss giving rise to the recaptured dual consolidated loss.

§1.1503(d)–6 Exceptions to the domestic use limitation rule.

(a) *In general*—(1) *Scope and purpose*. This section provides certain exceptions to the domestic use limitation rule of §1.1503(d)–4(b). Paragraph (b) of this section provides an exception for bilateral elective agreements. Paragraph (c) of this section provides rules regarding an exception that applies when there is no possibility of a foreign use. Paragraphs (d) through (h) of this section provide rules for an exception where a domestic use election is made. Paragraph (e) of this section provides rules with respect to triggering events, and paragraph (f) of this section provides rules regarding exceptions to triggering events. Paragraph (g) of this section provides rules with respect to the annual certification reporting requirement. Paragraph (h) of this section provides rules regarding the recapture of dual consolidated losses. Finally, paragraph (j) of this section provides rules regarding the termination of domestic use agreements and the annual certification requirement.

(2) *Absence of foreign affiliate or foreign consolidation regime*. The absence of a foreign affiliate or a foreign consolidation regime alone does not constitute an exception to the domestic use limitation rule. This is the case because it is still possible that all or a portion of the dual consolidated loss may 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 incurred. In addition, a foreign use may occur in the absence of a foreign consolidation regime through a sale, merger, or similar transaction. See §1.1503(d)–7(c) *Example 2*.

(3) *Foreign insurance companies treated as domestic corporations*. The exceptions contained in this section shall not apply to losses of a foreign insurance company that is a dual resident corporation under §1.1503(d)–1(b)(2)(ii), or to losses attributable to any separate unit of such foreign insurance company. In addition, these exceptions shall not apply to losses described in the preceding sentence that, subject to the rules of §1.1503(d)–4(d), carry over to a domestic corporation pursuant to a transaction described in section 381(a).

(b) *Elective agreement in place between the United States and a foreign country*—(1) *In general*. The domestic use limitation rule of §1.1503(d)–4(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 in a particular year may be used to offset income in only one country. This exception shall apply only if all the terms and conditions required under such agreement are

satisfied, including any reporting or filing requirements. See §1.1503(d)–3(e)(2)(iii) for the effect of an agreement described in this paragraph on a stand-alone domestic use agreement.

(2) *Application to combined separate units*. This paragraph (b)(2) applies where two or more individual separate units are treated as one combined separate unit pursuant to §1.1503(d)–1(b)(4)(ii), and an agreement described in paragraph (b)(1) of this section would apply to at least one of the individual separate units. In such a case, and except to the extent provided in the agreement, the consolidated group, unaffiliated dual resident corporation, or unaffiliated domestic owner, as the case may be, may apply the agreement to the individual separate units, as applicable, provided the terms and conditions of the agreement are otherwise satisfied. See §1.1503(d)–7(c) *Example 19*.

(c) *No possibility of foreign use*—(1) *In general*. The domestic use limitation rule of §1.1503(d)–4(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 (as defined in §1.1503(d)–3) of the dual consolidated loss occurred in the year in which it was incurred, and that no foreign 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)–7(c) *Examples 2*, *30*, and *31*.

(2) *Statement*. The statement described in this paragraph (c)(2) 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 correspond 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 paragraph (c) of this section.

(ii) The name, address, taxpayer 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. In the case of a combined separate unit, such information must be provided for each individual separate unit that is treated as part of the combined separate unit under §1.1503(d)–1(b)(4)(ii).

(iii) A statement of the amount of the dual consolidated loss at issue.

(iv) An analysis, in reasonable detail and specificity, of the treatment of the losses and deductions composing the dual consolidated loss under the relevant facts. The analysis must include the reasons supporting the conclusion that no foreign use of the dual consolidated loss can occur as described in paragraph (c)(1)(i) of this section. The analysis must be supported with official or certified English translations of the relevant provisions of foreign law. The analysis may, for example, be based on the taxpayer's interpretation of foreign law, on advice received from local tax advisers in an opinion, or on a ruling from local country tax authorities. In all cases, however, the determination must be made to the satisfaction of the Commissioner.

(d) *Domestic use election*—(1) *In general*. The domestic use limitation rule of §1.1503(d)–4(b) shall not apply to a dual consolidated loss if an election to be bound by the provisions of paragraphs (d) through (j) of this section is made by the consolidated group, unaffiliated dual resident corporation, or unaffiliated domestic owner, as the case may be (elector). In order to elect such relief, an agreement described in this paragraph (d)(1) (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 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 paragraph (d) of this section.

(ii) The information required by paragraph (c)(2)(ii) of this section.

(iii) An agreement by the elector to comply with all of the provisions of paragraphs (d) through (j) of this section, as applicable.

(iv) A statement of the amount of the dual consolidated loss at issue.

(v) A certification that there has not been, and will not be, a foreign use (as defined in §1.1503(d)–3) during the certification period (as defined in §1.1503(d)–1(b)(20)).

(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) of this section has occurred with respect to the dual consolidated loss within the taxable year in which the loss is incurred. See paragraph (g) of this section for notification of excepted triggering events occurring during the certification period.

(2) *No domestic use election available if there is a triggering event in the year the dual consolidated loss is incurred*. Except as otherwise provided in this section, if a dual resident corporation or separate unit incurs a dual consolidated loss in a taxable year and a triggering event, as described in paragraph (e)(1) of this section, occurs (and no exception applies) with respect to the dual consolidated loss in such taxable year, then 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 such dual consolidated loss and the loss will be subject to the domestic use limitation rule of §1.1503(d)–4(b). See §1.1503(d)–7(c) *Examples 5* through

7. See also §1.1503(d)–4(d) for rules that eliminate a dual consolidated loss after certain transactions.

(e) *Triggering events requiring the recapture of a dual consolidated loss*—(1) *Events*. Except as provided under paragraphs (e)(2) (rebuttal of triggering events) and (f) (exceptions to triggering events) of this section, if there is a triggering event described in this paragraph (e)(1) with respect to a dual consolidated loss of a dual resident corporation or a separate unit during the certification period (as defined in §1.1503(d)–1(b)(20)), the elector will recapture and report as ordinary income the amount of such 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 taxable 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, any of the following events shall constitute a triggering event:

(i) *Foreign use*. A foreign use (as defined in §1.1503(d)–3) of the dual consolidated loss. See §1.1503(d)–3(c) for exceptions to foreign use.

(ii) *Disaffiliation*. An affiliated dual resident corporation or affiliated domestic owner that incurred directly or through a separate unit, respectively, a dual consolidated loss that is subject to a domestic use election, ceases to be a member of the consolidated group that made the domestic use election. For purposes of this paragraph (e)(1)(ii), an affiliated dual resident corporation or affiliated 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)–7(c) *Example 34*. Any consequences resulting from this triggering event (for example, recapture of a dual consolidated loss) shall be taken into account on the tax return of the consolidated group for the taxable year that includes the date on which the affiliated dual resident corporation or affiliated domestic owner ceases to be a member of the consolidated group. This paragraph (e)(1)(ii) shall not apply to an acquisition described in §1.1502–75(d)(3) where the consolidated group that includes the affiliated dual resident corporation or affiliated domestic owner, as applicable, is treated as remaining in existence.

(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 on the tax return of the unaffiliated dual resident corporation or unaffiliated domestic owner for the taxable year that ends at the end of the day on which such corporation 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 transaction or, for multiple transactions, at the time of the first transaction) is sold or otherwise disposed of in either a single transaction or a series of transactions within a twelve-month period. See §1.1503(d)–7(c) *Examples 5* and *35* through *37*. In determining whether fifty percent or more of such assets is sold or otherwise disposed of, any dispositions occurring in the ordinary course of the dual resident corporation's or separate unit's trade or business shall be disregarded. In addition, for purposes of this paragraph (e)(1)(iv), an interest in another separate unit and the shares of a dual resident corporation shall not be treated as assets of a separate unit or a dual resident corporation.

(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 at the time of such transaction, or for multiple transactions, at the time of the first transaction) of the domestic owner, as determined by reference to such domestic owner's percentage interest 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. See §1.1503(d)–7(c) *Examples 5* and *35* through *37*.

(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, that incurred the dual consolidated loss, becomes a foreign corporation (for example, as a result of a reorganization or an election to be classified as a corporation under §301.7701–3(c) of this chapter).

(vii) *Conversion to a regulated investment company, a real estate investment trust, or an S corporation*. An unaffiliated dual resident corporation or unaffiliated domestic owner elects to be a regulated investment company pursuant to section 851(b)(1), a real estate investment trust pursuant to section 856(c)(1), or an S corporation pursuant to section 1362(a).

(viii) *Failure to certify*. The elector fails to file a certification with respect to a dual consolidated loss as required under paragraph (g) of this section.

(ix) *Cessation of stand-alone status*. In the case of a dual consolidated loss that is subject to the stand-alone exception described in §1.1503(d)–3(e)(2), the conditions described in §1.1503(d)–3(e)(2)(i) are no longer satisfied. See §1.1503(d)–7(c) *Example 18*.

(2) *Rebuttal*—(i) *General rule*. An event described in paragraph (e)(1) 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 (as defined in §1.1503(d)–3) of the dual consolidated loss during the remaining certification period by any means. See paragraph (j)(1) of this section for rules regarding the termination of domestic use agreements and annual certifications following rebuttals under this general rule.

(ii) *Certain asset transfers*. An event described in paragraph (e)(1)(iv) of this section shall not constitute a triggering event if the elector demonstrates, to the satisfaction of the Commissioner, that the transfer of assets did not result in a carryover under foreign law of the dual resident corporation's, or separate unit's, losses, expenses, or deductions to the transferee of the assets. For purposes of this determination, the exception to foreign use in §1.1503(d)–3(c)(7) shall be taken into account. Following rebuttal under this paragraph (e)(2)(ii), the domestic use agreement continues in effect.

(iii) *Reporting*. In order to satisfy the requirements of paragraph (e)(2)(i) or (ii) of this section, the elector must prepare a statement, labeled "Rebuttal of Triggering

Event" at the top of the page, that indicates that it is submitted under the provisions of this paragraph (e)(2). The statement must include the information described in paragraphs (c)(2)(ii) and (iii) of this section. The statement must also include the information described in paragraph (c)(2)(iv) of this section that supports the conclusions under paragraph (e)(2)(i) or (ii) of this section, as applicable. 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.

(iv) *Examples*. See §1.1503(d)–7(c) *Examples 32* and *33*.

(f) *Triggering event exceptions*—(1) *Continuing ownership of assets or interests*. The following events shall not constitute triggering events, requiring the recapture of the dual consolidated loss under paragraph (h) of this section:

(i) *Disaffiliation as a result of a transaction described in section 381*. 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) *Continuing ownership by consolidated group*. This paragraph (f)(1)(ii) applies when assets of an affiliated dual resident corporation, or assets of, or interests in, a separate unit of an affiliated domestic owner are sold or otherwise disposed of. In such a case, the sale or disposition shall not be treated as a triggering event to the extent the assets or interests are acquired by one or more members of the consolidated group that includes the affiliated dual resident corporation or affiliated domestic owner, or by a partnership or a grantor trust, but only if immediately after the acquisition more than 90 percent of the partnership's or grantor trust's interests is owned, directly or indirectly, by members of such consolidated group.

(iii) *Continuing ownership by unaffiliated dual resident corporation or unaffiliated domestic owner*. This paragraph (f)(1)(iii) applies when assets of an unaffiliated dual resident corporation, or assets of, or interests in, a separate unit of an unaffiliated domestic owner, are sold or otherwise disposed of. In such a case, the sale or disposition shall not be a triggering event to the extent such assets or interests are acquired by the unaffiliated dual resident corporation, or unaffiliated domestic owner, as applicable, or by a partnership or grantor trust, but only if immediately after the acquisition more than 90 percent of the partnership's or grantor trust's interests is owned, directly or indirectly, by the unaffiliated dual resident corporation or unaffiliated domestic owner. For example, this paragraph (f)(1)(iii) applies when an unaffiliated domestic owner acquires direct ownership of the assets of a separate unit that it had immediately before owned indirectly through a partnership.

(2) *Transactions requiring a new domestic use agreement*—(i) *Multiple-party events*. If all the requirements of paragraph (f)(2)(iii) of this section are satisfied, 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 assets of, or interests in, a separate unit, are sold or otherwise disposed of in a transaction in which such assets or interests are acquired by an unaffiliated domestic corporation, one or more members of a new consolidated group, or by a partnership or grantor trust, but only if immediately after the sale or disposition more than 90 percent of the partnership's or grantor trust's interests is owned, directly or indirectly, by the unaffiliated domestic owner or by members of a new consolidated group, as applicable. See the related exception to foreign use provided under §1.1503(d)–3(c)(8). See also §1.1503(d)–7(c) *Examples 36* and *37*.

(ii) *Events resulting in a single consolidated group*. If the requirements of paragraph (f)(2)(iii)(A) of this section are satisfied, the following events 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.

(B) A consolidated group ceases to exist as a result of a transaction described in §1.1502–13(j)(5)(i) (relating to acquisitions of the common parent of the consolidated group), 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)–7(c) *Example 34*.

(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 paragraph (f)(2) of this section.

(*2*) An agreement to assume the same obligations with respect to the dual consolidated loss as the unaffiliated dual resident corporation, unaffiliated domestic owner, or consolidated group, as applicable, that filed the original domestic use agreement (original elector) with respect to that loss. In such a case, obligations of an elector provided under this section shall also be considered to be obligations of a subsequent elector.

(*3*) In the event of a transaction described in section 384(a) involving the subsequent elector, 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 (for example, the threshold requirements under section 382(h)(3)(B)). The potential recapture amount treated as unrealized built-in gain under this paragraph (f)(2)(iii)(A)(*3*) may be reduced to the

extent permitted by paragraph (h)(2)(i) of this section.

(*4*) In the case of a multiple-party event described in paragraph (f)(2)(i) of this section, an agreement to be subject to the rules provided in paragraph (h)(3) of this section.

(*5*) The name, U.S. taxpayer identification number, and address of the original elector and prior subsequent electors, if any, with respect to the dual consolidated loss.

(B) *Statement filed by original elector*. In the case of a multiple-party event described in paragraph (f)(2)(i) of this section, 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 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 paragraph (f)(2) of this section.

(*2*) An agreement to be subject to the rules provided in paragraph (h)(3) of this section.

(*3*) The name, U.S. taxpayer identification number, and address of the subsequent elector.

(3) *Certain transfers qualifying for the de minimis exception to foreign use*. If a transaction or event qualifies for the *de minimis* exception to foreign use described in §1.1503(d)–3(c)(5), the transaction or event shall not constitute a triggering event under paragraph (e)(1)(iv) (transfers of assets) or (v) (transfers of an interest in a separate unit) of this section. For purposes of the preceding sentence, the transaction or event shall include deemed transfers that occur as a result of the transaction or event. See, for example, deemed transfers occurring pursuant to Rev. Rul. 99–5, 1999–1 C.B. 434, see §601.601(d)(2)(ii)(*b*), and section 708 and the related regulations. See also §1.1503(d)–7 *Example 5*. This paragraph (f)(3) only applies if the entire transaction or event qualifies for the *de minimis* exception to foreign use. For example, if a domestic owner sells five percent of a separate unit to a foreign corporation, which would qualify for the *de minimis* exception to foreign use if it were the only transfer, but pursuant to the same transaction also sells 70 percent of the same separate unit to another corporation in a manner that results in a triggering event under paragraph (e)(1)(v) of this section, this paragraph shall not apply to prevent the transaction from resulting in a triggering event.

(4) *Deemed transactions as a result of certain transfers that do not result in a foreign use*. The rules in this paragraph (f)(4) apply where the assets of, or the interests in, a separate unit are transferred in a transaction that would not result in a foreign use and, but for resulting deemed transactions or events, would not result in a triggering event described in paragraph (e)(1) of this section. For purposes of this paragraph (f)(4), deemed transactions or events shall include transactions or events that are deemed to occur pursuant to Rev. Rul. 99–5 and section 708 and the related regulations. In such a case, the deemed transactions shall not result in a triggering event under paragraph (e)(1)(iv) (transfers of assets) or (v) (transfers of an interest in a separate unit) of this section. See also §1.1503(d)–7 *Example 35*.

(5) *Compulsory transfers*. Transfers of the assets or stock of a dual resident corporation, or of the assets or interests in a separate unit, shall not constitute a triggering event (including a foreign use that occurs as a result of, or following, the transfer) if such transfers are—

(i) Legally required by a foreign government as a necessary condition of doing business in a foreign country;

(ii) Compelled by a genuine threat of immediate expropriation by a foreign government; or

(iii) The result of the expropriation of assets by the foreign government.

(6) *Subsequent triggering events*. Any triggering event described in paragraph (e) of this section that occurs subsequent to one of the transactions described in this paragraph (f), and that itself does not meet any of the exceptions provided in this paragraph (f), shall require recapture under paragraph (h) of this section by the elector or subsequent elector, as applicable.

(g) *Annual certification reporting requirement*. Unless and until the domestic use agreement is terminated pursuant to paragraph (j) 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 provide that there has been no foreign use of the 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 applicable, the certification must include a notification that an excepted triggering event under paragraph (f)(2) of this section has occurred with respect to the dual consolidated loss within the taxable year being certified. If dual consolidated losses of more than one taxable year are subject to the rules of this paragraph (g), the certification for those years may be combined in a single document, but each dual consolidated loss must be separately identified. See §1.1503(d)–3(e)(2)(ii) for additional certifications required where taxpayers elect the stand-alone exception of §1.1503(d)–3(e)(2).

(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) of this section that does not meet any of the exceptions provided in paragraph (f) of this section, the dual resident corporation or domestic owner of the separate unit shall recapture 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 taxable year during which such foreign use occurs). See §1.1503(d)–5(c)(4)(vi) for rules with respect to the attribution of recapture income to a separate unit. See also §1.1503(d)–7 *Examples 38* through *40*.

(ii) *Interest charge*. In connection with the recapture, the elector shall pay an interest charge. An interest charge may be due even if the amount of recapture income is reduced to zero pursuant to paragraph (h)(2)(i) of this section. See §1.1503(d)–7(c) *Example 39*. Except as otherwise provided in this section, the amount of the interest shall be computed under the rules of section 6601(a) by treating the additional tax resulting from the recapture as though it had been due and unpaid as of the date for payment of the tax for the taxable year in which the taxpayer received a tax benefit from the dual consolidated loss. For purposes of this paragraph (h)(1)(ii), a tax benefit shall be considered to have arisen in a taxable year in which the losses or deductions taken into account in computing the dual consolidated loss reduced U.S. taxable income. For the purpose of computing the interest charge, the additional tax resulting from the recapture is determined by treating the recapture income as the last income earned in the year of recapture. The interest shall be computed to the date for payment of the tax for the year of recapture and the interest thus computed becomes a part of the tax liability for that taxable year. See section 6601 for the computation of interest on a tax liability that it is not paid timely. The recapture interest charge shall be deductible to the same extent as interest under section 6601.

(2) *Reduction of presumptive recapture amount and presumptive interest charge*—(i) *Amount of recapture*. The dual resident corporation or domestic owner may recapture an amount less than the total dual consolidated loss if the elector demonstrates, to the satisfaction of the Commissioner, the lesser amount described in 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 (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 taxable year during which such foreign use occurs) if no domestic use election had been made for the loss such that it was subject to the domestic use limitation of §1.1503(d)–4(b) (and therefore subject to the limitation under §1.1503(d)–4(c)). For this purpose, the rules for attributing items of income, gain, deduction, and loss under §1.1503(d)–5 shall apply. An elector using this rebuttal rule must prepare a separate accounting showing the income for each year that would have offset the dual resident corporation's or separate unit's recapture amount if no domestic use election had been made for the dual consolidated loss. 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 this paragraph (h)(2)(i). 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. See §1.1503(d)–7(c) *Examples 38* through *40*.

(ii) *Interest charge*. The interest charge imposed under this section may be 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 recaptured dual consolidated loss was incurred, and for any other affected taxable years up to and including the taxable year of recapture, if no domestic use election had been made for the dual consolidated loss such that it had been subject to the restrictions of §1.1503(d)–4(b) (and therefore subject to the limitations under §1.1503(d)–4(c)). An elector using 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)–4(b) (and therefore subject to the limitations under §1.1503(d)–4(c)). 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 this paragraph (h)(2)(ii). 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)–7(c) *Examples 39* and *40*.

(3) *Rules regarding multiple-party event exceptions to triggering events*—(i) *Scope*. The rules of this paragraph (h)(3) apply when, after a triggering event described in paragraph (e) 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). See §1.1503(d)–7(c) *Examples 36* and *37*.

(ii) *Original elector and prior subsequent electors not subject to recapture or interest charge*—(A) Except to the extent otherwise provided in this paragraph (h)(3), neither the original elector nor any prior subsequent elector shall be subject to the rules of this paragraph (h) 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 this paragraph (h). For purposes of this paragraph (h), 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 shall take into account the recapture tax amount as determined under paragraph (h)(3)(iii)(B) of this section. 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 (or, when the subsequent triggering event is a foreign use of the dual consolidated loss, the taxable year that includes the last day of the foreign taxable year during which such foreign use occurs). The statement must be signed under penalties of perjury by the person who signs the return. The statement must be la-

beled "Statement Identifying 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)(*1*) through (*3*) of this section:

(*1*) A statement that the document is submitted under the provisions of §1.1503(d)–6(h)(3)(iii).

(*2*) A statement identifying the amount of the dual consolidated losses at issue and the taxable years in which they were used.

(*3*) The name, address, and taxpayer 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 that includes 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; over

(*2*) The income tax liability of the subsequent elector for such taxable year, computed by excluding the amount of recapture and related interest charge described in paragraph (h)(3)(iii)(B)(*1*) 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*—(1) *In general*. If the subsequent elector does not pay in full 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:

(*i*) The Commissioner properly has assessed the recapture tax amount pursuant to paragraph (h)(3)(iv)(A)(*1*) of this section.

(*ii*) 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.

(*iii*) The subsequent elector has failed to pay all of the recapture tax amount by the date specified in such notice and demand.

(*iv*) 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.

(*2*) *Joint and several liability*. 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 electors. The Commissioner shall then allocate and pay such refund to the original elector and prior subsequent electors, 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 the 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)–7(c) *Example 36*.

(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 may offset and absorb the recapture amount.

(ii) *Exception to presumptive rule*. The recapture amount included in gross income may be offset and absorbed by that portion of the elector's net operating loss carryover that is attributable to the dual resident corporation or separate unit that incurred the dual consolidated loss being recaptured, if the elector demonstrates, to the satisfaction of the Commissioner, the amount of such portion of the carryover. The principles of §1.1502–21(b)(2)(iv) shall apply for purposes of determining whether any portion of a net operating loss carryover is attributable to the dual resident corporation or separate unit. In the case of a separate unit, such determination shall be made by treating the separate unit as a domestic corporation and a member of the consolidated group composing its unaffiliated domestic owner, or members of the consolidated group of which its affiliated domestic owner is a member, as appropriate. 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), 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 (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 taxable year during which such foreign use occurs).

(5) *Character and source of recapture income*. The amount recaptured under this paragraph (h) 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, including sections 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 related regulations. For this determination, the *pro rata* computation of the items of deduction or loss composing the dual consolidated loss as described in §1.1503(d)–4(c)(4) shall apply. See §1.1503(d)–7(c) *Example 38*.

(6) *Reconstituted net operating loss*—(i) *General rule*. Except as provided in paragraphs (h)(6)(ii) and (iii) of this section, commencing in the taxable year immediately following the year in which the dual consolidated loss is recaptured, the dual resident corporation, or the domestic owner of the separate unit, that incurred the dual consolidated loss that is recaptured shall be treated as having a net operating loss (reconstituted net operating loss) in an amount equal to the amount actually recaptured under this paragraph (h). If a domestic corporation (transferee) acquires the assets of the dual resident corporation or domestic owner in a transaction described in section 381(a), the preceding sentence shall be applied by treating the transferee as the dual resident corporation or domestic owner, as applicable. In a case to which this paragraph (h)(6) applies, the transferee corporation shall be treated as having a reconstituted net operating loss in an amount equal to the amount actually recaptured under this paragraph (h). In no event, however, shall more than one corporation be treated as having a reconstituted net operating loss as a result of a single dual consolidated loss being recaptured. A reconstituted net operating loss of a domestic owner shall be attributable under §1.1503(d)–5 to the separate unit that incurred the dual consolidated loss that was recaptured. Moreover, a reconstituted net operating loss shall be subject to the domestic use limitation of §1.1503(d)–4(b) (and therefore subject to the limitation under §1.1503(d)–4(c)), without regard to the exceptions contained in paragraphs (b) through (d) of this section (relating to elective agreements in place between the United States and a foreign country, the ability to demonstrate no possibility of a foreign use, and a domestic use election, respectively). The reconstituted 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 reconstituted net operating 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)–7(c) *Examples 36*, *38*, and *40*.

