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Memorandum

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subject: Dual Consolidated Losses: Application of the Exception to Foreign Use for Certain Interests in Partnerships or Grantor Trusts

ISSUE

How does the exception to foreign use for certain interests in partnerships or grantor trusts provided under Treas. Reg. §1.1503(d)-3(c)(4) apply to the scenarios described below?

SCENARIOS

Presumed Facts

For purposes of the three scenarios described below, unless otherwise indicated, the following facts are presumed:

- i. All dual consolidated losses (DCLs) are subject to Treas. Reg. §§1.1503(d)-1 through -8.¹

¹ The IRS and Treasury Department issued regulations under section 1503(d) in March 2007 ("2007 regulations"). T.D. 9315. All references herein are to the 2007 regulations. The 2007 regulations generally apply to DCLs incurred in taxable years beginning on or after April 18, 2007, although taxpayers may elect