(ii) *Exception*. Paragraph (h)(6)(i) of this section shall not apply to the extent the dual consolidated loss that is the basis of the recapture amount would have been eliminated pursuant to §1.1503(d)–4(d) if no domestic use election had been made for such loss. See §1.1503(d)–7(c) *Example 40*.

(iii) *Special rule for recapture following multiple-party event exception to a triggering event*. This paragraph applies to an excepted event described in paragraph (f)(2)(i)(B) of this section that is followed by a subsequent triggering event requiring recapture as described in paragraph (f)(6) of this section. In such a case, the domestic corporation that owns, directly or indirectly, the assets of the dual resident corporation, or the assets of or the interests in a separate unit, immediately following the excepted event shall be treated as if it incurred the dual consolidated loss that is recaptured for purposes of applying paragraph (h)(6)(i) of this section. See §1.1503(d)–7(c) *Example 36*.

(i) [Reserved].

(j) *Termination of domestic use agreement and annual certifications*—(1) *Rebuttals, exceptions to triggering events, and recapture*. The domestic use agreement filed with respect to a dual consolidated loss shall terminate prior to the end of the certification period and have no further effect if—

(i) An elector is able to rebut the presumption of a triggering event pursuant to the general rule in paragraph (e)(2)(i) of this section;

(ii) An event described in paragraph (e)(1) of this section is not a triggering event as a result of the application of paragraphs (f)(2)(i) or (ii) (relating to events requiring a new domestic use agreement) of this section; this paragraph (j)(1)(ii) does not, however, apply to terminate the new domestic use agreement filed in connection with the event pursuant to paragraph (f)(2)(iii)(A) of this section. See also paragraph (h)(3)(iv) of this section regarding collection from the original elector and prior subsequent electors in certain cases; or

(iii) A dual consolidated loss is recaptured pursuant to paragraph (h) of this section. See §1.1503(d)–7(c) *Examples 32* through *34*.

(2) *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 (as defined in §1.1503(d)–3) of the dual consolidated loss can occur in any other year by any means; and

(B) Prepares a statement described in paragraph (j)(2)(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 (j)(2)(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 information, in paragraphs labeled to correspond with the following:

(A) A statement that the document is submitted under the provisions of paragraph (j)(2) of this section.

(B) The information required by paragraph (c)(2)(ii) of this section.

(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) The information described in paragraph (c)(2)(iv) of this section that supports the conclusion that no foreign use can occur as provided in paragraph (j)(2)(i)(A) of this section.

(3) *Agreements filed in connection with stand-alone exception.* See §1.1503(d)–3(e)(2)(iii) for the termination of domestic use agreements filed in connection with the stand-alone exception to the mirror legislation rule when a subsequent election is made under paragraph (b) of this section (relating to agreements entered into between the United States and a foreign country).

§1.1503(d)–7 Examples.

(a) *In general.* This section provides examples that illustrate the application of §§1.1503(d)–1 through 1.1503(d)–6. 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. All the interests in $DE1_X$, $DE2_X$, and $DE3_Y$ constitute hybrid entity separate units.

(5) FB_X is a Country X business operation that, if carried on by a U.S. person, would constitute a foreign branch, as defined in §1.367(a)–6T(g)(1), and is a Country X foreign branch separate unit.

(6) Neither the assets nor the activities of an entity constitute 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 country 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)–3(e)(1), in the applicable foreign country.

(10) There is no elective agreement described in §1.1503(d)–6(b) between the United States and the applicable foreign country.

(11) There is no income tax convention between the United States and the applicable foreign country.

(12) If a domestic use election, within the meaning of §1.1503(d)–6(d), is made, all the necessary filings related to such election are properly completed on a timely basis.

(13) 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)–6(h)(2).

(14) There are no other items of income, gain, deduction, and loss. In addition, the United States and the applicable foreign country recognize the same items of income, gain, deduction, and loss in each taxable year.

(15) All taxpayers use the calendar year as their taxable year.

(c) *Examples.* The following examples illustrate the application of §§1.1503(d)–1 through 1.1503(d)–6:

Example 1. Separate unit combination rule. (i) *Facts.* P owns $DE3_Y$ which, in turn, owns $DE1_X$. $DE1_X$ owns FB_X. PRS, an entity treated as a partnership for both U.S. and Country X tax purposes, is owned 50 percent by P and 50 percent by an unrelated foreign person. PRS carries on a business operation 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)(1). In addition, P owns DRC_X, a member of the consolidated group of which P is the parent, which carries on business operations in Country X that constitute a foreign branch within the meaning of §1.367(a)–6T(g)(1). S owns $DE2_X$.

(ii) *Result.* Pursuant to §1.1503(d)–1(b)(4)(ii), the interest in $DE1_X$, the interest in $DE2_X$, FB_X, P's share of the Country X business operations carried on by PRS (which is owned by P indirectly through its interest in PRS), and DRC_X's Country X business operations are combined and treated as a single separate unit of the consolidated group of which P is the parent. This is the case regardless of whether the losses of each individual separate unit are made available to offset the income of the other individual separate units under Country X tax laws. Because DRC_X is a dual resident corporation, it is not combined and treated as part of this combined separate unit and, as a result, DRC_x's income or dual consolidated loss is not taken into account in determining the income or dual consolidated loss of the combined separate unit. In addition, P's interest in $DE3_Y$ is not combined and is another separate unit because it is subject to tax in Country Y, rather than Country X.

Example 2. Definition of a separate unit and application of domestic use limitation—foreign branch separate unit. (i) *Facts.* P carries on business operations in Country X that constitute a permanent establishment under the U.S.-Country X income tax convention. In year 1, a loss is attributable to P's Country X permanent establishment, as determined under §1.1503(d)–5.

(ii) *Result.* Under §§1.1503(d)–1(b)(4)(i)(A) and 1.367(a)–6T(g)(1), P's Country X permanent establishment constitutes a foreign branch separate unit. Therefore, the year 1 loss attributable to 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 to the dual consolidated loss 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 a Country X affiliate acquired in a year subsequent to the year in which the dual consolidated loss was incurred. See §1.1503(d)–6(a)(2). Accordingly, unless an exception under §1.1503(d)–6 applies (such as a domestic use election), the year 1 dual consolidated loss attributable to P's Country X permanent establishment is subject to the domestic use limitation rule of §1.1503(d)–4(b). As a result, pursuant to §1.1503(d)–4(c), the year 1 dual consolidated loss cannot offset income of P that is not attributable to its Country X foreign branch separate unit, nor can it offset income of any other domestic affiliate. The loss can, however, offset income of the Country X foreign branch separate unit, subject to the application of §1.1503(d)–4(c). The result would be the same even if Country X did not have a consolidation regime that includes as members of consolidated groups Country X branches or permanent establishments of nonresident corporations. 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 a sale, merger, or similar transaction. See §1.1503(d)–6(a)(2).

(iii) *Alternative facts*. The facts are the same as in paragraph (i) of this *Example 2*, except that P's Country X business operations constitute a foreign branch as defined in §1.367(a)–6T(g)(1), but do not constitute a permanent establishment under the U.S.-Country X income tax convention. Although the activities carried on by P in Country X would otherwise constitute a foreign branch separate unit as described in §1.1503(d)–1(b)(4)(i)(A), the exception under §1.1503(d)–1(b)(4)(iii) applies because the activities do not constitute a permanent establishment under the U.S.-Country X income tax convention. Thus, the Country X business operations do not constitute a foreign branch separate unit, and the year 1 loss is not subject to the dual consolidated loss rules. If P instead carried on its Country X business operations through $DE1_X$, then the exception under §1.1503(d)–1(b)(4)(iii) would not apply because P carries on the business operations through a hybrid entity and, as a result, the business operations would constitute a foreign branch separate unit. Thus, in such a case the year 1 loss would be subject to the dual consolidated loss rules.

Example 3. 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 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 is not subject to tax by Country X. In addition, such U.S. source income is not attributable to FB_X under §1.1503(d)–5.

(ii) *Result*. Under §1.1503(d)–1(b)(4)(i)(A), P's and S's shares of FB_X owned indirectly through their interests in PRS_X are individual foreign branch separate units. Pursuant to §1.1503(b)–1(b)(4)(ii), these individual separate units are combined and treated as a single separate unit of the consolidated group of which P is the parent. Unless an exception under §1.1503(d)–6 applies, any dual consolidated loss attributable to FB_X cannot offset income of P or S (other than income attributable to FB_X, subject to the application of §1.1503(d)–4(c)), including their distributive share of the U.S. source income earned through their interests in PRS_X, nor can it offset income of any other domestic affiliates.

Example 4. Definition of a separate unit and 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 Federal tax purposes. P, S, and FS_X, are the sole partners of HPS_X. For U.S. tax purposes, P, S, and FS_X each has an equal interest in each item of HPS_X's profit or loss. HPS_X carries on 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)(1).

(ii) *Result*. Under §1.1503(d)–1(b)(4)(i)(B), the partnership interests in HPS_X held by P and S are individual hybrid entity separate units. These individual separate units are combined into a single separate unit under §1.1503(d)–1(b)(4)(ii). In addition, P's and S's share of the Country Y operations owned indirectly through their interests in HPS_X are individual foreign branch separate units under §1.1503(d)–1(b)(4)(i)(B). These individual separate units are also combined into a single separate unit under §1.1503(d)–1(b)(4)(ii). Unless an exception under §1.1503(d)–6 applies, dual consolidated losses attributable to P's and S's combined interests in HPS_X can only be used to offset income attributable to their combined interests in HPS_X (other than income attributable to P's and S's combined interests in the Country Y foreign branch separate unit), subject to the application of §1.1503(d)–4(c). Similarly, dual consolidated losses attributable to P's and S's combined interests in the Country Y operations of HPS_X can only be used to offset income attributable to their combined interests in such Country Y operations, subject to the application of §1.1503(d)–4(c). Neither FS_X's interest in HPS_X, nor its share of the Country Y operations owned by HPS_X, is a separate unit because FS_X is not a domestic corporation.

Example 5. Foreign use—general rule and de minimis reduction exception. (i) *Facts*. P owns $DE1_X$. $DE1_X$ owns FS_X. In year 1, there is a $100x loss attributable to P's interest in $DE1_X$ that is a dual consolidated loss. Also in year 1, FS_X earns $200x of income. $DE1_X$ and FS_X file a Country X consolidated tax return. For Country X tax purposes, the year 1 $100x loss of $DE1_X$ is used to offset $100x of year 1 income generated by FS_X. Under Country X tax law, unused losses are carried forward and available to offset income in subsequent taxable years.

(ii) *Result*. The $100x loss attributable to P's interest in $DE1_X$ is available to, and in fact does, offset FS_X's income under the laws of Country X. In addition, under U.S. tax principles, such income is considered to be an item of FS_X, a foreign corporation. As a result, under §1.1503(d)–3(a), 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 loss as provided under §1.1503(d)–6(d)(2), and such loss will be subject to the domestic use limitation rule of §1.1503(d)–4(b). The result would be the same even if FS_X, under Country X tax law, 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 tax law requires an election, and no such election is made).

(iii) *Alternative facts*. The facts are the same as in paragraph (i) of this *Example 5*, except that FS_X cannot use the loss of $DE1_X$ under Country X tax law without an election, and no such election is made. Pursuant to the exception in §1.1503(d)–3(c)(2), there is no foreign use of the year 1 dual consolidated loss attributable to P's interest in $DE1_X$. In addition, P files a domestic use election with respect to the year 1 dual consolidated loss attributable to its interest in $DE1_X$ and, at the beginning of year 3, P sells its interest in $DE1_X$ to F, a Country Y entity that is a foreign corporation. The sale of the interest in $DE1_X$ to F results in a foreign use triggering event pursuant to §1.1503(d)–6(e)(1)(i) because, immediately after the sale, the loss attributable to the interest in $DE1_X$ carries over under Country X law and, therefore, is available under U.S. tax principles to offset income of the owner of the interest in $DE1_X$ which, in the hands of F, is not a separate unit. It is also a foreign use because the loss is available under U.S. tax principles to offset the income of F, a foreign corporation. See §1.1503(d)–3(a)(1). Finally, the transfer is a triggering event pursuant to §1.1503(d)–6(e)(1)(iv) and (v).

(iv) *Alternative facts*. The facts are the same as in paragraph (iii), of this *Example 5*, except that P only sells 5 percent of its interest in $DE1_X$ to F. Pursuant to Rev. Rul. 99–5, 1999–1 C.B. 434, see §601.601(d)(2)(ii)(b) of this chapter, the transaction is treated as if P sold 5 percent of its interest in each of $DE1_X$'s assets to F, and then immediately thereafter P and F transferred their interests in the assets of $DE1_X$ to a partnership in exchange for an ownership interest therein. The sale of the 5 percent interest in $DE1_X$ generally results in a foreign use triggering event because a portion of the dual consolidated loss carries over under Country X tax law and is available under U.S. tax principles to offset income of the owner of the interest in $DE1_X$, a hybrid entity, which in the hands of F is not a separate unit. It is also a foreign use because the loss is available under U.S. tax principles to offset the income of F, a foreign corporation. See §1.1503(d)–3(a)(1). However, pursuant to the exception under §1.1503(d)–3(c)(5) (relating to a *de minimis* reduction of an interest in a separate unit), such availability does not result in a foreign use. In addition, pursuant to §1.1503(d)–6(f)(1) and (3), the deemed transfers pursuant to Rev. Rul. 99–5 as a result of the sale are not treated as triggering events described in §1.1503(d)–6(e)(1)(iv) or (v).

Example 6. Foreign use and indirect foreign use—foreign reverse hybrid structure and disregarded payments. (i) *Facts*. P owns $DE1_X$. $DE1_X$ owns 99 percent and S owns 1 percent of FRH_X, a Country X partnership that elected to be treated as a corporation for U.S. tax purposes. FRH_X conducts a trade or business in Country X. In year 1, $DE1_X$ incurs interest expense on a third-party loan, which constitutes a dual consolidated loss attributable to P's interest in $DE1_X$. In year 1, for Country X tax purposes, $DE1_X$ takes into account its distributive share of income generated by FRH_X and offsets such income with its interest expense.

(ii) *Result*. In year 1, the dual consolidated loss attributable to P's interest in $DE1_X$ is available to, and in fact does, offset 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)–3(a)(1), there is a foreign use of the dual consolidated loss. Therefore, P cannot make a domestic use election with respect to the year 1 dual consolidated loss attributable to its interest in $DE1_X$, as provided under §1.1503(d)–6(d)(2), and such loss will be subject to the domestic use limitation rule of §1.1503(d)–4(b).

(iii) *Alternative facts*. (A) The facts are the same as in paragraph (i) of this *Example 6*, except as follows. Instead of owning $DE1_X$, P owns $DE3_Y$ which, in turn, owns $DE1_X$. In addition, $DE3_Y$, rather than $DE1_X$, is the obligor on the third-party loan and therefore incurs the interest expense on such loan. Finally, $DE3_Y$ on-lends the loan proceeds from the third-party loan to $DE1_X$, and $DE1_X$ pays interest to $DE3_Y$ on such loan that is generally disregarded for U.S. tax purposes.

(B) Pursuant to §1.1503(d)–5(c)(1)(ii), for purposes of calculating income or a dual consolidated loss, $DE3_Y$ and $DE1_X$ do not take into account interest income or interest expense, respectively, with respect to amounts paid on the disregarded loan from $DE3_Y$ to $DE1_X$. As a result, such items neither create

a dual consolidated loss with respect to the interest in $DE1_X$, nor do they reduce (or eliminate) the dual consolidated loss attributable to the interest in $DE3_Y$. Thus, in year 1, there is a dual consolidated loss attributable to P's interest in $DE3_Y$, but not to P's indirect interest in $DE1_X$.

(C) In year 1, interest expense paid by $DE1_X$ to $DE3_Y$ on the disregarded loan is taken into account as a deduction in computing $DE1_X$'s taxable income for Country X tax purposes, but does not give rise to a corresponding item of income or gain for U.S. tax purposes (because it is generally disregarded). In addition, such interest has the effect of making an item of deduction or loss composing the dual consolidated loss attributable to P's interest in $DE3_Y$ available for a foreign use. This is the case because it may reduce or offset items of deduction or loss composing the dual consolidated loss for foreign tax purposes, and creates another deduction or loss that may reduce or offset income of $DE1_X$ for foreign tax purposes that, under U.S. tax principles, is treated as income of FRH_X, a foreign corporation. Moreover, because the disregarded item is incurred or taken into account as interest for foreign tax purposes, it is deemed to have been incurred or taken into account with a principal purpose of avoiding the provisions of section 1503(d). Accordingly, there is an indirect foreign use of the year 1 dual consolidated loss attributable to P's interest in $DE3_Y$, and P cannot make a domestic use election with respect to such loss as provided under §1.1503(d)–6(d)(2). Thus, the loss will be subject to the domestic use limitation rule of §1.1503(d)–4(b).

Example 7. Indirect foreign use—hybrid instrument. (i) *Facts.* P owns $DE1_X$ which, in turn, owns FS_X. $DE1_X$ borrows cash from an unrelated lender and transfers the cash to FS_X in exchange for an instrument (hybrid instrument). The hybrid instrument is treated as equity for U.S. tax purposes and debt for Country X tax purposes. Interest expense on the loan from the unrelated lender results in a dual consolidated loss being attributable to P's interest in $DE1_X$ in year 1. $DE1_X$ does not elect under Country X law to consolidate with FS_X. In year 1, FS_X distributes its stock as a payment on the hybrid instrument to $DE1_X$. For U.S. tax purposes, such payment is excluded from P's gross income under section 305. However, for Country X tax purposes, such payment is treated as interest and gives rise to a deduction taken into account in computing FS_X's Country X tax liability; the payment also gives rise to interest income to $DE1_X$ for Country X tax purposes.

(ii) *Result.* The payment on the hybrid instrument does not give rise to an item of income or gain for U.S. tax purposes and therefore does not reduce (or eliminate) the dual consolidated loss attributable to P's interest in $DE1_X$. In addition, such payment is taken into account as a deduction in computing FS_X's taxable income for Country X tax purposes. Moreover, such payment has the effect of making an item of deduction or loss composing the dual consolidated loss attributable to P's interest in $DE1_X$ available for a foreign use. This is the case because it may reduce or offset items of deduction or loss composing the dual consolidated loss for foreign tax purposes, and creates a deduction that reduces or offsets income of FS_X for foreign tax purposes that, under U.S. tax principles, is income of a foreign corporation. Further, because the item is incurred, or taken into account, using an instrument that is treated as equity for U.S. tax purposes and debt for foreign tax purposes, it is deemed to have been engaged in with the principal purpose of avoiding the provisions of section 1503(d). As a result, there has been an indirect foreign use of the year 1 dual consolidated loss, and P cannot make a domestic use election with respect to such loss, as provided under §1.1503(d)–6(d)(2). Thus, the year 1 dual consolidated loss will be subject to the domestic use limitation rule of §1.1503(d)–4(b).

Example 8. No indirect foreign use—transaction entered into in the ordinary course of business. (i) *Facts.* P owns $DE1_X$ and FB_Y. FB_Y is a foreign branch separate unit located in Country Y. $DE1_X$ owns FB_X and FS_X. P's interest in $DE1_X$ and FB_X are combined and treated as a single separate unit (Country X separate unit) pursuant to §1.1503(d)–1(b)(4)(ii). Under Country X tax laws, $DE1_X$ elects to consolidate with FS_X. FB_Y engages in the business of providing services and, in connection with its ordinary course of business, provides services to unrelated third parties and to $DE1_X$. As compensation for services, $DE1_X$ makes a payment to FB_Y. Under Country X tax law, the payment is deductible. However, the payment is generally disregarded for U.S. tax purposes and, pursuant to §1.1503(d)–5(c)(1)(ii), is not taken into account in calculating the income or dual consolidated loss attributable to the Country X separate unit or FB_Y. In year 1, the Country X separate unit and FB_Y each has a dual consolidated loss. The dual consolidated loss attributable to the Country X separate unit is subject to the domestic use limitation under §1.1503(d)–4(b) because $DE1_X$ and FS_X elect to consolidate and, as a result, the dual consolidated loss is put to a foreign use.

(ii) *Result.* The payment made by $DE1_X$ to FB_Y in connection with the performance of services is taken into account as a deduction in computing $DE1_X$'s taxable income for Country X tax purposes, but does not give rise to an item of income or gain for U.S. tax purposes. In addition, such payment has the effect of making an item of deduction or loss composing the dual consolidated loss attributable to FB_Y available for a foreign use. This is the case because it may reduce or offset items of deduction or loss composing the dual consolidated loss of FB_Y for foreign tax purposes, and creates another deduction that reduces or offsets income of FS_X for foreign tax purposes (because $DE1_X$ and FS_X elect to file a consolidated return) that, under U.S. tax principles, is income of a foreign corporation. However, the transaction between $DE1_X$ and FB_Y was entered into in the ordinary course of FB_Y's trade or business. As a result, if P can demonstrate to the satisfaction of the Commissioner that the transaction was not entered into with a principal purpose of avoiding the provisions of section 1503(d), FB_Y's year 1 dual consolidated loss will not be treated as having been made available for an indirect foreign use. In such a case, P would be entitled to make a domestic use election with respect to such loss.

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 percent 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. FS_X owns the remaining 20 percent of HPS_X. In year 1, DRC_X generates a $100x net operating loss (without regard to items attributable to DRC_X's interest in HPS_X). Also in year 1, HPS_X generates $100x of income, $80x of which is attributable to DRC_X's interest in HPS_X. 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.* DRC_X and its interest in HPS_X are not combined because DRC_X is a dual resident corporation and the combination rule under §1.1503(d)–1(b)(4)(ii) only applies to separate units. The $100x year 1 net operating loss incurred by DRC_X (without regard to items attributable to DRC_X's interest in HPS_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 (instead, there is $80x of income attributable to such separate unit). DRC_X's year 1 dual consolidated loss offsets $100x of income for Country X purposes, and $20x of such income is, under U.S. tax principles, income of FS_X, which owns an interest in HPS_X that is not a separate unit (in addition, FS_X is a foreign corporation). As a result, pursuant to §1.1503(d)–3(a), 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)–6(d)(2). Therefore, such loss will be subject to the domestic use limitation rule of §1.1503(d)–4(b). The result would be the same even if HPS_X, under Country X laws, had no income against which the dual consolidated loss could be offset (unless the ability to use the loss under Country X laws required an election, and no such election is made).

Example 10. Foreign use—foreign parent corporation. (i) *Facts.* F1 and F2, nonresident alien individuals, each owns 50 percent of FP_X, a Country X entity that is subject to Country X tax on its worldwide income. FP_X is classified as a foreign 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 incurs 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 for Country X tax purposes, 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)–3(a), 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)–6(d)(2). As a result, such loss will be subject to the domestic use limitation rule of §1.1503(d)–4(b).

(iii) *Alternative facts.* The facts are the same as in paragraph (i) of this *Example 10*, except that FP_X is classified as a partnership for U.S. tax purposes. The result would be the same as in paragraph (ii) of this *Example 10*, because the offset of the in-

come generated by FP_X is a foreign use pursuant to §1.1503(d)–3(a). This is the case 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. Moreover, the result would be the same if F1 and F2 owned their interests in FP_X indirectly through another partnership.

Example 11. 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. $DE1_X$ owns FB_X. P's interest in $DE1_X$ and P's indirect interest in FB_X are individual separate units that are combined into a single separate unit (Country X separate unit) pursuant to §1.1503(d)–1(b)(4)(ii). In year 1, DRC_X incurs a $200x net operating loss and $200x of income is attributable to P's Country X separate unit. The $200x net operating loss incurred by DRC_X is a dual consolidated loss. FS_X also earns $200x of income in year 1. 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)–3(c)(3), DRC_X's $200x loss shall be treated as having been made available to offset the $200x of income attributable to P's Country X separate unit. P's Country X separate unit is not, under U.S. tax principles, a foreign corporation, and there is no interest in $DE1_X$ (which is a hybrid entity) that is not a separate unit. As a result, DRC_X's loss being made available to offset the income attributable to P's Country X separate unit 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.

(iii) *Alternative facts.* The facts are the same as in paragraph (i) of this *Example 11*, except that in year 1 only $150x of income is attributable to P's Country X separate unit. Because only $150x of income is attributed to P's Country X separate unit, $50x of DRC_X's year 1 dual consolidated loss is treated as being made available to offset the income of FS_X, a foreign corporation, and therefore constitutes a foreign use. As a result, DRC_X cannot make a domestic use election with respect to its year 1 dual consolidated loss pursuant to §1.1503(d)–6(d)(2), and such loss will be subject to the domestic use limitation rule of §1.1503(d)–4(b).

Example 12. 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 taxable years. Country X law does not provide ordering rules for determining when a loss from a particular taxable year is used because, under Country X law, losses never expire. In addition, Country X law does not provide ordering rules for determining when a particular type of loss (for example, capital or ordinary) is used.

(B) In year 1, DRC_X incurs a capital loss of $80x which, under §1.1503(d)–5(b)(2), is not a dual consolidated loss. DRC_X also incurs a net operating loss of $80x in year 1 which is a dual consolidated loss. 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. Under the laws of Country X, 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 both year 2 and year 3, DRC_X incurs a net operating loss of $100x, while FS_X incurs no income or loss in years 2 and 3. DRC_X's $100x losses incurred in year 2 and year 3 are dual consolidated losses. Because DRC_X does not elect under the laws of Country X to use all or a portion of its year 2 or year 3 net operating losses 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 both the year 2 and year 3 dual consolidated losses of DRC_X. In year 4, DRC_X has a net operating loss of $10x and FS_X generates $125x of income. Country X law permits, upon an election, FS_X's $125x of income generated in year 4 to be offset by losses (including carryover losses from prior years) of other group members. Accordingly, in year 4, DRC_X elects to use $125x of its accumulated losses to offset the $125x of year 4 income generated by FS_X.

(ii) *Result.* (A) Under the ordering rules of §1.1503(d)–3(d)(3), 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 cannot make a domestic use election with respect to DRC_X's year 1 $80x dual consolidated loss because a portion of such loss is put to a foreign use.

(B) DRC_X's $10x year 4 net operating loss is also a dual consolidated loss. Under the ordering rules of §1.1503(d)–3(d)(1), such loss is considered to be used to offset $10x of FS_X's year 4 $125x of income. Consequently, P cannot make a domestic use election with respect to such loss. Under the ordering rules of §1.1503(d)–3(d)(2), $50x of capital loss carryover and $50x of ordinary loss from year 1 will be considered to offset $100x of FS_X's year 4 income because the income is first deemed to have been offset by losses the use of which would not constitute a triggering event that would result in the recapture of a dual consolidated loss. The remaining $15x of FS_X's year 4 income is considered to be offset by losses from year 3 because it is the most recent taxable year from which a loss may be carried forward. Thus, a portion of the year 3 dual consolidated loss has been put to a foreign use and the entire year 3 dual consolidated loss is recaptured. However, none of DRC_X's $100x year 2 net operating loss will be deemed to offset FS_X's year 4 income. As a result, DRC_X's year 2 dual consolidated loss will not be recaptured.

Example 13. Exception to foreign use through partnership interest. (i) *Facts.* (A) P owns 80 percent of HPS_X, a Country X entity subject to Country X tax on its worldwide income. FS_Z, an unrelated foreign corporation, owns the remaining 20 percent of HPS_X. HPS_X is classified as a partnership for Federal tax purposes and carries on 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)(1). P's interest in HPS_X and P's indirect interest in the Country X branch are individual separate units that are combined into a single separate unit (Country X separate unit) pursuant to §1.1503(d)–1(b)(4)(ii).

(B) In year 1, HPS_X incurs a loss of $100x, $80x of which is attributable to P's Country X separate unit. The $80x of loss attributable to P's Country X separate unit constitutes a dual consolidated loss and P makes a domestic use election with respect to such loss. In year 2, HPS_X generates $50x of income, $40x of which is attributable to P's interest in the Country X separate unit. 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 FS_Z maintain their 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 $80x dual consolidated loss attributable to P's Country X separate unit, is made available to offset income of HPS_X. Such income is attributable to P's interest in HPS_X, which is a separate unit. Such income also is income of FS_Z, a foreign corporation that is an owner of an interest in HPS_X, which is not a separate unit. However, pursuant to §1.1503(d)–3(c)(4), there is no foreign use of the year 1 dual consolidated loss in year 2. This is the case because P's interest in HPS_X as of the end of year 1 has not been reduced by more than a *de minimis* amount, and the portion of the $80x dual consolidated loss was made available for a foreign use in year 2 solely as a result of FS_Z's ownership in HPS_X and the allocation or carry forward of the dual consolidated loss as a result of such ownership.

(iii) *Alternative facts.* The facts are the same as in paragraph (i) of this *Example 13*, except that P also owns FS_X. In addition, FS_X and HPS_X elect to file a consolidated return under Country X law. The exception to foreign use under §1.1503(d)–3(c)(4) does not apply because there is a foreign use other than by reason of the dual consolidated loss being made available as a result of FS_Z's ownership in HPS_X and the allocation or carry forward of the dual consolidated loss as a result of such ownership. That is, the exception does not apply because there is also a foreign use of the dual consolidated loss as a result of FS_X and HPS_X filing a consolidated return under Country X law.

(iv) *Alternative facts.* The facts are the same as in paragraph (i) of this *Example 13*, except that at the end of year 2, FS_Z contributes cash to HPS_X in exchange for additional equity of HPS_X. As a result of the contribution, FS_Z's interest in HPS_X increases from 20 percent to 30 percent, and P's interest in HPS_X decreases from 80 percent to 70 percent. P's interest in HPS_X is reduced within a single 12-month period by 12.5 percent (10/80), as compared to P's interest in HPS_X as of the beginning of such 12-month period. Accordingly, pursuant to §1.1503(d)–3(c)(4)(iii), the exception to foreign use provided under §1.1503(d)–3(c)(4)(i) does not apply. Therefore, in year 2 there is a foreign use of the $80x year 1 dual consolidated loss attributable to P's Country X separate unit. Such foreign use constitutes a triggering event in year 2 and the $80x year 1 dual consolidated loss is recaptured. Alternatively, if FS_Z were a domestic corporation, there would not be a for-

eign use of the $80x year 1 dual consolidated loss because the loss would not be available to offset income that, under U.S. tax principles, is income of a foreign corporation or a direct or indirect owner of an interest in a hybrid entity that is not a separate unit.

Example 14. Exception to foreign use through partnership interest—combination rule. (i) *Facts.* (A) P and FS_X form PRS_X. P and FS_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 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. DE_Y conducts business operations in Country Y that, if carried on by a U.S. person, would constitute a foreign branch as defined in §1.367(a)–6T(g)(1). P's interest in the Country Y operations conducted by DE_Y is an individual foreign branch separate unit. P's interest in DE_Y, owned indirectly through PRS_X, is a hybrid entity individual separate unit. P also owns FB_Y, a Country Y foreign branch individual separate unit. Under §1.1503(d)–1(b)(4)(ii), FB_Y and P's indirect interests in DE_Y and DE_Y's Country Y business operations are treated as a combined separate unit (Country Y separate unit).

(B) In year 1, there is a $100x loss attributable to the Country Y business operations conducted by DE_Y. Thus, there is a $50x loss attributable to P's interest in DE_Y's Country Y business operations in year 1. Also in year 1, there is a $200x loss attributable to FB_Y. No income or loss is attributable to P's interest in DE_Y in year 1. Under §1.1503(d)–5(c)(4)(ii), the dual consolidated loss attributable to P's combined Country Y separate unit is $250x ($50x loss attributable to P's indirect interest in DE_Y's Country Y operations, plus $200x loss attributable to FB_Y). In year 2, neither DE_Y nor DE_Y's Country Y operations generates income or loss. 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.

(ii) *Result.* As a result of the carryover of the year 1 $100x loss (which includes $50x of the year 1 dual consolidated loss) under Country Y law, 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 FS_X's indirect ownership of DE_Y. Accordingly, under §1.1503(d)–3(a), 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 FS_X is a foreign corporation). However, there has not been a reduction of P's interest in DE_Y, DE_Y has not consolidated under the laws of Country Y, and there has not been any other foreign use of the dual consolidated losses. As a result, no foreign use occurs as a result of the carryforward pursuant to §1.1503(d)–3(c)(4)(i) and (ii).

Example 15. No foreign use—asset basis carryover exception. (i) *Facts.* P owns FB_X and FS_X. In year 1, there is a dual consolidated loss attributable to FB_X. P's items of income, gain, deduction, and loss that are taken into account in calculating FB_X's dual consolidated loss include depreciation deductions attributable to FB_X's assets. P makes a domestic use election under §1.1503(d)–6(d) with respect to the year 1 dual consolidated loss of FB_X. At the end of year 2, P contributes a portion of FB_X's assets to FS_X, in exchange for stock in FS_X. The aggregate adjusted basis of the assets transferred by P to FS_X is less than 10 percent of the aggregate adjusted basis of all of FB_X's assets held at the beginning of year 2. In addition, no other assets of FB_X are transferred during the certification period. Under Country X law, FS_X's basis in the transferred assets is determined by reference to P's basis in such assets. In addition, under Country X law, a portion of the depreciation deductions that were taken into account in year 1 for U.S. tax purposes, are taken into account in year 2 for Country X tax purposes.

(ii) *Result.* As a result of the transfer of assets from P to FS_X, a portion of the year 1 dual consolidated loss is available for a foreign use. This is the case because a portion of the basis in FB_X's assets, which gave rise to depreciation deductions that were taken into account in computing the year 1 dual consolidated loss, will give rise to a depreciation deduction under Country X laws that will be available, under U.S. tax principles, to offset the income of FS_X, a foreign corporation, in year 2. However, the aggregate adjusted basis of all the assets transferred by P to FS_X, within the 12-month period ending at the end of year 2, is less than 10 percent of the aggregate adjusted basis of all of FB_X's assets at the beginning of such 12-month period. Moreover, the aggregate adjusted basis of the assets transferred by P to FS_X at any time during the certification period is less than 30 percent of the aggregate adjusted basis of FB_X's assets held at the end of year 1. In addition, the item of deduction giving rise to the foreign use is being made available solely as a result of the adjusted basis of the transferred assets being determined in whole, or in part, by reference to the adjusted basis of such transferred assets in the hands of FB_X. As a result, this transfer will not result in a foreign use pursuant to §1.1503(d)–3(c)(6).

Example 16. No foreign use—liability assumption exception. (i) *Facts.* P owns FB_X. In year 1, there is a dual consolidated loss attributable to FB_X for which P makes a domestic use election under §1.1503(d)–6(d). The dual consolidated loss includes a deduction for salary expense that was deductible for U.S. tax purposes at the end of year 1, even though it was not paid until year 2. The deduction was incurred in the ordinary course of FB_X's trade or business. During year 2, and before the accrued salary expense liability was paid, P sells all the assets of FB_X to FS_X in exchange for cash and FS_X's assumption of the liabilities of the FB_X trade or business, including the obligation to pay the accrued salary expense. Under Country X law, the accrued salary expense of FB_X is deductible, and is taken into account for purposes of computing the taxable income of FB_X, when paid. FB_X pays the accrued salary expense after the sale of FB_X to FS_X.

(ii) *Result.* (A) As a result of FS_X's assumption of the FB_X liabilities, including the accrued salary expense, a portion of the dual consolidated loss is available for a foreign use in year 2. This is the case because the deduction that was taken into account in year 1 in computing the dual consolidated loss under U.S. tax principles will, under Country X tax law, be taken into account and will be available to offset the income of FS_X, a foreign corporation, in year 2. However, because this item of expense is made available solely as a result of the assumption of a liability of FB_X, and such liability was incurred in the ordinary course of FB_X's trade or business, there will not be a foreign use of the year 1 dual consolidated loss pursuant to §1.1503(d)–3(c)(7).

(B) The transfer of all the assets of FB_X to FS_X is a triggering event under §1.1503(d)–6(e)(1)(iv), unless P can rebut the triggering event under §1.1503(d)–6(e)(2). For purposes of determining whether, under §1.1503(d)–6(e)(2)(ii), the transfer of assets resulted in a carryover under foreign law of FB_X's losses, expenses, or deductions, the exception to foreign use for the assumption of liabilities is taken into account. However, the other exceptions to foreign use do not apply for this purpose (or for purposes of demonstrating that no foreign use of a dual consolidated loss can occur in any other year under §1.1503(d)–6(c), (e)(2)(i) or (j)(2)). See §1.1503(d)–3(c)(1). Provided the other requirements of §1.1503(d)–6(e)(2)(ii) and (iii) are satisfied, P may be able to rebut the occurrence of a triggering event upon the transfer of FB_X's assets to FS_X.

Example 17. Mirror legislation rule—dual resident corporation and hybrid entity separate unit. (i) *Facts.* P owns DRC_X, a member of the P consolidated group. DRC_X owns FS_X. In year 1, DRC_X incurs 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 consolidation. 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)–3(e), because the losses of DRC_X are subject to Country X's mirror legislation, there is a deemed foreign use of DRC_X's year 1 dual consolidated loss. The stand-alone exception to the mirror rule in §1.1503(d)–3(e)(2) does not apply because, absent the mirror legislation, DRC_X's year 1 dual consolidated loss would be available for a foreign use (as defined in §1.1503(d)–3), without regard to whether such availability is limited by election or similar procedure. That is, absent the mirror legislation, all or a portion of the dual consolidated loss would be available to offset the income of FS_X under the Country X consolidation regime. This is the case even if Country X did not recognize DRC_X as having a loss in year 1. Therefore, P may not make a domestic use election with respect to DRC_X's year 1 dual consolidated loss pursuant to §1.1503(d)–6(d)(2).

(iii) *Alternative facts.* The facts are the same as in paragraph (i) of this *Example 17*, except that P owns $DE1_X$ (rather than DRC_X) and, in year 1, there is a $100 dual consolidated loss attributable to P's interest in $DE1_X$ (rather than of DRC_X). The Country X mirror legislation only applies to Country X dual resident corporations and, therefore, does not apply to losses attributable to P's interest in $DE1_X$. As a result, the mirror legislation rule under §1.1503(d)–3(e) would not deny the opportunity of such loss from being put to a foreign use (for example, by offsetting the income of FS_X through the Country X consolidation regime). Therefore, a domestic use election can be made with respect to the dual consolidated loss (pro-

vided the conditions for such an election are otherwise satisfied).

Example 18. Mirror legislation rule—standalone foreign branch separate unit. (i) *Facts.* P owns FB_X. In year 1, there is a $100x dual consolidated loss attributable to FB_X. Country X enacted mirror legislation to prevent Country X branches and permanent establishments of nonresident corporations from offsetting losses both against income of Country X affiliates and against other income of its owner (or foreign affiliates thereof) under the tax laws of another country. The Country X mirror legislation prevents a Country X branch or permanent establishment 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 or permanent establishment) under the laws of another country.

(ii) *Result.* In general, under §1.1503(d)–3(e), because the losses of FB_X are subject to Country X's mirror legislation, there is a deemed foreign use of FB_X's year 1 dual consolidated loss. However, in the absence of the Country X mirror legislation, no item of deduction or loss composing FB_X's year 1 dual consolidated loss would be available in the year incurred for a foreign use (as defined in §1.1503(d)–3), without regard to whether such availability is limited by election or otherwise. This is the case because there is no Country X entity through which the dual consolidated loss could be put to a foreign use (absent a sale, merger, or similar transaction involving FB_X). As a result, the stand-alone exception in §1.1503(d)–3(e)(2) may apply, provided P complies with the requirements of §1.1503(d)–3(e)(2)(ii). Accordingly, P may make a domestic use election with respect to the year 1 dual consolidated loss of FB_X pursuant to §1.1503(d)–6(d). If, however, any item of the dual consolidated loss would otherwise be available for a foreign use during the certification period (for example, as a result of P acquiring a foreign corporation that is organized under the laws of Country X such that losses of FB_X could be put to a foreign use through consolidation or similar means), then such loss would be recaptured pursuant to §1.1503(d)–6(e)(1)(ix).

(iii) *Alternative facts.* The facts are the same as in paragraph (i) of this *Example 18*, except that the Country X mirror legislation operates in a manner similar to the rules under section 1503(d). That is, it allows the taxpayer to elect to use the loss to either offset income of an affiliate in Country X, or income of an affiliate (or other income of the owner of the Country X branch or permanent establishment) in the other country, but not both. Because the Country X mirror legislation permits the taxpayer to choose to put the dual consolidated loss to a foreign use, it does not deny the opportunity to put the loss to a foreign use. Therefore, there is no deemed foreign use of the dual consolidated loss pursuant to §1.1503(d)–4(e) and a domestic use election can be made for such loss.

Example 19. Application of mirror legislation rule to combined separate unit. (i) *Facts.* P owns FB_X, FS_X, and $DE1_X$. In year 1, there is a $50x dual consolidated loss attributable to FB_X and $10x of income attributable to P's interest in $DE1_X$. FS_X has income of $100x. Pursuant to §1.1503(d)–1(b)(4)(ii), FB_X and P's interest in $DE1_X$ are combined and treated as a single separate unit (Country X separate unit) which has a year 1 dual consolidated loss of $40x. Country X enacted mirror legislation to prevent Country X branches or permanent establishments of nonresident corporations from offsetting losses both against income of Country X affiliates and against other income of its owner (or foreign affiliates thereof) under the tax laws of another country. The Country X mirror legislation prevents a Country X branch or permanent establishment 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 or permanent establishment) under the laws of another country. However, the United States and Country X have entered into an agreement described in §1.1503(d)–6(b) pursuant to the U.S.-Country X income tax convention (mirror agreement). The mirror agreement applies to Country X foreign branch separate units of domestic corporations, but not to Country X hybrid entity separate units. The mirror agreement provides that neither the Country X mirror legislation nor the mirror legislation rule under §1.1503(d)–3(e) will apply to losses attributable to Country X foreign branch separate units, provided certain conditions and reporting requirements are satisfied (including a domestic use election, if the loss is to be used to offset income of a domestic affiliate). Thus, losses attributable to Country X foreign branch separate units can, subject to the requirements of the mirror agreement, be used to offset income of a domestic affiliate or a Country X affiliate (but not both).

(ii) *Result.* The Country X mirror legislation only applies to Country X foreign branch separate units and does not apply to hybrid entity separate units. In addition, if P complies with the terms and conditions of the mirror agreement, the Country X mirror legislation would not apply to FB_X. As a result, the income tax laws of Country X would not deny the opportunity of a loss of either individual separate unit that composes P's combined Country X separate unit from being put to a foreign use. Therefore, notwithstanding §1.1503(d)–3(e), a domestic use election can be made with respect to the dual consolidated loss attributable to P's Country X separate unit, provided the terms and conditions of the mirror agreement are satisfied. See §1.1503(d)–6(b)(2).

(iii) *Alternative facts.* The facts are the same as in paragraph (i) of this *Example 19*, except that the Country X mirror legislation also applies to losses attributable to $DE1_X$, but the mirror agreement does not apply to such losses. The mirror legislation rule would apply with respect to P's interest in $DE1_X$ and, as a result, there is a deemed foreign use of the dual consolidated loss attributable to the Country X separate unit and a domestic use election cannot be made for such loss. This is the case even though, pursuant to §1.1503(d)–5(c)(4)(ii)(A), P's interest in $DE1_X$ (which is subject to the Country X mirror legislation) does not, as an individual separate unit, have a dual consolidated loss in year 1. Further, the stand-alone exception to the mirror legislation rule in §1.1503(d)–3(e)(2) does not apply because, absent the mirror legislation, the Country X combined separate unit's dual consolidated loss would be available in the year incurred for a foreign use (as defined in §1.1503(d)–3) because it could be used to offset income of FS_X under the Country X consolidation regime. This is the case even if Country X requires an election to consolidate and no such election is made. The result would be the same even if Country X did not recognize $DE1_X$ as having a loss.

Example 20. 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)–4(b), DRC_X's year 1 dual consolidated loss is subject to the limitations under §1.1503(d)–4(c) and, therefore, may not be used to offset the income of P or S (or any other domestic affiliate) on the group's U.S. income tax return. At the beginning of year 2, DRC_X sells all of its assets for cash and distributes the cash to P pursuant to a liquidation that qualifies under section 332.

(ii) *Result.* In general, under section 381, P would succeed to, and be permitted to use, DRC_X's net operating loss carryover. However, §1.1503(d)–4(d)(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 21. Dual consolidated loss limitation applied to a separate unit transferred in a section 381 transaction. (i) *Facts.* S owns $DE1_X$ which, in turn, owns FB_X. S's interest in $DE1_X$ and its indirect interest in FB_X are combined and treated as a single separate unit (Country X separate unit) pursuant to §1.1503(d)–1(b)(4)(ii). In year 1, a dual consolidated loss is attributable to the Country X separate unit, and P does not make a domestic use election with respect to such loss. Under §1.1503(d)–4(b), the year 1 dual consolidated loss attributable to the Country X separate unit may not be used to offset the income of P or S (other than income attributable to the Country X separate unit, subject to the application of §1.1503(d)–4(c)) on the group's consolidated U.S. income tax return (nor may it be used to offset the income of any other domestic affiliates). At the beginning of year 2, S transfers its entire interest in $DE1_X$, and thus its entire indirect interest in FB_X, to FS_X in a transaction described in section 381.

(ii) *Result.* Section 1.1503(d)–4(d)(1)(ii) provides that the dual consolidated loss attributable to a separate unit that is subject to the domestic use limitation under §1.1503(d)–4(b) is eliminated if the separate unit ceases to be a separate unit of its affiliated domestic owner and all other members of the affiliated domestic owner's separate group. As a result of the transfer of the Country X separate unit to FS_x, the Country X separate unit ceases to be a separate unit of S, and is not a separate unit of any other member of the P consolidated group. In addition, the exceptions in §1.1503(d)–4(d)(2)(iii) do not apply because FS_X is not a domestic corporation. Thus, the year 1 dual consolidated loss attributable to the Country X separate unit is eliminated.

(iii) *Alternative facts.* Assume the same facts as in paragraph (i) of this *Example 21*, except S transfers its assets to DC, a domestic corporation that is not a member of the P consolidated group, in a transaction described in section 381(a). Immediately after the transaction, the Country X separate unit is a separate unit of DC. Under §1.1503(d)–4(d)(1)(ii), the year 1 dual consolidated loss of the Country X separate unit would be eliminated because it ceases to be a separate unit of S, and is not a separate unit of any other member of the P consolidated group. However,

because the transferee is a domestic corporation and the Country X separate unit is a separate unit in the hands of DC immediately after the transaction, the exception under §1.1503(d)–4(d)(2)(iii)(A) applies. As a result, the year 1 dual consolidated loss of the Country X separate unit is not eliminated and any income generated by DC that is attributable to the Country X separate unit following the transfer may be offset by the carryover dual consolidated losses attributable to the Country X separate unit, subject to the limitations of §1.1503(d)–4(b) and (c) applied as if DC generated the dual consolidated loss and such loss was attributable to the Country X separate unit.

(iv) *Alternative facts*. Assume the same facts as in paragraph (iii) of this *Example 21*, except that P owns $DE2_X$ and the interest in $DE2_X$ is combined with and therefore included in the Country X separate unit. In addition, a portion of the dual consolidated loss of the Country X separate unit is attributable to P's interest in $DE2_X$. Pursuant to §1.1503(d)–4(d)(2)(iii)(A), the result would be the same as in paragraph (iii) of this *Example 21*, with respect to the portion of the dual consolidated loss attributable to the combined separate unit that is succeeded to and taken into account by DC pursuant to section 381. The portion of the dual consolidated loss attributable to P's interest in $DE2_X$, however, does not carry over to DC but is retained by P and continues to be subject to the limitations of §1.1503(d)–4(b) and (c) with respect to P's interest in $DE2_X$.

(v) *Alternative facts*. Assume the same facts as in paragraph (iv) of this *Example 21*, except that DC is a member of the P consolidated group. Pursuant to §1.1503(d)–4(d)(2)(iii)(B), the dual consolidated loss of the Country X separate unit is not eliminated and income attributable to the Country X separate unit may continue to be offset by the dual consolidated loss that is succeeded to and taken into account by DC pursuant to section 381, subject to the limitations of §1.1503(d)–4(b) and (c). The result would be the same even if the interest in $DE1_X$ ceased to be a separate unit in the hands of DC (for example, because it dissolved under Country X law in connection with the transaction), provided P, or another member of the P consolidated group, continued to own a portion of the Country X separate unit.

Example 22. Tainted income. (i) *Facts*. P owns 100 percent of DRC_Z, a domestic corporation that is included as a member of the P consolidated group. DRC_Z conducts a business in the United States. 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 incurred 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)–4(b). At the end of year 1, DRC_Z moved its management and control to the United States and, as a result, 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 generated 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)–4(e)(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. The result would be the same if, instead of P transferring asset A to DRC_Z, such asset was received from a separate unit or a transparent entity of DRC_Z.

Example 23. Treatment of disregarded item and books and records of a hybrid entity. (i) *Facts*. P owns $DE1_X$ which, in turn, owns FS_X. In year 1, P borrows from a third party and on-lends the proceeds to $DE1_X$. In year 1, P incurs interest expense attributable to the third-party loan. Also in year 1, $DE1_X$ incurs interest expense attributable to its loan from P, but such expense is generally disregarded for U.S. tax purposes because $DE1_X$ is disregarded as an entity separate from P. The third-party loan and related interest expense are reflected on the books and records of P (and not on the books and records of $DE1_X$). The loan from P to $DE1_X$ and related interest expense are reflected on the books and records of $DE1_X$. There are no other items of income, gain, deduction, or loss reflected on the books and records of $DE1_X$ in year 1.

(ii) *Result*. Because the interest expense on P's third-party loan is not reflected on the books and records of $DE1_X$, no portion of such expense is attributable to P's interest in $DE1_X$ pursuant to §1.1503(d)–5(c)(3) for purposes of calculating the year 1 dual consolidated loss, if any, attributable to such interest. In addition, even though P's interest in $DE1_X$ is treated as a separate domestic corporation for purposes of determining the amount of income or dual consolidated loss attributable to it pursuant to §1.1503(d)–5(c)(1)(ii), such treatment does not cause the interest expense incurred on the loan from P to $DE1_X$ that is generally disregarded for U.S. tax purposes to be regarded for purposes of calculating the year 1 dual consolidated loss, if any, attributable to P's interest in $DE1_X$. As a result, even though the disregarded interest expense is reflected on the books and records of $DE1_X$, it is not taken into account for purposes of calculating income or a dual consolidated loss. Therefore, there is no dual consolidated loss attributable to P's interest in $DE1_X$ in year 1.

Example 24. Dividend income attributable to a separate unit. (i) *Facts*. P owns $DE1_X$ which, in turn, owns FB_X. P's interest in $DE1_X$ and its indirect interest in FB_X are combined and treated as a single separate unit (Country X separate unit) pursuant to §1.1503(d)–1(b)(4)(ii). $DE1_X$ owns $DE3_Y$. $DE3_Y$ owns the stock of FS_X. P's Country X separate unit would, without regard to year 1 dividend income (or related section 78 gross-up) received from FS_X, have a dual consolidated loss of $75x in year 1. In year 1, FS_X 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 under section 902 of $25x and includes that amount in gross income under section 78.

(ii) *Result*. The $50x dividend is reflected on the books and records of $DE3_Y$ and, therefore, is attributable to P's interest in $DE3_Y$ pursuant to §1.1503(d)–5(c)(3)(i). In addition, the $25x section 78 gross-up is attributable to P's interest in $DE3_Y$ pursuant to §1.1503(d)–5(c)(4)(iv). The distribution of $50x from $DE3_Y$ to $DE1_X$ is generally disregarded for U.S. tax purposes and, therefore, does not give rise to an item that is taken into account for purposes of calculating income or a dual consolidated loss. This is the case even though the item would be reflected on the books and records of $DE1_X$. In addition, pursuant to §1.1503(d)–5(c)(1)(iii), each separate unit must calculate its own income or dual consolidated loss, and each item of income, gain, deduction, and loss must be taken into account only once. As a result, the dual consolidated loss of $75x attributable to P's Country X separate unit in year 1 is not reduced by the amount of dividend income attributable to P's indirect interest in $DE3_Y$.

Example 25. Items reflected on books and records of a combined separate unit. (i) *Facts*. P owns $DE1_X$ which, in turn, owns FB_X. P's interest in $DE1_X$ and its indirect interest in FB_X are combined and treated as a single separate unit (Country X separate unit) pursuant to §1.1503(d)–1(b)(4)(ii). The following items are reflected on the books and records of $DE1_X$ in year 1: sales, depreciation expense, a political contribution, royalty expense paid to P, repairs and maintenance expense paid to a third party, and Country X income tax expense. The amount of sales under U.S. tax principles equals the amount of sales reported for accounting purposes. The depreciation expense is calculated on a straight-line basis over the useful life of the asset for accounting purposes, but is subject to accelerated depreciation for U.S. tax purposes. In addition, the repairs and maintenance expense, which is deducted when paid for accounting purposes, is properly capitalized and amortized over five years for U.S. tax purposes. Finally, P elects to claim as a credit under section 901 the Country X income tax expense that was paid in year 1.

(ii) *Result*. (A) For purposes of determining the income or dual consolidated loss attributable to P's Country X separate unit, items of income, gain, deduction, and loss must first be attributed to the individual separate units (that is, P's interest in $DE1_X$ and its indirect interest in FB_X). For purposes of attributing items to P's interest in $DE1_X$, P's items that are reflected on $DE1_X$'s books and records, as adjusted to conform to U.S. tax principles, are taken into account. See §1.1503(d)–5(c)(3)(i). For

purposes of attributing items (other than interest expense) to FB_X, the principles of section 864(c)(2), (c)(4), and (c)(5) (as set forth in §1.864–4(c) and §§1.864–5 through 1.864–7) must be applied and, for interest expense, the principles of §1.882–5, as modified under §1.1503(d)–5(c)(2)(ii), must be applied; however, for these purposes, pursuant to §1.1503(d)–5(c)(4)(i)(A), FB_X only takes into account items attributable to P's interest in $DE1_X$ and the assets, liabilities, and activities of such interest. In addition, to the extent such items are taken into account by FB_X, they are not taken into account in determining the items attributable to P's interest in $DE1_X$. §1.1503(d)–5(c)(4)(i)(B). Because P's interest in $DE1_X$ has no assets or liabilities, and conducts no activities, other than through its ownership of FB_X, all of the items that are reflected on the books and records of $DE1_X$, as adjusted to conform to U.S. tax principles, are attributable to FB_X; no items are attributable to P's interest in $DE1_X$.

(B) The items reflected on the books and records of $DE1_X$ must be adjusted to conform to U.S. tax principles. No adjustment is required to sales because the amount of sales under U.S. tax principles equals the amount of sales for accounting purposes. The amount of straight-line depreciation expense reflected on $DE1_X$'s books and records must be adjusted to reflect the amount of depreciation on the asset that is allowable for U.S. tax purposes. The political contribution is not taken into account because it is not deductible for U.S. tax purposes. Similarly, because the royalty expense is paid to P, and therefore is generally disregarded for U.S. tax purposes, it is not taken into account. The repair and maintenance expense that is deducted in year 1 for accounting purposes also must be adjusted to conform to U.S. tax principles. Thus, the repair and maintenance expense will be taken into account in computing the income or dual consolidated loss attributable to P's Country X separate unit over five years (even though no item related to such expense would be reflected on the books and records of $DE1_X$ for years 2 through 5). Finally, because P elected to claim as a credit the Country X foreign taxes paid during year 1, no deduction is allowed for such amount pursuant to section 275(a)(4) and, therefore, the Country X tax expense is not taken into account.

(C) Pursuant to §1.1503(d)–5(c)(4)(ii)(B), the combined Country X separate unit of P calculates its income or dual consolidated loss by taking into account all the items of income, gain, deduction, and loss that were separately attributable to P's interest in $DE1_X$ and FB_X. However, in this case, there are no items attributable to P's interest in $DE1_X$. Therefore, the items attributable to the Country X separate unit are the items attributable to FB_X.

Example 26. Items attributable to a combined separate unit. (i) *Facts.* P owns $DE1_X$. $DE1_X$ owns a 50 percent 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. FS_X, which is unrelated to P, owns the remaining 50 percent interest in PRS_Z. PRS_Z carries on operations in Country X that, if carried on by a U.S. person, would constitute a foreign branch as defined in §1.367(a)–6T(g)(1). Therefore, P's share of the Country X operations carried on 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, including all of the interests in TE_T, a disregarded entity. TE_T is an entity incorporated under the laws of Country T, a country that does not have an income tax. Under the laws of Country X, an interest holder of TE_T does not take into account on a current basis the interest holder's share of items of income, gain, deduction, and loss of TE_T.

(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 operations carried on by PRS_Z, are combined and treated as a single separate unit (Country X separate unit). Pursuant to §1.1503(d)–5(c)(4)(ii)(A), for purposes of determining P's items of income, gain, deduction, and loss attributable to the Country X separate unit, the items of P are first attributed to each separate unit that composes the Country X separate unit.

(B) Pursuant to §1.1503(d)–5(c)(2)(i), the principles of section 864(c)(2), (c)(4), and (c)(5) (as set forth in §1.864–4(c) and §§1.864–5 through 1.864–7), apply for purposes of determining P's items of income, gain, deduction (other than interest expense), and loss that are attributable to P's indirect interest in the Country X operations carried on by PRS_Z. For purposes of determining P's interest expense that is attributable to P's indirect interest in the Country X operations carried on by PRS_Z, the principles of §1.882–5, as modified under §1.1503(d)–5(c)(2)(ii), shall apply. For purposes of applying these rules, P is treated as a foreign corporation, the Country X operations carried on by PRS_Z are treated as a trade or business within the United States, and the assets of P (including its share of the PRS_Z assets, other than those of the Country X operations) are treated as assets that are not U.S. assets. In addition, because P carries on its share of the Country X operations through $DE1_X$, a hybrid entity, §1.1503(d)–5(c)(4)(i)(A) provides that only the items attributable to P's interest in $DE1_X$, and only the assets, liabilities, and activities of P's interest in $DE1_X$, are taken into account for purposes of this determination.

(C) TE_T is a transparent entity as defined in §1.1503(d)–1(b)(16) because it is not taxable as an association for Federal tax purposes, is not subject to income tax in a foreign country as a corporation (or otherwise at the entity level) either on its worldwide income or on a residence basis, and is not treated as a pass-through entity under the laws of Country X (the applicable foreign country). TE_T is not a pass-through entity under the laws of Country X because a Country X holder of an interest in TE_T does not take into account on a current basis the interest holder's share of items of income, gain, deduction, and loss of TE_T. For purposes of determining P's items of income, gain, deduction, and loss that are attributable to P's interest in TE_T, only those items of P that are reflected on the books and records of TE_T, as adjusted to conform to U.S. tax principles, are taken into account. §1.1503(d)–5(c)(3)(i). Because the interest in TE_T is not a separate unit, a loss attributable to such interest is not a dual consolidated loss and is not subject to section 1503(d) and these regulations. Items must nevertheless be attributed to the interests in TE_T. For example, such attribution is required for purposes of calculating the income or dual consolidated loss attributable to the Country X separate unit, and for purposes of applying the domestic use limitation under §1.1503(d)–4(b) to a dual consolidated loss attributable to the Country X separate unit.

(D) For purposes of determining P's items of income, gain, deduction, and loss that are attributable to P's interest in $DE1_X$, only those items of P that are reflected on the books and records of $DE1_X$, as adjusted to conform to U.S. tax principles, are taken into account. §1.1503(d)–5(c)(3)(i). For this purpose, $DE1_X$'s distributive share of the items of income, gain, deduction, and loss that are 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 operations of PRS_Z. See §1.1503(d)–5(c)(3)(ii) and (4)(i)(B). Because TE_T is a transparent entity, the items reflected on its books and records are not treated as being reflected on the books and records of $DE1_X$.

(E) Pursuant to §1.1503(d)–5(c)(4)(ii)(B), the combined Country X separate unit of P calculates its income or dual consolidated loss by taking into account all the items of income, gain, deduction, and loss that were separately attributable to P's interest in $DE1_X$ and the Country X operations of PRS_Z owned indirectly by P.

Example 27. Sale of separate unit by another separate unit. (i) *Facts.* P owns $DE3_Y$ which, in turn, owns $DE1_X$. $DE3_Y$ also owns other assets that do not constitute a foreign branch separate unit. $DE1_X$ owns FB_X. Pursuant to §1.1503(d)–1(b)(4)(ii), P's indirect interests in $DE1_X$ and FB_X are combined and treated as one Country X separate unit (Country X separate unit). $DE3_Y$ sells its interest in $DE1_X$ at the end of year 1 to an unrelated foreign person for cash. The sale results in an ordinary loss of $30x. Items of income, gain, deduction, and loss derived from the assets that gave rise to the $30x loss would be attributable to the Country X separate unit under §1.1503(d)–5(c) through (e). Without regard to the sale of $DE1_X$, no items of income, gain, deduction, and loss are attributable to P's Country X separate unit in year 1.

(ii) *Result.* Pursuant to §1.1503(d)–5(c)(4)(iii)(A), the $30x ordinary loss recognized on the sale is attributable to the Country X separate unit, and not P's interest in $DE3_Y$. This is the case because the Country X separate unit is treated as owning the assets that gave rise to the loss under §1.1503(d)–5(f). Thus, the loss attributable to the sale creates a year 1 dual consolidated loss attributable to the Country X separate unit. In addition, pursuant to §1.1503(d)–6(d)(2), P cannot make a domestic use election with respect to the dual consolidated loss because the sale of the interest in $DE1_X$ is a triggering event described in §1.1503(d)–6(e)(1)(iv) and (v). Further, although the year 1 dual consolidated loss would otherwise be subject to the domestic use limitation rule of §1.1503(d)–4(b), it is eliminated pursuant to §1.1503(d)–4(d)(1)(ii). Finally, if there were a dual consolidated loss attributable to P's interest in $DE3_Y$, the sale of the interest in $DE1_X$ would not be taken into account for purposes of determining whether there is an asset triggering event with respect to such dual consolidated loss under §1.1503(d)–6(e)(1)(iv).

Example 28. Gain on sale of tiered separate units. (i) *Facts.* P owns 75 percent of HPS_X, a Country X entity subject to Country X tax on its

worldwide income. FS_X owns the remaining 25 percent of HPS_X. HPS_X is classified as a partnership for Federal tax purposes. HPS_X carries on 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)(1). HPS_X also owns assets that do not constitute a part of its Country Y operations and would not themselves constitute a foreign branch within the meaning of §1.367(a)–6T(g)(1) if owned by a U.S. person. Neither HPS_X nor the Country Y operations has liabilities. P's indirect interest in the Country Y operations carried on 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 portion of the assets of the Country Y operations (that is, assets the income, gain, deduction and loss from which would be attributable to P's Country Y foreign branch separate unit) had a built-in gain of $200x, and P's portion of HPS_X's other assets (that is, assets the income, gain, deduction and loss from which would be attributable to P's interest in HPS_X) had a built-in gain of $100x.

(ii) *Result*. Pursuant to §1.1503(d)–5(c)(4)(iii)(B), $100x of the total $150x of gain recognized ($200x/$300x x $150x) is attributable to P's indirect interest in its share of the Country Y operations carried on by HPS_X. Similarly, $50x of such gain ($100x/$300x x $150x) is attributable to P's interest in HPS_X.

Example 29. Effect on domestic affiliate. (i) *Facts*. (A) P owns $DE1_X$ which, in turn, owns FB_X. P's interest in $DE1_X$ and its indirect interest in FB_X are combined and treated as a single separate unit (Country X separate unit) pursuant to §1.1503(d)–1(b)(4)(ii). In years 1 and 2, the items of income, gain, deduction, and loss that are attributable to P's Country X separate unit pursuant to §1.1503(d)–5 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 the year 1 dual consolidated loss attributable to its Country X separate unit. Pursuant to §1.1503(d)–4(b) and (c)(2), the year 1 dual consolidated loss of $50x is treated as a loss incurred by a separate domestic corporation and is subject to the limitations under §1.1503(d)–4(c)(3). The P consolidated group has $100x of consolidated taxable income in year 2.

(ii) *Result*. (A) P must compute its taxable income for year 1 without taking into account the $50x dual consolidated loss, pursuant to §1.1503(d)–4(c)(2). Such amount consists of a *pro rata* portion of the expenses that were taken into account in calculating the 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)–4(c), the year 1 $50x dual consolidated loss is carried forward and is available to offset the $10x of income attributable to the Country X separate unit in year 2. Pursuant to §1.1503(d)–4(c)(4), 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)–4(c).

Example 30. Exception to domestic use limitation—no possibility of foreign use because items are not deducted or capitalized under foreign law. (i) *Facts*. P owns $DE1_X$ which, in turn, owns FS_X. In year 1, the sole item of income, gain, deduction, and loss attributable to P's interest in $DE1_X$, as provided under §1.1503(d)–5, is $100x of interest expense paid on a loan to an unrelated lender. 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 (at any time) 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)–6(c)(1), if P prepares a statement described in §1.1503(d)–6(c)(2) and attaches it to its timely filed tax return, the year 1 dual consolidated loss attributable to P's interest in $DE1_X$ will not be subject to the domestic use limitation rule of §1.1503(d)–4(b).

Example 31. No exception to domestic use limitation—inability to demonstrate no possibility of foreign use. (i) *Facts*. P owns $DE1_X$ which, in turn, owns FB_X. P's interest in $DE1_X$ and its indirect interest in FB_X are combined and treated as a single separate unit (Country X separate unit) pursuant to §1.1503(d)–1(b)(4)(ii). In year 1, the sole items of income, gain, deduction, and loss attributable to P's Country X separate unit, as provided under §1.1503(d)–5, 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 until year 2.

(ii) *Result*. The year 1 $25x net loss attributable to P's interest in the Country X separate unit constitutes a dual consolidated loss. 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 with respect to the Country X separate unit's dual consolidated loss as provided under §1.1503(d)–6(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.

(iii) *Alternative facts*. (A) The facts are the same as in paragraph (i) of this *Example 31*, except as follows. In year 1, the sole items of income, gain, deduction, and loss attributable to P's Country X separate unit, as provided in §1.1503(d)–5, 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; the $100x interest expense is treated as a repayment of principal and therefore cannot be deducted or capitalized (at any time); and the $25x of depreciation expense is not deductible in year 1, but is deductible in year 2.

(B) In year 1, the $50x net loss attributable to P's Country X separate unit constitutes a dual consolidated loss. Even though the $100x interest expense, a nondeductible and noncapital item for Country X tax purposes, exceeds the $50x year 1 dual consolidated loss attributable to P's Country X separate unit, P cannot demonstrate that there is no possibility of foreign use of the dual consolidated loss as provided under §1.1503(d)–6(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 tax purposes that would constitute a foreign use.

Example 32. 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 5. In year 5, P sells the stock of DRC_X to FS_X. 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 tax purposes because the laws of Country X only provide for a three-year carryover period for such items.

(ii) *Result.* The sale of DRC_X to FS_X generally would be a triggering event under §1.1503(d)–6(e)(1)(ii), which would require DRC_X to recapture the year 1 dual consolidated loss (and pay an applicable interest charge) on the P consolidated group's tax return for the year that includes the date on which DRC_X ceases to be a member of the P consolidated group. However, upon adequate documentation that the losses and deductions have expired for Country X tax purposes, P can rebut the presumption that a triggering event has occurred pursuant to §1.1503(d)–6(e)(2)(i). 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 pursuant to §1.1503(d)–6(j)(1)(i). If the presumptive triggering event is not rebutted, the domestic use agreement would terminate and have no further effect pursuant to §1.1503(d)–6(j)(1)(iii) because the dual consolidated loss would be recaptured.

Example 33. Triggering events and rebuttals—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, the $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 the 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, and loss in year 1 for Country X tax purposes.

(C) During year 2, P sells its interest in $DE1_X$ to FS_X for $80x. P's disposition of its interest in $DE1_X$ constitutes a presumptive triggering event under §1.1503(d)–6(e)(1)(iv) and (v) requiring the recapture of the year 1 $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 deduction or loss was recognized by $DE1_X$ at 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 be available to offset income for Country X tax 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 (or an amount of loss recognized by $DE1_X$ would be increased) and, therefore, an item composing the dual consolidated loss would be available, under U.S. tax principles, to reduce income of a foreign corporation (and an owner of an interest in a hybrid entity that is not a separate unit). Thus, P cannot demonstrate pursuant to §1.1503(d)–6(e)(2)(i) 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)–6(j)(1)(iii), the domestic use agreement filed by the P consolidated group with respect to the year 1 dual consolidated loss is terminated and has no further effect.

(iii) *Alternative facts.* The facts are the same as paragraph (i) of this *Example 33*, except that instead of P selling its interest in $DE1_X$ to FS_X, $DE1_X$ sells asset A to FS_X for $80x and, for Country X tax purposes, FS_X's tax basis in A immediately after the sale is $80x. P's disposition of Asset A constitutes a presumptive triggering event under §1.1503(d)–6(e)(1)(iv) requiring the recapture of the year 1 $20x dual consolidated loss (plus the applicable interest charge). For Country X tax purposes, FS_X'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 tax purposes (for example, when FS_X disposes of A). Therefore, P may be able to demonstrate (for example, by obtaining the opinion of a Country X tax advisor) pursuant to §1.1503(d)–6(e)(2)(i) that there can be no foreign use of the year 1 dual consolidated loss and, thus, would not be required to recapture the year 1 dual consolidated loss.

Example 34. Triggering event resulting in a single consolidated group where acquirer files a new domestic use agreement. (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 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. At the end of 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)–6(f)(2)(ii)(B), the acquisition by T of the P consolidated group is not an event described in §1.1503(d)–6(e)(1)(ii) 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)–6(f)(2)(iii)(A). If a new domestic use agreement is filed, then pursuant to §1.1503(d)–6(j)(1)(ii), 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.

(B) Assume that T files a new domestic use agreement and a triggering event occurs at the end of year 3. As a result, 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)–6(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)–6(j)(1)(iii), 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 35. Triggering event exceptions for certain deemed transfers. (i) *Facts.* P owns $DE1_X$. In year 1, there is a $100x dual consolidated loss attributable to P's interest in $DE1_X$. P files a domestic use agreement under §1.1503(d)–6(d) with respect to such loss. During year 2, P sells 33 percent of its interest in $DE1_X$ to T, an unrelated domestic corporation.

(ii) *Result.* Pursuant to Rev. Rul. 99–5, the transaction is treated as if P sold 33 percent of its interest in each of $DE1_X$'s assets to T and then immediately thereafter P and T transferred their interests in the assets of $DE1_X$ to a partnership in exchange for an ownership interest therein. Upon the transfer of 33 percent of P's interest to T, a domestic corporation, no foreign use occurs and, therefore, there is no foreign use triggering event. However, P's deemed transfer of 67 percent of its interest in the assets of $DE1_X$ to a partnership is nominally a triggering event under §1.1503(d)–6(e)(1)(iv). Because the initial transfer of 33 percent of $DE1_X$'s interest was to a domestic corporation and there is only a triggering event because of the deemed transfer under Rev. Rul. 99–5, the deemed asset transfer is not treated as resulting in a triggering event pursuant to §1.1503(d)–6(f)(4).

(iii) *Alternative facts.* The facts are the same as in paragraph (i) of this *Example 35*, except that P sells 60 percent (rather than 33 percent) of its interest in $DE1_X$ to T. The sale is a triggering event under §1.1503(d)–6(e)(1)(iv) and (v) without regard to the occurrence of a deemed transaction. Therefore, §1.1503(d)–6(f)(4) does not apply.

Example 36. Triggering event exception involving multiple parties. (i) *Facts.* P owns $DE1_X$ which, in turn, owns FB_X. P's interest in $DE1_X$ and its indirect interest in FB_X are combined and treated as a single separate unit (Country X separate unit) pursuant to §1.1503(d)–1(b)(4)(ii). In year 1, there is a $100x dual consolidated loss attributable to P's Country X separate unit 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. At the end of year 2, T, the parent of the T consolidated group, acquires all of P's interest in $DE1_X$ for cash.

(ii) *Result.* (A) Under §1.1503(d)–6(f)(2)(i)(B), the acquisition by T of the interest in $DE1_X$ is not an event described in §1.1503(d)–6(e)(1)(iv) or (v) requiring the recapture of the year 1 dual consolidated loss attributable to the Country X separate unit (and the payment of an interest charge), provided: (1) the T consolidated group files a new domestic use agreement described in §1.1503(d)–6(f)(2)(iii)(A) with respect to the year 1 dual consolidated loss of the Country X separate unit; and (2) the P

consolidated group files a statement described in §1.1503(d)–6(f)(2)(iii)(B) with respect to the year 1 dual consolidated loss. If these requirements are satisfied, then pursuant to §1.1503(d)–6(j)(1)(ii) the domestic use agreement filed by the P consolidated group with respect to the year 1 dual consolidated loss is terminated and has no further effect (if these requirements are not satisfied such that the P consolidated group recaptures the dual consolidated loss, the domestic use agreement would terminate pursuant to §1.1503(d)–6(j)(1)(iii)).

(B) Assume a triggering event occurs at the end of year 3 that requires recapture by the T consolidated group of the year 1 dual consolidated loss, as well as the payment of an interest charge, as provided in §1.1503(d)–6(h). T continues to own the Country X separate unit after the triggering event. In that case, each member of the T consolidated group is severally liable for the additional tax (and the interest charge) due upon the recapture of the year 1 dual consolidated loss. The T consolidated group must prepare a statement that computes the recapture tax amount as provided under §1.1503(d)–6(h)(3)(iii). Pursuant to §1.1503(d)–6(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)–6(h)(3)(iv)(B). Pursuant to §1.1503(d)–6(j)(1)(iii), the new domestic use agreement filed by the T consolidated group is terminated and has no further effect. Finally, pursuant to §1.1503(d)–6(h)(6)(iii), T is treated as if it incurred the dual consolidated loss that is recaptured for purposes of applying §1.1503(d)–6(h)(6)(i). Thus, T has a reconstituted net operating loss equal to the amount of the year 1 dual consolidated loss that was recaptured, and such loss is attributable to the Country X separate unit (and subject to the rules and limitations under §1.1503(d)–6(h)(6)(i)). Because T is treated as if it incurred the year 1 dual consolidated loss, P shall not be treated as having a net operating loss under §1.1503(d)–6(h)(6)(i).

Example 37. No foreign use following multiple-party event exception to triggering event. (i) *Facts.* P owns $DE1_X$ which, in turn, owns FB_X. P's interest in $DE1_X$ and its indirect interest in FB_X are combined and treated as a single separate unit (Country X separate unit) pursuant to §1.1503(d)–1(b)(4)(ii). In year 1, there is a $100x dual consolidated loss attributable to P's Country X separate unit and P makes a domestic use election with respect to such loss. T, a domestic corporation unrelated to P, owns 95 percent of PRS, a partnership. FS_X owns the remaining 5 percent of PRS. At the beginning of year 3, PRS purchases 100 percent of the interest in $DE1_X$ from P for cash. For Country X tax purposes, the $100x loss incurred by $DE1_X$ in year 1 carries forward and is available to offset income of $DE1_X$ in subsequent years.

(ii) *Result.* P's sale of its interest in $DE1_X$ is a triggering event under §1.1503(d)–6(e)(1)(iv) and (v). However, if P and T comply with the requirements under §1.1503(d)–6(f)(2)(iii), the sale would qualify for the multiple-party event exception under §1.1503(d)–6(f)(2)(i). In addition, because the $100x loss of $DE1_X$ carries forward to subsequent years for Country X purposes and is available to offset income of $DE1_X$, there would be a foreign use of the dual consolidated loss immediately after the sale pursuant to §1.1503(d)–3(a)(1). This is the case because the dual consolidated loss would be available to offset or reduce income that is considered, under U.S. tax principles, to be an item of FS_X, a foreign corporation (it would also be a foreign use because FS_X is an indirect owner of an interest in a hybrid entity that is not a separate unit). However, there is no foreign use in this case as a result of FS_X's 5 percent interest in $DE1_X$ pursuant to §1.1503(d)–3(c)(8).

Example 38. Character and source of recapture income. (i) *Facts.* (A) P owns FB_X. In year 1, the items of income, gain, deduction, and loss that are attributable to FB_X for purposes of determining whether it 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 FB_X and, thus, the $25x dual consolidated loss is used to offset the P group's consolidated taxable income.

(C) Pursuant to §1.861–8, the $75x of salary expense incurred by FB_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 FB_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, $5x of income is attributable to FB_X under the rules of §1.1503(d)–5, and the P consolidated group has $100x of consolidated taxable income. At the end of year 2, FB_X undergoes a triggering event described in §1.1503(d)–6(e)(1), and P continues to own FB_X following the triggering event. Pursuant to §1.1503(d)–6(h)(2)(i), P is able to demonstrate to the satisfaction of the Commissioner that the $25x dual consolidated loss attributable to FB_X in year 1 would have offset the $5x of income attributable to FB_X in year 2, if no domestic use election were made with respect to the year 1 loss such that it was subject to the limitations of §1.1503(d)–4(b) and (c).

(ii) *Result.* P must recapture and report as ordinary income $20x ($25x - $5x) of FB_X's year 1 dual consolidated loss, plus applicable interest. The $20x recapture income is attributable to FB_X pursuant to §1.1503(d)–5(c)(4)(vi). Pursuant to §1.1503(d)–6(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. Further, pursuant to §1.1503(d)–6(h)(5), the *pro rata* computation described in §1.1503(d)–4(c)(4) shall apply. Thus, the character and source of the recapture income is determined in the same proportion as each item of deduction or loss that contributed to the dual consolidated loss being recaptured. 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)–6(h)(6)(i), commencing in year 3, the $20x recapture amount is reconstituted and treated as a net operating loss incurred by FB_X in a separate return limitation year, subject to the limitation under §1.1503(d)–4(b) (and therefore subject to the restrictions of §1.1503(d)–4(c)). Pursuant to §1.1503(d)–6(j)(1)(iii), the domestic use agreement filed by the P consolidated group with respect to the year 1 dual consolidated loss of FB_X is terminated and has no further effect.

Example 39. Interest charge without recapture. (i) *Facts.* P owns $DE1_X$ which, in turn, owns FB_X. P's interest in $DE1_X$ and its indirect interest in FB_X are combined and treated as a single separate unit (Country X separate unit) pursuant to §1.1503(d)–1(b)(4)(ii). In year 1, a dual consolidated loss of $100x is attributable to P's Country X separate unit. P makes a domestic use election with respect to such loss and uses the loss to offset the P group's consolidated taxable income. In year 2, there is $100x of income attributable to P's Country X separate unit and the P consolidated group has $200x of consolidated taxable income. At the end of year 2, the Country X separate unit undergoes a triggering event within the meaning of §1.1503(d)–6(e)(1). P demonstrates, to the satisfaction of the Commissioner, that if no domestic use election were made with respect to the year 1 dual consolidated loss such that it was subject to the limitations of §1.1503(d)–4(b) and (c), the year 1 $100x dual consolidated loss would have been offset by the $100x of year 2 income.

(ii) *Result.* There is no recapture of the year 1 dual consolidated loss attributable to P's Country X separate unit because it is reduced to zero under §1.1503(d)–6(h)(2)(i). However, P is liable for one year of interest charge under §1.1503(d)–6(h)(1)(ii), even though P's recapture amount is zero. This is the case because the P consolidated group had the benefit of the dual consolidated loss in year 1, and the income that offset the recapture income was not recognized until year 2. Pursuant to §1.1503(d)–6(j)(1)(iii), the domestic use agreement filed by the P consolidated group with respect to the year 1 dual consolidated loss is terminated and has no further effect.

Example 40. Reduced recapture and interest charge, and reconstituted dual consolidated loss. (i) *Facts.* S owns $DE1_X$ which, in turn, owns FB_X. S's interest in $DE1_X$ and its indirect interest in FB_X are combined and treated as a single separate unit (Country X separate unit) pursuant to §1.1503(d)–1(b)(4)(ii). In year 1, there is a $100x dual consolidated loss attributable to S's Country X separate unit, and P earns $100x. P makes a domestic use election with respect to the Country X separate unit's year 1 dual consolidated loss. Therefore, the consolidated group is permitted to offset P's $100x of income with the Country X separate unit's $100x dual consolidated loss. In year 2, $30x of income is attributable to the Country X separate unit under the rules of §1.1503(d)–5 and such income is offset by a $30x net operating loss incurred by P in such year. In

year 3, $25x of income is attributable to the Country X separate unit under the rules of §1.1503(d)–5, and P earns $15x of income. In addition, at the end of year 3 there is a foreign use of the year 1 dual consolidated loss that constitutes a triggering event. S continues to own the Country X separate unit after the triggering event.

(ii) *Result.* (A) Under the presumptive rule of §1.1503(d)–6(h)(1)(i), S must recapture $100x (plus applicable interest). However, under §1.1503(d)–6(h)(2)(i), S may be able to demonstrate that a lesser amount is subject to recapture. The lesser amount is the amount of the $100x dual consolidated loss that would have remained subject to §1.1503(d)–4(c) at the time of the foreign use triggering event if a domestic use election had not been made for such loss.

(B) Although the combined separate unit earned $30x of income in year 2, there was no consolidated taxable income in such year. As a result, as of the end of year 2 the $100x dual consolidated loss would continue to be subject to §1.1503(d)–4(c) if a domestic use election had not been made for such loss. However, the $30x earned in year 2 can be carried forward to subsequent taxable years and may reduce the recapture income to the extent of consolidated taxable income generated in subsequent years. In year 3, $25x of income was attributable to the Country X separate unit and P earns $15x of income. Thus, the P consolidated group has $40x of consolidated taxable income in year 3. As a result, the $100x of recapture income can be reduced by $40x. This is the case because if a domestic use election had not been made for the $100x year 1 dual consolidated loss such that it was subject to the limitations of §1.1503(d)–4(b) and (c), only $60x of the loss would have remained subject to such limitations at the time of the foreign use triggering event. Accordingly, if S can adequately document the lesser amount, the amount of recapture income is $60x ($100x - $40x). The $60x recapture income is attributable to the Country X separate unit pursuant to §1.1503(d)–5(c)(4)(vi).

(C) Pursuant to §1.1503(d)–6(h)(6)(i), commencing in year 4, the $60x recapture amount is reconstituted and treated as a net operating loss incurred by the Country X separate unit of S in a separate return limitation year, subject to the limitation under §1.1503(d)–4(b) (and therefore subject to the restrictions of §1.1503(d)–4(c)). The loss is only available for carryover to taxable years after year 3 (and is not available for carryback). The carryover period of the loss, for purposes of section 172(b), will start from year 1, when the dual consolidated loss that was subject to recapture was incurred. In addition, such reconstituted net operating loss is not eligible for the exceptions contained in §1.1503(d)–6(b) through (d). Pursuant to §1.1503(d)–6(j)(1)(iii), the domestic use agreement filed by the P consolidated group with respect to the year 1 dual consolidated loss of the Country X separate unit is terminated and has no further effect.

(iii) *Alternative facts*. The facts are the same as in paragraph (i) of this *Example 40*, except that the triggering event that occurs at the end of year 3 is a sale by S of its entire interest in $DE1_X$ to B, an unrelated domestic corporation. The sale does not qualify as a transaction described in section 381. The results are the same as in paragraph (ii) of this *Example 40*, except that pursuant to §1.1503(d)–6(h)(6)(ii) the $60x net operating loss is not reconstituted (with respect to either S or B). The loss is not reconstituted with respect to S because the Country X separate unit ceases to be a separate unit of S (or any other member of the consolidated group that includes S) and therefore would have been eliminated pursuant to §1.1503(d)–4(d)(1)(ii) if no domestic use election had been made with respect to such loss. The loss is not reconstituted with respect to B because B was not the domestic owner of the combined separate unit when the dual consolidated loss that is recaptured was incurred, and B did not acquire the Country X separate unit in a section 381 transaction.

§1.1503(d)–8 Effective dates.

(a) *General rule*. Except as provided in paragraph (b) of this section, this paragraph (a) provides the dates of applicability of §§1.1503(d)–1 through 1.1503(d)–7. Sections 1.1503(d)–1 through 1.1503(d)–7 shall apply to dual consolidated losses incurred in taxable years beginning on or after April 18, 2007. However, a taxpayer may apply §§1.1503(d)–1 through 1.1503(d)–7, in their entirety, to dual consolidated losses incurred in taxable years beginning on or after January 1, 2007, by filing its return and attaching to such return the domestic use agreements, certifications, or other information in accordance with these regulations. For purposes of this section, the term *application date* means either April 18, 2007, or, if the taxpayer applies these regulations pursuant to the preceding sentence, January 1, 2007. Section 1.1503–2 applies for dual consolidated losses incurred in taxable years beginning on or after October 1, 1992, and before the application date.

(b) *Special rules*—(1) *Reduction of term of agreements filed under §§1.1503–2(g)(2)(i) or 1.1503–2T(g)(2)(i).* If an agreement was filed (or subsequently treated as filed) under §§1.1503–2A(c)(3), 1.1503–2(g)(2)(i), or 1.1503–2T(g)(2)(i) and remains in effect (that is, the dual consolidated loss subject to the agreement has not been recaptured pursuant to §1.1503–2(g)(2)(vii)) as of the application date, such agreement will be considered by the Internal Revenue Service to apply only for any taxable year up to and including the fifth taxable year following the year in which the dual consolidated loss that is the subject of the agreement was incurred and thereafter will have no effect.

(2) *Reduction of term of closing agreements entered into pursuant to §1.1503–2(g)(2)(iv)(B)(3)(i).* Taxpayers subject to the terms of a closing agreement entered into with the Internal Revenue Service pursuant to §1.1503–2(g)(2)(iv)(B)(*3*)(*i*) or Rev. Proc. 2000–42, 2000–2 C.B. 394, see §601.601(d)(2)(ii)(*b*) of this chapter, will be deemed to have satisfied the closing agreement's fifteen-year certification period requirement if the five-year certification period specified in §1.1503(d)–1(b)(20) has elapsed, provided such closing agreement is still in effect as of the application date, and provided the dual consolidated losses have not been recaptured. For example, if a calendar year taxpayer that has a January 1, 2007, application date entered into a closing agreement with respect to a dual consolidated loss incurred in 2003 and, as of January 1, 2007, the closing agreement is still in effect and the dual consolidated loss subject to the closing agreement has not been recaptured, then the closing agreement's fifteen-year certification period will be deemed satisfied when the five-year certification period described in §1.1503(d)–1(b)(20) has elapsed. Thus, the dual consolidated loss will be subject to the recapture and certification provisions of the closing agreement in such a case only through December 31, 2008. Alternatively, if a calendar year taxpayer that has a January 1, 2007, application date entered into a closing agreement with respect to a dual consolidated loss incurred in 2000 and, as of January 1, 2007, the closing agreement is still in effect and the dual consolidated loss subject to the closing agreement has not been recaptured, then the certification period is deemed to be satisfied.

(3) *Relief for untimely filings*. Paragraphs (b)(3)(i) through (iii) of this section set forth the effective dates for rules that provide relief for the failure to make timely filings of an election, agreement, statement, rebuttal, computation, closing agreement, or other information, pursuant to section 1503(d) and these regulations.

(i) *General rule*. Except as provided in paragraphs (b)(3)(ii) and (iii) of this section, the reasonable cause relief standard of §1.1503(d)–1(c) applies for all untimely filings with respect to dual consolidated losses, including with respect to dual consolidated losses incurred in taxable years beginning before the application date.

(ii) *Closing agreements*. Solely with respect to closing agreements described in §1.1503–2(g)(2)(iv)(B)(*3*)(*i*) and Rev. Proc. 2000–42, taxpayers must request relief for untimely requests through the process provided under §§301.9100–1 through 301.9100–3 of this chapter. See paragraph (b)(4) of this section for rules that permit the multiple-party event exception, rather than closing agreements, for certain triggering events.

(iii) *Pending requests for relief*. Taxpayers that have letter ruling requests under §§301.9100–1 through 301.9100–3 of this chapter pending as of March 19, 2007, (other than requests under paragraph (b)(3)(ii) of this section) are not required to use the reasonable cause procedure under §1.1503(d)–1(c); however, if such taxpayers have not yet received a determination of their request, they may withdraw their request consistent with the procedures contained in Rev. Proc. 2007–1, 2007–1 I.R.B. 1, see §601.601(d)(2)(ii)(*b*) of this chapter, (or any succeeding document) and use the reasonable cause procedure set forth in §1.1503(d)–1(c). In that event, the Internal Revenue Service will refund the taxpayer's user fee.

(4) *Multiple-party event exception to triggering events*. This paragraph (b)(4) applies to events described in §1.1503–2(g)(2)(iv)(B)(*1*)(*i*) through (*iii*) that occur after April 18, 2007, and that are with respect to dual consolidated losses that were incurred in taxable years beginning on or after October 1, 1992, and before the application date. The events described in the previous sentence are not eligible for the exception described in §1.1503–2(g)(2)(iv)(B)(*1*), but instead are eligible for the multiple-party event exception described in §1.1503(d)–6(f)(2)(i), as modified by this paragraph (b)(4). Thus, such events are not eligible for a closing agreement described in §1.1503–2(g)(2)(iv)(B)(*3*)(*i*) and Rev. Proc. 2000–42. For purposes of applying §1.1503(d)–6(f)(2)(i) to transactions covered by this paragraph, agreements described in §1.1503–2(g)(2)(i) (rather than domestic use agreements) shall be filed, and subsequent triggering events and exceptions thereto have the meaning provided in §1.1503–2(g)(2)(iii)(A) and (iv) (other than the exception provided under §1.1503–2(g)(2)(iv)(B)(*1*)). For example, if a calendar year taxpayer that has a January 1, 2007, application date filed an election under §1.1503–2(g)(2)(i) with respect to a dual consolidated loss that was incurred in 2004, and a triggering event described in §1.1503–2(g)(2)(iv)(B)(*1*)(*ii*) occurs with respect to such dual consolidated loss after April 18, 2007, then the event is eligible for the multiple-party event exception under §1.1503(d)–6(f)(2)(i) (and not the exception under §1.1503–2(g)(2)(iv)(B)(*1*)). However, in order to comply with §1.1503(d)–6(f)(2)(iii)(A), the subsequent elector must file a new agreement described in §1.1503–2(g)(2)(i) (rather than a new domestic use agreement). In addition, for purposes of determining whether there is a subsequent triggering event, and exceptions thereto, pursuant to such new agreement, §1.1503–2(g)(2)(iii)(A) and (iv) (other than the exception provided under §1.1503–2(g)(2)(iv)(B)(*1*)) shall apply. Notwithstanding the general application of this paragraph (b)(4) to events described in §1.1503–2(g)(2)(iv)(B)(*1*)(*i*) through (*iii*) that occur after April 18, 2007, a taxpayer may choose to apply this paragraph (b)(4) to events described in §1.1503–2(g)(2)(iv)(B)(*1*)(*i*) through (*iii*) that occur after March 19, 2007, and on or before April 18, 2007.

(5) *Basis adjustment rules*. Taxpayers may apply the basis adjustment rules of §1.1503(d)–5(g) for all open years in which such basis is relevant, even if the basis adjustment is attributable to a dual consolidated loss incurred (or recaptured) in a closed taxable year. Taxpayers applying the provisions of §1.1503(d)–5(g), however, must do so consistently for all open years.

PART 602—OMB CONTROL NUMBERS UNDER PAPERWORK REDUCTION ACT

Par. 5. The authority citation for part 602 continues to read as follows:

Authority: 26 U.S.C. 7805.

Par. 6. In §602.101, paragraph (b) is amended by adding entries in numerical order to the table to read as follows:

§602.101 OMB Control numbers.

* * * * *

(b) * * *

CFR part or section where identified and described	Current OMB control No.
* * * * *	
1.1503(d)–1	1545–1946
1.1503(d)–3	1545–1946
1.1503(d)–4	1545–1946
1.1503(d)–5	1545–1946
1.1503(d)–6	1545–1946
* * * * *	

Kevin M. Brown,
Deputy Commissioner for Services and Enforcement.

Approved February 27, 2007.

Eric Solomon,
Assistant Secretary of the Treasury (Tax Policy).

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Section 7520.—Valuation Tables

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of April 2007. See Rev. Rul. 2007-23, page 889.

Section 7872.—Treatment of Loans With Below-Market Interest Rates

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of April 2007. See Rev. Rul. 2007-23, page 889.

Part III. Administrative, Procedural, and Miscellaneous

Common Mistakes on Tax Returns

Notice 2007–35

The purpose of this notice is to alert taxpayers about common mistakes made by individuals while preparing their federal income tax returns. These mistakes may result in taxpayers failing to fully pay their correct tax liabilities. In addition, these mistakes may result in delays in processing returns and receiving refunds. Taxpayers should carefully read all the instructions to the tax forms and schedules and review their entire return before filing. In addition, e-filing, either through the Service's Free File Program at *www.irs.gov* or through tax preparation software or a tax professional, will help reduce errors and speed refunds. Taxpayers who e-file and use direct deposit will generally receive their refunds in as little as two weeks.

Additional taxpayer resources, including answers to frequently asked questions, also can be found at *www.irs.gov*. Taxpayers can learn more about common mistakes and find an error checklist on page 64 of the Instructions to the 2006 Form 1040, *U.S. Individual Income Tax Return*; this information also is available at Tax Topic 303 on the internet at *www.irs.gov* and from the toll-free TeleTax number, 1–800–829–4477.

1. ***Choosing the wrong filing status.*** Taxpayers should confirm that the filing status (*i.e.*, single, married filing jointly, married filing separately, head of household, qualifying widow(er) with dependent child) selected on the return is correct. For example, taxpayers often incorrectly claim "head of household" filing status without meeting the requirements for that status. In addition to delaying the processing of the return and any refund, designating the wrong filing status on a return also may affect a taxpayer's eligibility for the Earned Income Credit. The Instructions to the 2006 Forms 1040, 1040–A, and 1040–EZ provide detailed information to assist taxpayers in choosing their correct filing status.

2. ***Failing to include or using incorrect Social Security numbers.*** The names and Social Security numbers for the taxpayer, taxpayer's spouse, dependents, and qualifying children for the Earned Income Credit or Child Tax Credit must be included on the return exactly as they appear on the Social Security cards.

3. ***Failing to use the correct forms and schedules.*** Taxpayers should review the instructions to all applicable forms and schedules to be sure they have correctly used, and accurately completed, each form or schedule.

4. ***Failing to sign and date the return.*** Taxpayers must sign and date their return under penalties of perjury. If the return is not signed, it will not be accepted as filed by the Service. If it is a joint return, both spouses must sign the return.

5. ***Claiming ineligible dependents.*** Taxpayers may claim a person as a dependent only if that person meets the legal definition of a dependent. Taxpayers should consult the Instructions to Form 1040 or 1040–A to confirm that a person qualifies as a dependent. Each dependent must have a valid Social Security number (or other Taxpayer Identification Number, as applicable), which must be included on the tax return. The failure to include a dependent's name and Social Security number, or claiming an ineligible dependent, may result in an underpayment of tax and/or a denial of the Earned Income Credit.

6. ***Failing to file for the Earned Income Credit.*** Taxpayers should review carefully the eligibility requirements for the Earned Income Credit, including income limits, before filing returns. For example, many military families may qualify for the credit because they can choose to include or exclude combat zone compensation in the income calculations, depending on which treatment is more favorable. Detailed instructions for claiming and computing the credit are contained in the Instructions to the Form 1040 (and the Instructions to Forms 1040–A and 1040–EZ), Fact Sheet 2006–15, and Publication 596 (*Earned Income Credit (EIC)*) and through links at 1040 Central at *www.irs.gov*.

7. ***Improperly claiming the Earned Income Credit.*** Taxpayers must have earned income from work to claim the Earned Income Credit. For example, a taxpayer whose sole income is from Temporary Assistance for Needy Families or Social Security benefits does not have earned income and is therefore ineligible for the credit. Detailed instructions for claiming and computing the credit are contained in the Instructions to the Form 1040 (and the Instructions to Forms 1040–A and 1040–EZ), Fact Sheet 2006–15, and Publication 596 (*Earned Income Credit (EIC)*) and through links at 1040 Central at *www.irs.gov*.

8. ***Failing to report and pay domestic payroll taxes.*** Taxpayers employing household workers, such as a house cleaner, an in-home caregiver, or a nanny, must report and pay payroll taxes for those individuals when the payments exceed certain threshold amounts. Failure to pay and report payroll taxes may result in the assessment of additional tax due, interest on the unpaid amounts, and penalties. The Instructions to the Form 1040, Publication 926 (*Household Employer's Tax Guide*), and Publication 15–A (*Employer's Supplemental Tax Guide*) contain detailed information to assist taxpayers in determining whether an individual providing household help is a household employee for whom the taxpayer must report and pay payroll taxes.

9. ***Failing to report income because it was not included on a Form W–2, Form 1099, or other information return.*** Taxpayers must include on their tax returns income reported on a third-party information reporting statement such as a Form W–2 or Form 1099, or other similar statement. But even if income was not reported on a third-party reporting statement, taxpayers must still report all income. Failure to report all income may result in the assessment of additional tax due, interest on the unpaid amounts, and penalties.

10. ***Treating employees as independent contractors.*** Employers may not treat an employee as an "independent contractor" to avoid paying and reporting payroll taxes. Employers who improperly treat an employee as an independent contractor may be liable for additional tax due, interest on the unpaid amounts, and penalties. Publication 15–A (*Employer's Supplemental Tax Guide*) contains detailed information to assist taxpayers in determin-

ing whether an individual is an employee or an independent contractor.

11. ***Failing to file a return when due a refund.*** Taxpayers must file a return to claim a refund of withheld taxes when a refund is due. Taxpayers will forfeit refunds of withheld tax if a return requesting a refund is not filed within three years of the due date.

12. ***Failing to check liability for the alternative minimum tax.*** Taxpayers should determine whether the alternative minimum tax, or AMT, applies. If a taxpayer is liable for AMT but does not include it on the return, the Service will determine the taxpayer's liability and may reduce or deny a requested refund or assess any additional tax due, interest on the unpaid amounts, and penalties.

13. ***Failing to request federal telephone excise tax.*** Taxpayers can request a one-time credit of $30 to $60 for federal excise taxes paid for long-distance or bundled (local and long-distance) telephone service billed after February 28, 2003, and before August 1, 2006, whether for landline, cell phone or Voice over Internet Protocol service. Alternatively, taxpayers can request a one-time credit for the actual amount of excise taxes paid during the period using Form 8913, *Credit for Federal Telephone Excise Tax Paid.* Detailed information is provided in the 2006 Form 1040, 1040–A, and 1040–EZ Instructions, Fact Sheet 2007–1, and the Telephone Excise Tax Refund page at *www.irs.gov*.

14. ***Failing to accurately use or compute the Schedule D Tax Worksheet or Qualified Dividends and Capital Gain Tax Worksheet.*** Taxpayers should determine which worksheet they should use when computing their tax. Failure to use the correct worksheet may result in a reduction or denial of a requested refund or an assessment of additional tax due, interest on the unpaid amounts, and penalties.

15. ***Failing to enter the correct amount of taxable Social Security benefits.*** Taxpayers should report not only the total amount of their Social Security benefits, but also the correct amount of taxable Social Security benefits. In addition to delaying the processing of the tax return and any refund, reporting the incorrect amount of taxable Social Security benefits may result in an assessment of additional tax due, interest on the unpaid amounts, and penalties.

16. ***Mailing a return to the wrong address.*** Taxpayers who file their income tax returns by mail should send the returns to the appropriate Internal Revenue Service Center based on where the taxpayer lives and whether the taxpayer is including a check or money order with the return. The Forms 1040, 1040–A, and 1040–EZ Instructions, as well as the "Where To File" resource available on *www.irs.gov*, list the applicable mailing addresses according to where the taxpayer resides. Taxpayers who receive one of the Form Series 1040 booklets in the mail may also use the preaddressed envelope that is included in the booklet to mail the return, unless the taxpayer has moved to another area with a different filing location. Mailing an income tax return to the wrong Internal Revenue Service Center or otherwise misaddressing the return could delay the processing of the return and any refund.

The principal author of this notice is the Office of Associate Chief Counsel (Procedure & Administration), Administrative Provisions & Judicial Practice Division. For further information regarding this notice, contact that office at (202) 622–7800 (not a toll-free call).

Part IV. Items of General Interest

Notice of Proposed Rulemaking

Suspension of Statutes of Limitations in Third-Party and John Doe Summons Disputes and Expansion of Taxpayers' Rights to Receive Notice and Seek Judicial Review of Third-Party Summonses

REG–153037–01

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document contains proposed amendments to the regulations relating to third-party and John Doe summonses. These proposed regulations reflect amendments to sections 7603 and 7609 of the Internal Revenue Code of 1986 made by the Internal Revenue Service Restructuring and Reform Act of 1998, the Omnibus Budget Reconciliation Act of 1990, the Technical and Miscellaneous Revenue Act of 1988, and the Tax Reform Act of 1986, which were enacted subsequent to adoption of the current regulations. These proposed regulations provide guidance relating to the manner in which summonses may be served on third-party recordkeepers, the expanded class of third-party summonses subject to notice requirements and other procedures, and the suspension of periods of limitations if a court proceeding is brought involving a challenge to a third-party summons, or if a third party's response to a summons is not finally resolved within six months after service. These proposed regulations affect third parties who are served with a summons, taxpayers identified in a third-party summons, and other persons entitled to notice of a third-party summons.

DATES: Written comments and requests for a public hearing must be received by October 19, 2006.

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG–153037–01), room 5203, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Alternatively, submissions may be hand delivered between the hours of 8 a.m. and 4 p.m. to: CC:PA:LPD:PR (REG–153037–01), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC. Comments may also be submitted electronically to *www.irs.gov/regs* or the Federal eRulemaking Portal at *www.regulations.gov* (IRS—REG–153037–01).

FOR FURTHER INFORMATION CONTACT: Elizabeth Rawlins at (202) 622–3630 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

This document contains proposed regulations amending the Procedure and Administration Regulations (26 CFR part 301) under sections 7603 and 7609 of the Internal Revenue Code of 1986 (Code). The proposed regulations reflect amendments to sections 7603 and 7609 enacted in the Internal Revenue Service Restructuring and Reform Act of 1998 (Public Law 105–206, 112 Stat. 685) (RRA 1998), the Technical and Miscellaneous Revenue Act of 1988 (Public Law 100–647, 102 Stat. 3343) (TAMRA 1988), and the Tax Reform Act of 1986 (Public Law 99–514, 100 Stat. 2085) (TRA 1986). The proposed regulations also reflect changes made to section 6503(j) in the Omnibus Budget Reconciliation Act of 1990 (Public Law 101–508, 104 Stat. 1388) (OBRA 1990).

Explanation of Provisions

In general, section 7609 provides that if a summons is served on a third party requiring the third party to give testimony or produce records relating to a taxpayer or other person identified in the summons, the Internal Revenue Service (IRS) must provide notice of the summons to the taxpayer and to any other person identified in the description of summoned records and testimony within three days of the date on which the summons was served, but no later than 23 days prior to the date fixed in the summons as the day on which the examination of the summoned person or materials is scheduled. Persons entitled to notice of a third-party summons are entitled to bring a proceeding to quash the summons by filing a petition in district court within 20 days after notice is given. Persons entitled to notice also may intervene in any proceeding to enforce the summons. During the pendency of a proceeding to quash a summons brought by the taxpayer, or during the pendency of a proceeding to enforce a summons in which the taxpayer has intervened, the periods of limitations on assessment and criminal prosecution are suspended. These periods of limitations are also suspended if the third-party's response to the summons remains unresolved six months after the summons is served, regardless of whether a proceeding has been brought with respect to the summons. These proposed regulations amend prior regulations relating to third-party summonses to reflect the statutory changes to sections 7603 and 7609 described below.

Notice of Third-Party Summonses

Section 7609(a) requires the IRS to provide notice of a third-party summons to the taxpayer being investigated and every person identified in the description of summoned records and testimony unless the summons is excepted from the notice requirements under section 7609(c)(2). Prior to RRA 1998, the IRS was required to provide notice of a third-party summons only if the summons was served on a third-party recordkeeper and the summons required the production of records made or kept of another person's business transactions or affairs (or testimony about such records). RRA 1998 expanded the types of third-party summonses to which the notice, intervention, and proceeding to quash procedures apply by removing the prior specifically-defined third-party recordkeeper limitation. The proposed regulations reflect the expansion of the notice procedures to all third-party summonses not excepted by section 7609(c)(2).

Exceptions to Notice, Intervention, and Proceeding to Quash Procedures

Section 7609(c)(2) provides that certain summonses, including summonses served on the person with respect to whose liability the summons was issued, third-party summonses issued to confirm or deny the existence of records, and summonses that require court approval before service, are excepted from the notice, intervention, and proceeding to quash provisions of subsections 7609(a) and (b). Two additional exceptions, relating to third-party summonses issued in aid of collection under section 7609(c)(2)(D) and summonses issued by a criminal investigator under section 7602(c)(2)(E), were the subject of recent statutory changes.

Prior to RRA 1998, former section 7609(c)(2)(B) broadly excepted from the notice requirements and other procedural rules a summons issued in aid of the collection of any person's liability. RRA 1998 narrowed the collection exception, now found in section 7609(c)(2)(D), to except only summonses issued in aid of the collection of either: (i) an assessment or judgment against the person with respect to whose liability the summons is issued, or (ii) the liability of a transferee or fiduciary of the liable person. Under section 7609(c)(2)(D), as amended, the IRS now must give notice of a third-party summons issued in aid of the collection of a person's potential liability for an unassessed tax. For example, the IRS must provide notice of a third-party summons to a potentially responsible person if the purpose of the third-party summons is to determine whether the person is liable for the trust fund recovery penalty under section 6672.

The exception from notice, intervention, and proceeding to quash procedures for summonses issued by a criminal investigator under section 7609(c)(2)(E) was added by RRA 1998. Section 7609(c)(2)(E) excepts third-party summonses issued by criminal investigators if the summoned third party is not a third-party recordkeeper, as that term is defined under new section 7603(b).

Third-Party Recordkeepers

Section 7603(b)(1) provides that third-party recordkeeper summonses may be served by certified or registered mail to the last known address of the third-party recordkeeper. Section 7603(b)(2) enumerates classes of persons that are third-party recordkeepers, including banks, credit card issuers, attorneys, accountants, and enrolled agents.

1. *When third-party recordkeeper status arises*

Prior to RRA 1998, third-party recordkeeper summonses were defined under former section 7609(a)(1) as summonses that were served on a third-party recordkeeper, *i.e.*, a person belonging to one of several enumerated classes of business occupations, for the production of records made or kept of another person's business transactions or affairs. Based on these requirements, existing §301.7609–2(b) provides that "[a] person is a 'third-party recordkeeper' with respect to a given set of records only if the person made or kept the records in the person's capacity as a third-party recordkeeper."

RRA 1998 amended section 7603, relating to service of summonses, by adding to new subsection (b) the enumerated classes of third-party recordkeepers, but did not incorporate the requirement of former section 7609(a)(1)(B) that the records of the business transactions or affairs be made or kept by the third-party recordkeeper in its capacity as such. There is no indication in the legislative history to RRA 1998 that Congress intended to alter the requirement under §301.7609–2(b) that the records of a third-party recordkeeper be made or kept in the third-party recordkeeper's capacity as such. Accordingly, the proposed regulations maintain the requirement under existing §301.7609–2(b).

2. *Owners or developers of computer software source code*

RRA 1998 added owners or developers of computer software source code to the enumerated classes of third-party recordkeepers under section 7603(b)(2). The proposed regulations define owners or developers of computer software source code as third-party recordkeepers if they are summoned to produce the source code or the programs and data to which the source code relates, whether or not they make or keep records of another person's business transactions or affairs.

Suspension of Periods of Limitations

1. *Suspension under section 7609(e)(1)*

Section 7609(e)(1) provides that the periods of limitations under section 6501 (relating to assessment and collection) and section 6531 (relating to criminal prosecution) are suspended if any person with respect to whose liability a third-party summons was issued (or the agent, nominee, or other person acting under the direction and control of such person), pursuant to section 7609(b), intervenes in a judicial proceeding to enforce a third-party summons or brings a proceeding to quash a third-party summons. The suspension continues for the period during which the proceeding, including appeals, is pending.

2. *Suspension under section 7609(e)(2)*

Section 7609(e)(2) provides that the periods of limitations under section 6501 and section 6531, are suspended if there is no final resolution of the third party's response to the summons within six months after service of such summons, regardless of whether the person with respect to whose liability the summons was issued has intervened in an enforcement proceeding or brought a proceeding to quash.

Suspension of the periods of limitations under section 7609(e)(2) begins six months after the summons is served and ends upon the final resolution of the summoned party's response. The proposed regulations describe the types of summonses to which the suspension of periods of limitations under section 7609(e)(2) apply and define final resolution.

a. *Summonses to which suspension under section 7609(e)(2) may apply*

Prior to RRA 1998, former section 7609(e)(2) suspended a taxpayer's periods of limitations if either a third-party recordkeeper's response to a summons, for which the taxpayer was entitled to receive notice under section 7609(a), or if a summoned person's response to a John Doe summons was not finally resolved within six months after the summons was served. Nothing in the legislative history to RRA 1998 suggests that Congress intended to expand the basic statutory structure of section 7609(e)(2) to encompass any summonses other than John Doe summonses

and third-party summonses subject to the notice requirement of section 7609(a). Therefore, the proposed regulations provide that the periods of limitations are suspended under section 7609(e)(2) only with respect to third-party summonses to which the notice requirements of section 7609(a) apply, or to John Doe summonses for which taxpayers are entitled to notice of any statute suspension pursuant to section 7609(i)(4).

b. *Final resolution of a third party's response to a summons*

Section 7609(e)(2) provides that suspension of the periods of limitations ends on the date of final resolution of the third party's response to the summons. The purpose of section 7609(e)(2) is to suspend the periods of limitations if an investigation is delayed by a summoned person's failure to produce all of the summoned information within six months. Although final resolution is not defined in section 7609, nor is it elaborated on in the legislative history of that statute, the same term is found in section 6503(j), which suspends the period of limitations on assessment during a judicial enforcement period relating to designated and related summonses. Like section 7609(e)(2), section 6503(j) provides that the suspension period will not end until there is final resolution of the summoned person's response to the summons. The legislative history of section 6503(j) indicated that the term *final resolution* means, in cases in which a court proceeding is brought, that no court proceeding remains pending and the summoned party has complied with the summons to the extent the court required. Therefore, the proposed regulations define final resolution as occurring when the summoned person fully complies with the production required by the summons. If the summons is the subject of litigation, full compliance occurs when any order enforcing any part of the summons is fully complied with and all appeals are either disposed of or the period in which an appeal may be taken or a request for further review may be made has expired. The IRS will administratively create procedures by which taxpayers can inquire about the suspension of their periods of limitations under section 7609(e)(2).

Protections for and Duties of Summoned Third Parties

Section 7609(i)(3) provides that any summoned party who produces records or gives testimony in good faith reliance on an IRS certificate or court order is not liable to a customer or other person for disclosure of records or testimony in response to a third-party summons. RRA 1998 modified these provisions by extending protection to all recipients of third-party summonses subject to the notice requirements of section 7609(a) and by expanding the protection from liability to include the giving of testimony by a third party, in addition to the production of records. The proposed regulations reflect these statutory changes.

Notification Requirement for John Doe Summonses under Section 7609(i)(4)

Section 7609(i)(4) requires the recipient of a John Doe summons to notify the unnamed taxpayers to which the summons applies if those taxpayers' periods of limitations are suspended by operation of section 7609(e)(2), relating to the absence of a resolution to the summoned party's response six months after service of the summons.

The proposed regulations specify the time and the manner for providing the notice required under section 7609(i)(4). Notice must be given as soon as possible after the suspension of the periods of limitations and must be made in writing. The written notification may be hand delivered, sent to the address of the taxpayer last known by the summoned person to be valid, or transmitted by any electronic means. Failure by the summoned party to comply with the notice requirements of section 7609(i)(4) will not preclude the suspension of the periods of limitations pursuant to section 7609(e)(2).

Use of Informal Procedures not Precluded by Section 7609

Section 7609(j) provides that nothing in section 7609 shall be construed to limit the IRS's ability to obtain information through formal or informal procedures authorized by sections 7601 and 7602. The proposed regulations provide that section 7609 does not require the IRS to issue a third-party summons before conducting an informal inquiry of a third party or examining a third party's books, papers, records, or other data during an investigation.

Proposed Effective Dates

These amendments are proposed to be applicable on the date the final regulations are filed with the **Federal Register**.

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 a collection of information under the Paperwork Reduction Act (44 U.S.C. section 3501), the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply to these regulations. Pursuant to section 7805(f) of the 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 (preferably a signed original and eight (8) copies) that are submitted timely to the IRS. The IRS and the Treasury Department specifically request comments on the clarity of the proposed rule and how it may be made easier to understand. All comments will be available for public inspection and copying. A public hearing may be scheduled if requested in writing by a person who timely submits written comments. If a public hearing is scheduled, notice of the date, time, and place for the hearing will be published in the **Federal Register**.

Drafting Information

The principal author of these regulations is Elizabeth Rawlins of the Office of the Associate Chief Counsel, Procedure and Administration (Collection, Bankruptcy and Summonses Division), Internal Revenue Service.

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Proposed Amendment to the Regulations

Accordingly, 26 CFR part 301 is proposed to be 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 301.7603–1 is revised to read as follows:

§301.7603–1 Service of summons.

(a) *In general*—(1) *Hand delivery or delivery to place of abode*. Except as otherwise provided in paragraph (a)(2) of this section, a summons issued under section 6420(e)(2), 6421(g)(2), 6427(j)(2), or 7602 shall be served by an attested copy delivered in hand to the person to whom it is directed, or left at such person's last and usual place of abode.

(2) *Summonses issued to third-party recordkeepers*. A summons issued under section 6420(e)(2), 6421(g)(2), 6427(j)(2), or 7602 for the production of records (or testimony about such records) by a third-party recordkeeper, as described in section 7603(b)(2) and §301.7603–2, may also be served by certified or registered mail to the third-party recordkeeper's last known address, as defined in §301.6212–2. If service to a third-party recordkeeper is made by certified or registered mail, the date of service is the date on which the summons is mailed.

(b) *Persons who may serve a summons*. The officers and employees of the Internal Revenue Service whom the Commissioner has designated to carry out the authority described in §301.7602–1(b) to issue a summons are authorized to serve a summons issued under section 6420(e)(2), 6421(g)(2), 6427(j)(2), or 7602.

(c) *Effect of certificate of service*. The certificate of service signed by the person serving the summons shall be evidence of the facts it states on the hearing of an application for the enforcement of the summons.

(d) *Sufficiency of description of summoned records*. When a summons requires the production of records, it shall be sufficient if such records are described with reasonable certainty.

(e) *Records*. For purposes of this section and §301.7603–2, the term *records* includes books, papers, or other data.

(f) *Effective date*. This section is applicable on the date final regulations are published in the **Federal Register**.

Par. 3. Section 301.7603–2 is added to read as follows:

§301.7603–2 Third-party recordkeepers.

(a) *Definitions*—(1) *Accountant*. A person is an accountant under section 7603(b)(2)(F) for purposes of determining whether that person is a third-party recordkeeper if, on the date the records described in the summons were created, the person was registered, licensed, or certified as an accountant under the authority of any state, commonwealth, territory, or possession of the United States, or of the District of Columbia.

(2) *Attorney*. A person is an attorney under section 7603(b)(2)(E) for purposes of determining whether that person is a third-party recordkeeper if, on the date the records described in the summons were created, the person was registered, licensed, or certified as an attorney under the authority of any state, commonwealth, territory, or possession of the United States, or of the District of Columbia.

(3) *Credit cards*—(i) *Person extending credit through credit cards*. The term *person extending credit through the use of credit cards or similar devices* under section 7603(b)(2)(C) generally includes any person who issues a credit card. The term does not include a seller of goods or services who honors credit cards issued by other parties but who does not extend credit through the use of credit cards or similar devices.

(ii) *Devices similar to credit cards*. An object is a device similar to a credit card under section 7603(b)(2)(C) only if it is physical in nature, such as a charge plate or similar device that may be tendered to obtain an extension of credit. Thus, a person who extends credit by requiring customers to sign sales slips without requiring the use of, or reference to, a physical object issued by that person is not a third-party recordkeeper under section 7603(b)(2)(C).

(iii) *Debit cards*. A debit card is not a credit card or similar device because a debit card is not tendered to obtain an extension of credit.

(4) *Enrolled agent*. A person is an enrolled agent under section 7603(b)(2)(I) for purposes of determining whether that person is a third-party recordkeeper if the person is enrolled as an agent authorized to practice before the Internal Revenue Service pursuant to Circular 230, 31 CFR Part 10.

(5) *Owner or developer of certain computer code and data*. An owner or developer of computer software source code under section 7603(b)(2)(J) is a third-party recordkeeper when summoned to produce a computer software source code (as defined in section 7612(d)(2)), or an executable code and associated data described in section 7612(b)(1)(A)(ii), even if that person did not make or keep records of another person's business transactions or affairs.

(b) *When third-party recordkeeper status arises*—(1) *In general*. Except as provided in paragraph (a)(5) of this section, a person listed in section 7603(b)(2) is a third-party recordkeeper for purposes of section 7609(c)(2)(E) and §301.7603–1 only if the summons served on that person seeks records (or testimony regarding such records) of a third party's business transactions or affairs and such recordkeeper made or kept the records in the capacity of a third-party recordkeeper. For instance, an accountant is not a third-party recordkeeper (by reason of being an accountant) with respect to the accountant's records of a sale of property by the accountant to another person. Similarly, a credit card issuer is not a third-party recordkeeper (by reason of being a person extending credit through the use of credit cards or similar devices) with respect to—

(i) Records relating to non-credit card transactions, such as a cash sale by the issuer to a holder of the issuer's credit card; or

(ii) Records relating to transactions involving the use of another issuer's credit card.

(2) *Examples*. The rules of paragraph (b)(1) of this section are illustrated by the following examples:

Example 1. V issues a credit card (the V card) that is honored by R, a retailer. When using the V card, C, a customer, signs a sales slip in triplicate. C, R,

and V each retain one copy. Only the copy held by V is held by a third-party recordkeeper under section 7603(b)(2), even though R may issue its own credit card.

Example 2. R, a retailer, issues its own credit card (the R card) to C, a customer. When C makes a credit purchase from R using the R card, C signs a sales slip in duplicate. C and R each retain one copy. Because R keeps the copy in its capacity as credit card issuer, as well as in its capacity as a retailer, it is a third-party recordkeeper under section 7603(b)(2) with respect to its copy of the sales slip.

(c) *Effective date*. This section is applicable on the date the final regulations are published in the **Federal Register**.

Par. 4. Sections 301.7609–1 through 301.7609–5 are revised to read as follows:

§301.7609–1 Special procedures for third-party summonses.

(a) *In general*—(1) Section 7609 requires the Internal Revenue Service (IRS) to follow special procedures when summoning a third party's testimony, records, or computer software source code. Except as provided in §301.7609–2(b), the IRS must provide notice of a third-party summons to any person identified in the summons, other than the person summoned. A person entitled to notice of a third-party summons may intervene in any proceeding brought to enforce the summons or may bring a proceeding to quash the summons, regardless of whether they receive notice of the summons from the IRS pursuant to section 7609(a) and §301.7609–2.

(2) Neither section 7609 nor §301.7603–1, §301.7603–2, or §§301.7609–1 through 301.7609–5, limit the IRS's ability to obtain information, other than by summons, through formal or informal procedures authorized by sections 7601 and 7602.

(b) *Cross references*. See §301.7609–2 for rules relating to persons who must be notified of a third-party summons and exceptions to the notification requirements. See §301.7609–3 for rules relating to the rights and duties of summoned parties. See §301.7609–4 for rules relating to actions to quash a summons or to intervene in a summons enforcement proceeding. See §301.7609–5 for rules relating to the suspension of periods of limitations.

(c) *Records*. For purposes of §§301.7609–1 through 301.7609–5, the term "records" includes books, papers, or other data.

(d) *Effective date*. This section is applicable on the date the final regulations are published in the **Federal Register**.

§301.7609–2 Notification of persons identified in third-party summonses.

(a) *In general*—(1) *Persons entitled to notice*. Except as provided in §301.7609–2(b), the Internal Revenue Service (IRS) shall give notice of a third-party summons to any person, other than the person summoned, who is identified in the summons. The only persons so identified are the person with respect to whose liability the summons is issued and any other person identified in the description of summoned records or testimony. For example, if the IRS issues a summons to a bank with respect to the liability of C that requires the production of account records of A and B, both of whom are named in the summons, the IRS must notify A, B and C of the summons.

(2) *Time for providing notice*. If notice is required by this paragraph (a)(1), such notice must be given within three days of the date on which the summons is served on the third party, but no later than 23 days prior to the date fixed in the summons as the date on which the examination of the summoned person or records is scheduled.

(3) *Methods for serving notice*. Notice may be served by hand delivery to any person entitled to notice or by leaving notice at such person's last and usual place of abode. Notice also may be served by certified or registered mail to the person's last known address, as defined in §301.6212–2. If service to a person entitled to notice is made by certified or registered mail, the date of service is the date on which the notice is mailed.

(4) *Content of the notice*. Notice required to be given to any person entitled to notice must be accompanied by a copy of the summons that has been served and must include an explanation of the right to bring a proceeding to quash the summons. The copy of the summons accompanying the notice is not required to contain the attestation that appears pursuant to section 7603 on the copy of the summons served on the summoned person.

(b) *Exceptions*. The IRS is not required to provide notice to persons identified in the following third-party summonses:

(1) *Summons served on the taxpayer*. The IRS is not required to provide notice of a summons served on the person with respect to whose liability the summons was issued, or any officer or employee of such person.

(2) *Existence of records*. The IRS is not required to provide notice in the case of a summons issued to determine whether or not records of the business transactions or affairs of a person identified in the summons have been made or kept.

(3) *Numbered account or similar arrangement*. The IRS is not required to provide notice in the case of a summons issued solely to determine the identity of a person having a numbered account or similar arrangement with a bank or other institution. An account is a numbered account or similar arrangement within the meaning of this paragraph (b)(3) if it is an account through which a person may authorize transactions solely through the use of a number, symbol, code name, or other device not involving the disclosure of the person's identity. The term *person having a numbered account or similar arrangement* includes the person who opened the account and any person authorized to access the account or to receive records or statements concerning it.

(4) *Summonses in aid of the collection of liabilities*—(i) *In general*. The IRS is not required to provide notice in the case of a summons issued in aid of the collection of liabilities. A summons is in aid of the collection of liabilities within the meaning of this paragraph if it is issued in connection with the collection of—

(A) An assessment or judgment against the person with respect to whose liability the summons is issued; or

(B) The liability determined at law or in equity of any transferee or fiduciary of a person described in paragraph (b)(4)(i)(A) of this section.

(ii) *Examples*. The rules of paragraph (b)(4) of this section are illustrated by the following examples:

Example 1. A third-party summons is issued to a bank to determine the amount held in an account in the name of A, against whom unpaid income taxes have been assessed. Notice of the summons is not required to be given to A or any other persons identified in the summons because the summons is issued in connection with the collection of taxes that have been assessed.

Example 2. A third-party summons is issued to determine whether assessments should be made against A, who is potentially liable for a trust fund

recovery penalty under section 6672 with respect to the assessed but unpaid withholding tax liability of employer E. The summons is captioned: In the matter of A. Notice of the summons must be provided to A and to any other persons identified in the summons because the summons was issued with respect to A's potential, unassessed liability under section 6672.

(5) *Summonses issued by a criminal investigator*. The IRS is not required to provide notice in the case of a summons issued by a criminal investigator to a person other than a third-party recordkeeper, as defined in section 7603(b). For purposes of section 7609(c)(2)(E), a summons issued by a criminal investigator is any summons issued as part of a criminal investigation by an IRS officer or employee having authority to conduct a criminal investigation and to issue a summons.

(6) *John Doe summons*. The IRS is not required to provide notice in the case of a John Doe summons issued under section 7609(f).

(7) *Summons issued pursuant to a court order to prevent spoliation of evidence*. The IRS is not required to provide notice in the case of a summons for which a court determines there is reasonable cause to believe the giving of notice may lead to attempts to conceal, destroy, or alter records relevant to the examination, to prevent communication of information from other persons through intimidation, bribery, or collusion, or to flee to avoid prosecution, testifying, or production of records.

(c) *Effective date*. This section is applicable on the date the final regulations are published in the **Federal Register**.

§301.7609–3 Duty of and protection for the summoned party.

(a) *Duty of the summoned party*. Upon receipt of a summons, the summoned party must begin to assemble the summoned records. The summoned party must be prepared to produce the summoned records on the date on which the summons states that they are to be examined, regardless of the institution or anticipated institution of a proceeding to quash or the summoned party's intervention in a proceeding to quash, as allowed under section 7609(b)(2)(C).

(b) *Disclosing summoned party not liable*—(1) *In general*. A summoned party, or an agent or employee thereof, who makes a disclosure of records or gives testimony as required by a summons in good faith reliance on the certificate of the Secretary (as defined in paragraph (b)(2) of this section) or an order of a court requiring production of records or giving of testimony, will not be liable for any claim arising from such disclosure brought by any customer, any party with respect to whose tax liability the summons was issued, or any other person.

(2) *Certificate of the Secretary*. The Secretary may issue to the summoned party a certificate if the person with respect to whose liability the summons was issued expressly consents to the examination of the records summoned and the taking of testimony. The Secretary also may issue to the summoned party a certificate stating that—

(i) The 20-day period within which a person entitled to notice of the summons may institute a proceeding to quash the summons has expired; and

(ii) No proceeding has been instituted within that period.

(c) *Reimbursement of costs*. Summoned third parties may be entitled to reimbursement of their costs of assembling and preparing to produce summoned records, to the extent allowed by section 7610 and §301.7610–1.

(d) *Notification of suspension of periods of limitations in connection with a John Doe summons*—(1) *Requirement of notification*. If any periods of limitations are suspended under section 7609(e)(2) and §301.7609–5(d) with respect to a John Doe summons described in section 7609(f), the summoned party is required under section 7609(i)(4) to provide notice of such suspension to all persons with respect to whose liability the summons was issued.

(2) *Content of notification*. A summoned party required to notify a person of the suspension of the periods of limitations shall provide the following information to such person—

(i) A John Doe summons was served on the summoned party seeking records that may be relevant to the person's tax liability;

(ii) The date on which the summons was served;

(iii) The tax period(s) to which the summons relates;

(iv) Six months has passed since service of the summons and the summoned party's response to the summons has not been finally resolved;

(v) The periods of limitations under section 6501 (relating to assessment and collection) and section 6531 (relating to criminal prosecution), have been suspended; and

(vi) The date on which suspension of the periods of limitations under sections 6501 and 6531 began.

(3) *Time and manner of notification*. The notification must be made in writing and may be delivered in person, by mail sent to the address last known by the summoned party, or by use of any electronic means of transmission. Notification should be made as soon as possible after the suspension of the periods of limitations begins. Failure by a summoned party to give notice of the suspension of periods of limitations as required by section 7609(i)(4) does not prevent the suspension of the periods of limitations under section 7609(e)(2).

(e) *Effective date*. This section is applicable on the date the final regulations are published in the **Federal Register**.

§301.7609–4 Right to intervene; right to institute a proceeding to quash.

(a) *Intervention in proceeding with respect to enforcement of a summons*. Under section 7609(b)(1), a person entitled to notice of a summons under section 7609(a) and §301.7609–2 is entitled to intervene in any proceeding brought under section 7604 with respect to the enforcement of that summons.

(b) *Right to institute a proceeding to quash*—(1) *In general*. Under section 7609(b), a person entitled to notice of a summons under section 7609(a) and §301.7609–2 may institute a proceeding to quash the summons in the United States district court for the district in which the summoned person resides or is found.

(2) *Requirements for a proceeding to quash*. To institute a proceeding to quash a summons, a person entitled to notice of the summons must, not later than the 20th day following the day the notice of the summons was served on or mailed to such person—

(i) File a petition to quash a summons in the name of the person entitled to notice of the summons in the proper district court;

(ii) Notify the Internal Revenue Service (IRS) by sending a copy of that petition to quash by registered or certified mail to the IRS employee and office designated in the notice of summons to receive the copy; and

(iii) Notify the summoned person by sending by registered or certified mail a copy of the petition to quash to the summoned person.

(3) *Failure to give timely notice*. If a person entitled to notice of the summons fails to give proper and timely notice to either the summoned person or the IRS in the manner described in this paragraph (b)(2) of this section, that person has failed to institute a proceeding to quash and the district court lacks jurisdiction to hear the proceeding. For example, if the person entitled to notice mails a copy of the petition to the summoned person, but fails to mail a copy of the petition to the designated IRS employee and office, the person entitled to notice has failed to institute a proceeding to quash. Similarly, if the person entitled to notice mails a copy of such petition to the summoned person but, instead of sending a copy of the petition by registered or certified mail to the designated IRS employee and office, the person entitled to notice provides the designated IRS employee and office the petition by some other means, the person entitled to notice has failed to institute a proceeding to quash.

(4) *Failure to institute a proceeding to quash*. If a person entitled to notice fails to institute a proceeding to quash within 20 days following the day the notice of the summons was served on or mailed to such person, the IRS may examine the summoned records and take summoned testimony following the 23rd day after notice of the summons was served on or mailed to the person entitled to notice.

(c) *Presumption no notice has been mailed*. Section 7609(b)(2)(B) permits a person entitled to notice to institute a proceeding to quash by filing a petition in district court and notifying both the IRS and the summoned person. Unless the person entitled to notice has notified both the IRS and the summoned person in the appropriate manner, the person entitled to notice has failed to institute a proceeding to quash. For the purpose of permitting the IRS to examine the summoned witnesses and records, it is presumed that the notification was not timely mailed if the copy of the petition was not delivered to the summoned person or to the person and office designated to receive the notice on behalf of the IRS within three days after the close of the 20-day period allowed for instituting a proceeding to quash.

(d) *Effective date*. This section is applicable on the date the final regulations are published in the **Federal Register**.

§301.7609–5 Suspension of periods of limitations.

(a) *In general*. Except in the case of a summons that is a designated or related summons described in section 6503(j), the following rules relating to the suspension of certain periods of limitations apply to all third-party summonses subject to the notice requirements of section 7609(a) and to all John Doe summonses subject to the requirements of section 7609(f).

(b) *Intervention in an action to enforce the summons*—(1) *In general*. If a person entitled to notice of a summons under section 7609(a) and §301.7609–2 with respect to whose liability the summons was issued, or such person's agent, nominee, or other person acting under the direction or control of the person entitled to notice, takes any action to intervene in a proceeding with respect to enforcement of such summons brought pursuant to section 7604, that person's periods of limitations under sections 6501 (relating to assessment and collection) and 6531 (relating to criminal prosecutions) for the tax period or periods that are the subject of the summons are suspended for the period during which such proceeding is pending.

(2) *Action to intervene*. A person entitled to notice takes any action to intervene in a proceeding to enforce a summons within the meaning of §301.7609–4(a) on the date when a motion to intervene is filed with the court.

(c) *Institution of a proceeding to quash a summons*—(1) *In general*. If a person entitled to notice of a summons under section 7609(a) and §301.7609–2 with respect to whose liability the summons was issued, or such person's agent, nominee, or other person acting under the direction or control of the such person, takes any action described in §301.7609–4(b) to institute a proceeding to quash such summons, that person's periods of limitations under sections 6501 and 6531 for the tax period or periods that are the subject of the summons are suspended for the period during which such proceeding is pending.

(2) *Action to institute a proceeding to quash a summons*. A person entitled to notice takes any action to institute a proceeding to quash if he or she files a petition to quash the summons in any district court, regardless of whether the timely filing requirements of section 7609(b)(2)(A) or the notice requirements of section 7609(b)(2)(B) are satisfied. For example, a person entitled to notice takes an action to institute a proceeding to quash a summons for purposes of this section if that person files a petition to quash the summons in district court and notifies the summoned person by sending a copy of the petition by registered or certified mail, but fails to mail a copy of that notice to the appropriate Internal Revenue Service (IRS) person and office.

(d) *Summoned party's failure to finally resolve the response to a summons after six months from service*—(1) *In general*. If a third party's response to a summons for which the IRS was required to provide notice to persons identified in the summons, or to a John Doe summons described in section 7609(f), is not finally resolved within six months after the date of service of the summons, the periods of limitations are suspended under sections 6501 and 6531, for the person with respect to whose liability the summons was issued and for any person whose identity is sought to be obtained by a John Doe summons, for the tax period or periods that are the subject of the summons. The suspension shall begin on the date which is six months after the service of the summons and shall end on the date on which there is a final resolution of the summoned party's response to the summons.

(2) *Example*. The rules of paragraph (d)(1) of this section are illustrated by the following example:

Example. A John Doe summons is issued on April 1, 2000, to the promoter of a tax shelter and seeks the names of all participants in the shelter in order to investigate the participants' income tax liabilities for 1997 and 1998. The district court approves service of the summons on April 30, 2000, and the summons is served on the promoter on May 1, 2000. The promoter does not provide the names of the participants. The periods of limitations for the participants' income tax liabilities and criminal prosecution for 1997 and 1998 are suspended under section 7609(e)(2) beginning on November 1, 2000, the date which is six months after the date the John Doe

summons was served until the date on which the promoter's response to the summons is finally resolved.

(e) *Definitions*—(1) *Agent, nominee, etc*. A person is the agent, nominee, or other person of a person entitled to notice under section 7609(a) and §301.7609–2, and is acting under the direction or control of the person entitled to notice for purposes of section 7609(e)(1), if the person entitled to notice has the ability in fact or at law to cause the agent, nominee or other person, to take the actions permitted under section 7609(b).

(2) *Period during which a proceeding is pending*—(i) *Intervention in an enforcement proceeding*. The period during which the periods of limitations under sections 6501 and 6531 are suspended under section 7609(e)(1) begins on the date any person described in paragraph (b) of this section intervenes in an action to enforce the summons. The periods of limitations remain suspended until all appeals are disposed of, or until the expiration of the period during which an appeal may be taken or a request for further review may be made. The periods of limitations remain suspended for the period during which a proceeding is pending, regardless of compliance (or partial compliance) with the summons during that period. If, following issuance of an order to enforce a third-party summons, a collateral proceeding is brought challenging whether production made by the summoned party fully satisfied the court order and whether sanctions should be imposed against the summoned party for a failure to satisfy that order, the periods of limitations remain suspended until all appeals of the collateral proceeding are disposed of, or until the expiration of the period during which an appeal may be taken or a request for further review of the collateral proceeding may be made. Any collateral proceeding to the original proceeding shall be considered to be a continuation of the original proceeding.

(ii) *Proceeding to quash a summons*. The period during which the periods of limitations under sections 6501 and 6531 are suspended under section 7609(e)(1) begins on the date any person described in paragraph (c) of this section files a petition to quash the summons in district court. The periods of limitations remain suspended until all appeals are disposed of, or until expiration of the period in which an appeal may be taken or a request for further review may be made. The periods of limitations remain suspended for the period during which a proceeding is pending, regardless of compliance (or partial compliance) with the summons during that period,

(iii) *Examples*. The rules of paragraph (e)(2) are illustrated by the following examples:

Example 1. A revenue agent issues a summons to A, an accountant for B, requiring production of records relating to B's income tax liabilities for 1998. The summons is served on A on March 1, 2000. B files a petition to quash the summons in district court on March 15, 2000. The district court dismisses B's petition on July 1, 2000. B fails to appeal this decision by filing a notice of appeal within 60 days from the date of the district court's order of dismissal. The revenue agent notifies A that B did not appeal the district court's order. A turns over all of the records requested in the summons. The periods of limitations applicable to B for 1998 under sections 6501 and 6531 are suspended under section 7609(e)(1) from March 15, 2000, the date B filed a petition to quash, until August 30, 2000, the last day on which B could have filed a notice of appeal.

Example 2. A revenue agent issues a summons to A, an accountant for B, requiring production of records relating to B's income tax liabilities for 1999. The summons is served on A on June 1, 2001. B files an untimely petition to quash the summons in district court on June 30, 2001. The district court dismisses B's petition on July 31, 2001. B does not file an appeal of the district court's order. The periods of limitations applicable to B for 1999 under sections 6501 and 6531 are suspended under section 7609(e)(1) from June 30, 2001, the date B filed an untimely petition to quash, until September 29, 2001, the last day on which B could have filed a notice of appeal.

(3) *Final resolution of the summoned third party's response to a summons*. For purposes of section 7609(e)(2)(B), final resolution with respect to a summoned party's response to a third-party summons occurs when the summons or any order enforcing any part of the summons is fully complied with and all appeals are disposed of or the period in which an appeal may be taken or a request for further review may be made has expired. The determination of whether there has been full compliance will be made within a reasonable time, given the volume and complexity of the records produced, after the later of the giving of all testimony or the production of all records requested by the summons. If, following an enforcement order, collateral proceedings are brought challenging whether the production made by the summoned party fully satisfied the court order and whether sanctions should be imposed against the summoned party for a failing to do so, the suspension of the periods of limitations shall continue until the summons or any order enforcing any part of the summons is fully complied with and the decision in the collateral proceeding becomes final. A decision in a collateral proceeding becomes final when all appeals are disposed of or when the period in which an appeal may be taken or a request for further review may be made has expired.

(f) *Effective date*. This section is applicable on the date the final regulations are published in the **Federal Register**.

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

(Filed by the Office of the Federal Register on July 20, 2006, 8:45 a.m., and published in the issue of the Federal Register for July 21, 2006, 71 F.R. 41377)

Escrow Accounts, Trusts, and Other Funds Used During Deferred Exchanges of Like-Kind Property

Announcement 2007–35

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Proposed Rulemaking; Revised Initial Regulatory Flexibility Analysis.

SUMMARY: This document contains a revised initial regulatory flexibility analysis relating to proposed regulations (REG–113365–04, 2006–10 I.R.B. 580) under section 468B of the Internal Revenue Code on the taxation and reporting of income earned on escrow accounts, trusts, and other funds used during deferred exchanges of like-kind property, and proposed regulations under section 7872 regarding below-market loans to facilitators of these exchanges. The proposed regulations affect taxpayers that engage in deferred like-kind exchanges and escrow holders, trustees, qualified intermediaries, and others that hold funds during deferred like-kind exchanges.

DATES: Written or electronic comments must be received by May 4, 2007.

ADDRESSES: Send submissions to CC:PA:LPD:PR (REG–113365–04), 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–113365–04), courier's desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC. Alternatively, taxpayers may submit electronic comments via the Federal eRulemaking Portal at *www.regulations.gov* (IRS-REG–113365–04).

FOR FURTHER INFORMATION CONTACT: Concerning the revised initial regulatory flexibility analysis and the proposed regulations under section 468B, Jeffrey Rodrick, (202) 622–4930; concerning the proposed regulations under section 7872, David Silber, (202) 622–3930; concerning submission of comments, Kelly Banks, (202) 622–3628 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

On February 7, 2006, a partial withdrawal of notice of proposed rulemaking, notice of proposed rulemaking, and notice of public hearing was published in the **Federal Register** (71 FR 6231). The initial regulatory flexibility analysis included in that notice of proposed rulemaking concluded that the number of transactions involving small businesses that will be affected and the full extent of the economic impact on small businesses could not be precisely determined and requested additional comments. This notice revises the initial regulatory flexibility analysis included in that notice of proposed rulemaking in response to comments provided in writing and at a public hearing. These comments asserted that the analysis did not adequately define the industry, determine the number of small businesses affected, describe the economic impact of the proposed regulations on small businesses, or discuss alternatives to the proposed rules that were considered and the bases for conclusions reached. The IRS and the Department of the Treasury have worked closely with the Small Business Administration's (SBA) Office of Advocacy (Advocacy) to obtain additional information from the affected industry to identify and quantify the small businesses affected and to determine the likely economic impact of the proposed regulations on small businesses. In a letter dated August 3, 2006, the president of the leading industry association for qualified intermediaries (QI), wrote that the association "believes we have or can develop information that would be helpful in this [impact-study] effort," and volunteered to provide this information to the IRS. The industry association surveyed its members based on questions developed by the IRS and the Department of the Treasury, and submitted a summary of the survey responses for consideration. The association, which according to its website has over 300 member companies (not all of which are QIs), received approximately 130 responses. Seventy-one respondents indicated they engage in the QI business exclusively, which represents 22 percent of the estimated number of 325 full-time QIs in the industry (as discussed in this notice, not all of which are small businesses). The summary of the survey responses submitted did not address a substantial number of the issues important to evaluating the effect of the proposed regulations on small business. The summary of the survey responses is available at *www.IRS.gov/regs*. This notice seeks additional comments and reiterates questions that will assist in assessing the economic impact of the proposed regulations on small businesses in the QI industry and in considering reasonable alternatives. The survey information provided is discussed in this revised initial regulatory flexibility analysis and will be considered further in the development of final regulations.

Revised Initial Regulatory Flexibility Analysis

Reasons for Action and Succinct Statement of the Objectives of, and Legal Basis for, the Proposed Rule

The proposed regulations are issued under the authority of section 7805, section 468B(g) (which provides that nothing in any provision of law shall be construed as providing that an escrow account, settlement fund, or similar fund is not subject to current income tax and that the Secretary shall prescribe regulations providing for the taxation of such accounts or funds whether as a grantor trust or otherwise), and section 7872.

Section 1.468B–6 of the Income Tax Regulations was included in proposed regulations issued in 1999 under section 468B(g) (the 1999 proposed regulations), and provided rules for the current taxation of income of a qualified escrow account or qualified trust used in a section 1031 deferred exchange of like-kind property. The 1999 proposed regulations included a facts and circumstances test to determine whether the taxpayer (the transferor or exchangor of the property), the QI, or a transferee is the owner of the assets in a qualified escrow account or qualified trust and must take into account all items of income, deduction, and credit (including capital gains and losses) of the account or trust. The 1999 proposed regulations further provided that, if a QI or transferee is the owner of the assets transferred, the transaction may be characterized as a below-market loan from the taxpayer to the owner to which section 7872 may apply. Under this proposed rule, if a QI or transferee is the owner of the assets, the transaction is a loan to which section 7872 generally applies if the loan is below-market.

Comments received on the 1999 proposed regulations reflected differing interpretations of the 1999 proposed regulations and disagreement on the proper rules for taxing these transactions. Some commentators interpreted the 1999 proposed regulations as allowing a QI to "own" the funds held in connection with the deferred like-kind exchange and never characterize the arrangement between the taxpayer and the QI as a loan.

Rules based on a facts and circumstances test are inherently difficult for taxpayers to apply and for the IRS to administer, and are subject to inconsistent application. Therefore, the 2006 proposed regulations eliminate the facts and circumstances test and propose specific rules that determine whether the income of an escrow account, trust, or fund used in a deferred like-kind exchange is taxed to the taxpayer or to an exchange facilitator, which is a QI, transferee, or other party that holds the exchange funds. These rules are intended to provide greater certainty for taxpayers, enhance administrability, and ensure consistent treatment of taxpayers.

Description and Estimate of the Number of Small Businesses to Which the Proposed Regulations Will Apply

The 2006 proposed regulations affect exchange facilitators that hold exchange funds for taxpayers engaging in deferred exchanges of like-kind property. Exchange facilitators may be large or small businesses (including individuals operating as sole proprietors). For this purpose, the SBA size standards set forth at 13 CFR 121.201 for North American Industry Classification System (NAICS) code 531390 (other activities related to real estate), define a business with annual gross receipts of up to $2 million as a small business. There is no NAICS code associated specifically with exchange facilitators or QIs. Although like-kind exchanges are not limited to real estate transactions, 70 percent of the respondents to the industry survey indicated that they use NAICS code 531390. Therefore, notwithstanding comments criticizing the use of NAICS code 531390 for purposes of determining the applicable size standard with respect to the 2006 proposed regulations, after consultation with Advocacy, the IRS and the Department of the Treasury have determined that NAICS code 531390 is appropriate for this industry. Accordingly, the applicable size standard for determining what constitutes a small business with respect to the 2006 proposed regulations is $2 million in annual gross receipts, the SBA's definition of a small business for NAICS code 531390.

The IRS and the Department of the Treasury estimate that there are approximately 325 businesses (primarily QIs) that are full-time exchange facilitators. This estimate is based on information originally provided by the industry association in connection with the development of the 2006 proposed regulations. The recent industry survey did not provide any additional information regarding this number. Seventy-one of 121 (58.7 percent) respondents to the survey indicated that they are engaged exclusively in the QI business, although it is unclear how many of these are small businesses. Although 84 percent of respondents reported having annual gross revenues (fees plus net retained interest, if any) from the QI business of $1.5 million or less (the previous size standard for NAICS code 531390) for the most recent year, it is unclear how many of this number are exclusively in the QI business. The survey also indicated that almost 90 percent of respondents have 10 or fewer employees (including owners active in the business), and nearly 70 percent have fewer than 5 employees. An estimate of the percentage of the QI industry that consists of small businesses is difficult to make based on the available information. The summary of the survey responses did not correlate information on annual gross revenues reported with information on the number of respondents engaged exclusively in the QI business. Nonetheless, it appears that a significant portion of the QI industry consists of small businesses under the SBA's size standard. Accordingly, the IRS and the Department of the Treasury continue to seek information regarding the number of small businesses engaged in the QI industry. Specific comments are requested from QIs engaged exclusively in that business indicating whether their annual gross receipts are $2 million or less, or more than $2 million.

Searches for information through the Department of Commerce and the SBA disclosed no data collected or maintained on QIs or exchange facilitators as an industry.

Description of Compliance Requirements and Estimate of the Classes of Small Businesses that Will Be Affected by the Compliance Requirements

Under the 2006 proposed regulations, exchange funds are treated as loaned by the taxpayer to the exchange facilitator unless all of the income earned is paid to the taxpayer. If the exchange funds are treated as loaned to the exchange facilitator, interest generally is imputed to the taxpayer under section 7872 unless the exchange facilitator pays sufficient interest. If a loan between the taxpayer and the exchange facilitator does not provide for sufficient interest and the loan is not otherwise exempt from section 7872, interest income is imputed to the taxpayer at the applicable Federal rate (AFR) (or the difference between the rate paid and the AFR). Therefore, exchange facilitators must keep records of the amount of income paid to the taxpayer and may be required to report the income on Form 1099.

Under section 7872 and the 2006 proposed regulations, if the exchange funds are treated as loaned from the taxpayer to the QI and the loan is a below-market loan, income is deemed transferred to the exchange facilitator as compensation and retransferred to the taxpayer as interest. The taxpayer's imputed interest income is not offset by a deduction for the taxpayer's imputed payment to the exchange facilitator because compensation paid to the exchange facilitator is a cost of acquiring the replacement property that must be capitalized and added to the property's basis. The exchange facilitator has income from the imputed compensation and an offsetting deduction for the interest deemed paid to the taxpayer.

Seventy percent of respondents to the industry survey reported that they engage in at least 100 exchange transactions a year. According to information provided by the industry association from an earlier survey of its members, over 92 percent of the small business respondents currently pay to the taxpayer at least 20 percent of the income earned on exchange funds, including accounts that commingle the exchange funds of multiple taxpayers. The IRS and the Department of the Treasury request additional comments providing more specific information to clarify these results. The information available suggests that an overwhelming majority of small businesses affected by the 2006 proposed regulations currently maintain records of the amount of income paid to the taxpayer and report the payments on Form 1099. Therefore, the IRS and the Department of the Treasury estimate that for most small businesses the 2006 proposed regulations should not increase significantly the compliance burden associated with keeping records and reporting income paid to the taxpayer.

Nonetheless, commentators have stated generally that complying with the 2006 proposed regulations would result in additional recordkeeping and reporting requirements. Fifty-eight percent of respondents to the recent industry survey indicated that the 2006 proposed regulations significantly will increase recordkeeping burdens and accounting costs, but the survey did not provide quantified data on the amount of any additional time or cost expected to result from the 2006 proposed regulations. Comments are requested esti-

mating the annual number of transactions that will result in an increased recordkeeping and reporting burden, per transaction, under the 2006 proposed regulations, as well as the amount of time and additional cost that each additional recordkeeping and reporting burden would impose.

Commentators also have stated that accounting for individual taxpayers' earnings in commingled accounts would necessitate additional labor and system design costs that would fall disproportionately on small business QIs. The IRS and the Department of the Treasury have not received specific comments quantifying the effect of these costs on small businesses. Specific comments are requested estimating the amount of these costs.

Commentators have asserted that complying with the loan characterization rules of the 2006 proposed regulations will result in a substantial revenue loss and cause a large number of small businesses to fail or to reduce their workforces. They claimed that small business QIs would be disproportionately affected because the small business QIs predominantly apply a business model that would place them at a disadvantage under the 2006 proposed regulations.

In general, commentators have described two business models employed to facilitate deferred like-kind exchanges:

1. The exchange facilitator segregates the exchange funds in separate accounts, charges a separate fee for its services, and pays all earnings to the taxpayer, or

2. The exchange facilitator commingles the exchange funds, pays a portion of the earnings to the taxpayer and retains a portion of the earnings, or may retain all of the earnings. Some of these exchange facilitators also may charge a separate fee for their services. If a fee is charged, it is likely to be lower than the fee that would be charged if the exchange facilitator retains no earnings.

Some small businesses offer customers both forms of structuring the transaction. Comments from and discussions with industry members, however, have disclosed that the first model is employed most commonly by large businesses often "affiliated" (in the sense of having some level of corporate relationship and not necessarily within the meaning of section 1504) with banks. The second model also may be employed by large businesses but is used widely by independent, small business QIs. In the recent industry survey, 95.8 percent of respondents indicated that they are not affiliated with a bank, savings and loan company, brokerage firm, or similar financial institution.

The earlier industry survey indicated that 96 percent of the small business respondents retain at least a portion of the interest earned on the exchange funds. Commentators have stated that if these small businesses are required to impute interest on the exchange funds, taxpayers will demand that this interest be paid to them. According to commentators, to compensate for this loss of revenue these businesses will be required to change their business practices to pay all income to the taxpayer and to charge higher fees. Commentators further stated that absent charging higher fees, paying all interest to the taxpayer is expected to result in a reduction of revenues ranging from 10 to 80 percent. Specific comments are requested estimating the effect on revenues or profits of a change in business practices to pay all income to the taxpayer.

Some commentators have asserted that, in contrast, bank-affiliated QIs generally pay all the income to the taxpayer under their current business practices and therefore will not be required to change their business practices or charge higher fees as a result of the 2006 proposed regulations. These commentators claim that bank-affiliated QIs are able to pay all the income to the taxpayer and charge fees commensurate with the fees charged by independent QIs because bank-affiliated QIs are compensated through the receipt of fees paid by institutions in which the funds are deposited. Moreover, these commentators maintain that bank-affiliated QIs indirectly benefit when funds are deposited with related-party depositary institutions that invest deposited exchange funds and earn income that is not required to be paid to the taxpayer under the 2006 proposed regulations. If, as these commentators claim, bank-affiliated QIs would not be required to change their business model as a result of the 2006 proposed regulations, the commentators predict that the 2006 proposed regulations will cause many small business QIs to be disadvantaged in competing with bank-affiliated QIs. Specific comments are requested estimating the number of QIs that would change their business model as a result of the 2006 proposed regulations.

Significant Alternatives Considered

Various alternatives to the rules contained in the 2006 proposed regulations were considered. For example, retaining the facts and circumstances test of the 1999 proposed regulations was considered but rejected because the test is difficult for taxpayers to apply, lacks administrability, is subject to misinterpretation, and may result in inconsistent tax treatment of similarly-situated taxpayers.

Rules that would allow the exchange facilitator and taxpayer to determine which party will be taxed on the earnings were considered but regarded as lacking certainty and administrability and violating established tax principles. Rules that would tax the party that receives the income (and thus treat only income paid and not income retained by the QI as the taxpayer's taxable income) were considered but not adopted. Under some circumstances, a QI's retention of income earned by an exchange fund is properly characterized as a payment of compensation by the taxpayer for the QI's services. Therefore, under the appropriate circumstances, a rule that taxed only the QI on retained earnings would violate the doctrine of *Old Colony Trust v. Commissioner*, 279 U.S. 716 (1929), that a payment that satisfies the obligation of a taxpayer to a third party is includible in the income of the taxpayer.

A rule that would treat all the earnings of the exchange funds in all circumstances as the taxpayer's income was considered but lacked flexibility and did not conform in all cases to the substance of the transaction. Other alternatives were considered and not adopted because they were considered inconsistent with section 7872. In the legislative history to section 7872, Congress stated that when a service provider is permitted to retain customer funds without paying interest to the customer, and the benefit the service provider derives from the funds is in lieu of a fee for services, the transaction is a compensation-related loan under section 7872. H.R. Conf. Rep. No. 861, 98th Cong., 2d Sess. 1019 (1984) (1984–3 (Vol. 2) C.B. 272). Moreover, it was determined that exchange funds are not received in consideration for the sale or exchange of property (within the mean-

ing of section 1274(c)(1)) or received as a deferred payment on account of a sale or exchange of property (within the meaning of section 483).

The industry survey indicates that 30 percent of respondents closed at least half of their deferred like-kind exchange transactions within 60 days or less. Only eight percent completed at least half of their transactions in more than 150 days. In addition, 42 percent of survey respondents reported that at least half of their transactions typically involve exchange funds of $250,000 or less, while about 8 percent of respondents reported that most of their transactions involve exchange funds in excess of $1 million. In light of this information, comments specifically are requested regarding the average duration of exchange transactions, the average dollar amount of exchange funds, and the appropriateness and nature of a *de minimis* rule that would except certain exchange transactions from the application of section 7872.

If exchange funds are characterized as loaned by the taxpayer to the exchange facilitator, interest may be imputed if the exchange facilitator does not pay sufficient interest to the taxpayer. To reduce the administrative burden of determining imputed interest, the 2006 proposed regulations provide a special AFR, equal to the investment rate on a 182-day Treasury bill, in lieu of the short-term AFR (which applies to loans of 3 years or less), to qualify as sufficient interest for purposes of determining whether interest must be imputed. This special AFR was intended to be a more accurate measure of a market rate of interest for these loans than the short-term AFR, and was expected to result in characterization of fewer transactions as below-market loans than if the short-term AFR were used. Commentators have stated that the special AFR is significantly higher than the market rate paid on funds held for the periods of time that exchange funds typically are held by QIs. They state, for example, that few if any QIs that pay less than all the income to the taxpayer pay an amount that is equal to or greater than the special AFR provided in the 2006 proposed regulations. Specific comments are requested identifying the rate of return typically earned by small business QIs on exchange funds, the interest rate QIs typically pay to taxpayers, and an appropriate rate for testing exchange facilitator loans for sufficient interest under section 7872.

Duplicative, Overlapping, and Conflicting Rules

The IRS and the Department of the Treasury are not aware of any duplicative, overlapping, or conflicting federal rules.

Kevin M. Brown,
Deputy Commissioner for Services and Enforcement.

(Filed by the Office of the Federal Register on March 19, 2007, 8:45 a.m., and published in the issue of the Federal Register for March 20, 2007, 72 F.R. 13055)

Expenses for Household and Dependent Care Services Necessary for Gainful Employment; Correction

Announcement 2007–36

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Correction to notice of proposed rulemaking.

SUMMARY: This document contains a correction to notice of proposed rulemaking (REG–139059–02, 2006–24 I.R.B. 1052) that was published in the Federal Register on Wednesday, May 24, 2006 (71 FR 29847) regarding the credit for expenses for household and dependent care services necessary for gainful employment.

FOR FURTHER INFORMATION CONTACT: Sara Shepherd, (202) 622–4960 (not a toll-free call).

SUPPLEMENTARY INFORMATION:

Background

The notice of proposed rulemaking (REG–139059–02) that is the subject of this correction is under section 21 of the Internal Revenue Code.

Need for Correction

As published, the notice of proposed rulemaking (REG–139059–02) contains an error that may prove to be misleading and is in need of correction.

* * * * *

Correction of Publication

Accordingly, the notice of proposed rulemaking (REG–139059–02), that was the subject of FR Doc. E6–7390, is corrected 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 * * *

§ 1.21–1 [Corrected]

Par. 2. On page 29851, column 1, Sec. 1.21–1 is amended by revising paragraph (b)(5)(ii) to read as follows:

§ 1.21–1 Expenses for household and dependent care services necessary for gainful employment.

* * * * *

(b) * * *

(5) * * *

(ii) Custodial parent allowed the credit. A child to whom this paragraph (b)(5) applies is the qualifying individual of only one parent in any taxable year and is the qualifying child of the custodial parent even if the noncustodial parent may claim the dependency exemption for that child for that taxable year. See section 152(e). The custodial parent is the parent with whom a child shared the same principal place of abode the greater portion of the calendar year. See section 152(e)(4)(A).

* * * * *

Guy R. Traynor,
Branch Chief, Publications and Regulations Branch, Legal Processing Division, Associate Chief Counsel (Procedure and Administration).

(Filed by the Office of the Federal Register on July 5, 2006, 8:45 a.m., and published in the issue of the Federal Register for July 6, 2006, 71 F.R. 38322)

Expenses for Household and Dependent Care Services Necessary for Gainful Employment; Correction

Announcement 2007–37

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Correction to notice of proposed rulemaking.

SUMMARY: This document contains a correction to notice of proposed rulemaking (REG–139059–02, 2006–24 I.R.B. 1052) that was published in the Federal Register on Wednesday, May 24, 2006 (71 FR 29847) regarding the credit for expenses for household and dependent care services necessary for gainful employment.

FOR FURTHER INFORMATION CONTACT: Sara Shepherd, (202) 622–4960 (not a toll-free call).

SUPPLEMENTARY INFORMATION:

Background

The notice of proposed rulemaking (REG–139059–02) that is the subject of this correction is under section 21 of the Internal Revenue Code.

Need for Correction

As published, the notice of proposed rulemaking (REG–139059–02) contains an error that may prove to be misleading and is in need of correction.

Correction of Publication

Accordingly, the notice of proposed rulemaking (REG–139059–02), that was the subject of FR Doc. E6–7390, is corrected as follows:

1. On page 29848, column 2, in the preamble under the paragraph heading "3. Special Rule for Children of Separated or Divorced Parents", line 4 from the bottom of the paragraph, the language "section 152(e)(3)(A) as the parent with" corrected to read "section 152(e)(4)(A) as the parent with."

Guy R. Traynor,
Branch Chief, Publications and Regulations Branch, Legal Processing Division, Associate Chief Counsel (Procedure and Administration).

(Filed by the Office of the Federal Register on July 5, 2006, 8:45 a.m., and published in the issue of the Federal Register for July 6, 2006, 71 F.R. 38323)

Deletions From Cumulative List of Organizations Contributions to Which are Deductible Under Section 170 of the Code

Announcement 2007–38

The names of organizations that no longer qualify as organizations described in section 170(c)(2) of the Internal Revenue Code of 1986 are listed below.

Generally, the Service will not disallow deductions for contributions made to a listed organization on or before the date of announcement in the Internal Revenue Bulletin that an organization no longer qualifies. However, the Service is not precluded from disallowing a deduction for any contributions made after an organization ceases to qualify under section 170(c)(2) if the organization has not timely filed a suit for declaratory judgment under section 7428 and if the contributor (1) had knowledge of the revocation of the ruling or determination letter, (2) was aware that such revocation was imminent, or (3) was in part responsible for or was aware of the activities or omissions of the organization that brought about this revocation.

If on the other hand a suit for declaratory judgment has been timely filed, contributions from individuals and organizations described in section 170(c)(2) that are otherwise allowable will continue to be deductible. Protection under section 7428(c) would begin on April 9, 2007, and would end on the date the court first determines that the organization is not described in section 170(c)(2) as more particularly set forth in section 7428(c)(1). For individual contributors, the maximum deduction protected is $1,000, with a husband and wife treated as one contributor. This benefit is not extended to any individual, in whole or in part, for the acts or omissions of the organization that were the basis for revocation.

Quality Industrial Services
Snohomish, WA

Nazareth, Inc.
Cleveland Heights, OH

One Step Ahead Daycare, Inc.
Racine, WI

Gift America Program
Rockville, MD

The Patrick and Janet Hayes
Charitable Supporting Organization
Houston, TX

10th Life Foundation
Santa Barbara, CA

San Francisco Neighbors Resource Center
San Francisco, CA

Emerald Foundation, Inc.
Ojai, CA

Osterville Village Association
Osterville, MA

Further Extension of Deadline for Settlement Offered to Certain Foreign Embassy Staff

Announcement 2007–39

Following is a copy of the News Release issued by the Office of Deputy Commissioner, International, on March 22, 2007 (IR–2007–67).

IRS Further Extends Deadline for Settlement Offered To Certain Foreign Embassy Staff

IR–2007–67, Mar. 22, 2007

WASHINGTON — The Internal Revenue Service is providing a further extension, until June 30, 2007, of the deadline for current and former U.S.-based employees of foreign embassies, consular offices and missions and international organizations to

participate in a one-time settlement initiative to resolve outstanding tax matters related to their employment.

Following requests from several embassies, the date is again being extended to make certain those wishing to participate in the initiative have the opportunity to do so.

The offer is open to employees of those organizations who are U.S. citizens, green-card holders and foreign employees who have tax obligations. Accredited diplomatic personnel are generally exempt from income taxes on their wages under the Internal Revenue Code and international treaties or agreements.

The IRS estimates that as many as half of these employees subject to U.S. tax fail to report their wages, claim deductions they are not entitled to, incorrectly establish SEP/IRA retirement plans, fail to pay self-employment tax or fail to file tax returns.

To participate, employees must submit amended or original tax returns for tax years 2004 and 2005 that properly reflect their income and expenses. Participants in the settlement will not be required to provide tax year 2003 returns, which was previously part of the settlement eligibility requirement. In addition, participants with erroneously established SEP/IRA plans will not be required to distribute amounts contributed to these SEP/IRAs for tax years prior to the 2004 tax year. This change follows discussions with embassies and provides consistency with the income tax portion of the settlement initiative.

IRS will remove the 2003 tax year issues from the settlement elections previously received from taxpayers.

IRS encourages those affected taxpayers to act quickly so to avoid a future audit process that could prove costly. Foreign embassy, consular office or international organization employees who fail to come forward may be subject to IRS audits and penalties which could cover more than just three years.

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.

Numerical Finding List[1]

Bulletins 2007–1 through 2007–15

Announcements:

Notices:

Notices— Continued:

Proposed Regulations:

Revenue Procedures:

Revenue Procedures— Continued:

Revenue Rulings:

Tax Conventions:

Treasury Decisions:

[1] A cumulative list of all revenue rulings, revenue procedures, Treasury decisions, etc., published in Internal Revenue Bulletins 2006–27 through 2006–52 is in Internal Revenue Bulletin 2006–52, dated December 26, 2006.

Finding List of Current Actions on Previously Published Items[1]

Bulletins 2007–1 through 2007–15

Notices:

2002-45
Modified by
Notice 2007-22, 2007-10 I.R.B. *670*

2005-29
Modified and superseded by
Notice 2007-4, 2007-2 I.R.B. *260*

2005-86
Modified by
Notice 2007-22, 2007-10 I.R.B. *670*

2005-98
Modified and superseded by
Notice 2007-26, 2007-14 I.R.B. *870*

2006-2
Modified and superseded by
Notice 2007-4, 2007-2 I.R.B. *260*

2006-13
Obsoleted by
T.D. 9315, 2007-15 I.R.B. *891*

2006-50
Amplified, clarified, and modified by
Notice 2007-11, 2007-5 I.R.B. *405*

2006-87
Modified and supplemented by
Notice 2007-25, 2007-12 I.R.B. *760*

Proposed Regulations:

REG-208270-86
Corrected by
Ann. 2007-4, 2007-7 I.R.B. *518*

REG-121509-00
Corrected by
Ann. 2007-17, 2007-8 I.R.B. *597*

REG-139059-02
Corrected by
Ann. 2007-36, 2007-15 I.R.B. *953*
Ann. 2007-37, 2007-15 I.R.B. *954*

REG-141901-05
Corrected by
Ann. 2007-7, 2007-4 I.R.B. *377*

REG-142270-05
Corrected by
Ann. 2007-2, 2007-2 I.R.B. *263*

REG-125632-06
Corrected by
Ann. 2007-26, 2007-10 I.R.B. *682*

Proposed Regulations— Continued:

REG-127819-06
Corrected by
Ann. 2007-5, 2007-4 I.R.B. *376*

REG-136806-06
Corrected by
Ann. 2007-6, 2007-4 I.R.B. *376*
Hearing cancelled by
Ann. 2007-19, 2007-7 I.R.B. *521*

Revenue Procedures:

98-20
Superseded by
Rev. Proc. 2007-12, 2007-4 I.R.B. *354*

2000-38
Modified by
Rev. Proc. 2007-16, 2007-4 I.R.B. *358*

2000-42
Obsoleted in part by
T.D. 9315, 2007-15 I.R.B. *891*

2000-50
Modified by
Rev. Proc. 2007-16, 2007-4 I.R.B. *358*

2001-42
Modified and amplified by
Rev. Proc. 2007-19, 2007-7 I.R.B. *515*

2002-9
Modified and amplified by
Rev. Proc. 2007-14, 2007-4 I.R.B. *357*
Modified by
Rev. Proc. 2007-16, 2007-4 I.R.B. *358*

2004-11
Superseded by
Rev. Proc. 2007-16, 2007-4 I.R.B. *358*

2004-65
Modified and superseded by
Rev. Proc. 2007-20, 2007-7 I.R.B. *517*

2005-12
Superseded by
Rev. Proc. 2007-17, 2007-4 I.R.B. *368*

2005-51
Amplified by
Rev. Proc. 2007-25, 2007-12 I.R.B. *761*

2005-69
Superseded by
Rev. Proc. 2007-15, 2007-3 I.R.B. *300*

2005-74
Superseded by
Rev. Proc. 2007-24, 2007-11 I.R.B. *692*

2006-1
Superseded by
Rev. Proc. 2007-1, 2007-1 I.R.B. *1*

Revenue Procedures— Continued:

2006-2
Superseded by
Rev. Proc. 2007-2, 2007-1 I.R.B. *88*

2006-3
Superseded by
Rev. Proc. 2007-3, 2007-1 I.R.B. *108*

2006-4
Superseded by
Rev. Proc. 2007-4, 2007-1 I.R.B. *118*

2006-5
Superseded by
Rev. Proc. 2007-5, 2007-1 I.R.B. *161*

2006-6
Superseded by
Rev. Proc. 2007-6, 2007-1 I.R.B. *189*

2006-7
Superseded by
Rev. Proc. 2007-7, 2007-1 I.R.B. *227*

2006-8
Superseded by
Rev. Proc. 2007-8, 2007-1 I.R.B. *230*

2006-17
Obsoleted in part by
Rev. Proc. 2007-26, 2007-13 I.R.B. *814*

2006-35
Modified by
Rev. Proc. 2007-22, 2007-10 I.R.B. *675*

Revenue Rulings:

54-19
Obsoleted in part by
Rev. Rul. 2007-14, 2007-12 I.R.B. *747*

55-132
Obsoleted by
Rev. Rul. 2007-14, 2007-12 I.R.B. *747*

56-462
Obsoleted by
Rev. Rul. 2007-14, 2007-12 I.R.B. *747*

56-518
Obsoleted by
Rev. Rul. 2007-14, 2007-12 I.R.B. *747*

57-505
Obsoleted by
Rev. Rul. 2007-14, 2007-12 I.R.B. *747*

58-370
Obsoleted by
Rev. Rul. 2007-14, 2007-12 I.R.B. *747*

58-500
Obsoleted by
Rev. Rul. 2007-14, 2007-12 I.R.B. *747*

[1] A cumulative list of current actions on previously published items in Internal Revenue Bulletins 2006–27 through 2006–52 is in Internal Revenue Bulletin 2006–52, dated December 26, 2006.

Revenue Rulings— Continued:

69-141
Modified by
Notice 2007-22, 2007-10 I.R.B. *670*

69-212
Obsoleted by
Rev. Rul. 2007-14, 2007-12 I.R.B. *747*

69-587
Revoked by
Rev. Rul. 2007-12, 2007-11 I.R.B. *685*

71-477
Obsoleted by
Rev. Rul. 2007-14, 2007-12 I.R.B. *747*

75-161
Obsoleted by
Rev. Rul. 2007-8, 2007-7 I.R.B. *469*

76-188
Obsoleted by
Rev. Rul. 2007-8, 2007-7 I.R.B. *469*

78-330
Modified by
Rev. Rul. 2007-8, 2007-7 I.R.B. *469*

81-225
Clarified and amplified by
Rev. Rul. 2007-7, 2007-7 I.R.B. *468*

92-19
Supplemented in part by
Rev. Rul. 2007-10, 2007-10 I.R.B. *660*

96-51
Amplified by
Rev. Rul. 2007-12, 2007-11 I.R.B. *685*

2002-41
Modified by
Notice 2007-22, 2007-10 I.R.B. *670*

2003-43
Modified by
Notice 2007-2, 2007-2 I.R.B. *254*

2003-92
Clarified and amplified by
Rev. Rul. 2007-7, 2007-7 I.R.B. *468*

2003-102
Modified by
Notice 2007-22, 2007-10 I.R.B. *670*

2005-24
Modified by
Notice 2007-22, 2007-10 I.R.B. *670*

2005-76
Supplemented and superseded by
Rev. Rul. 2007-4, 2007-4 I.R.B. *351*

2006-36
Modified by
Notice 2007-22, 2007-10 I.R.B. *670*

Treasury Decisions:

9263
Corrected by
Ann. 2007-22, 2007-9 I.R.B. *631*

9276
Corrected by
Ann. 2007-20, 2007-8 I.R.B. *599*
Ann. 2007-21, 2007-9 I.R.B. *630*

9278
Corrected by
Ann. 2007-9, 2007-5 I.R.B. *417*
Ann. 2007-10, 2007-6 I.R.B. *464*

9286
Corrected by
Ann. 2007-8, 2007-5 I.R.B. *416*

9298
Corrected by
Ann. 2007-32, 2007-11 I.R.B. *734*

9303
Corrected by
Ann. 2007-25, 2007-10 I.R.B. *682*

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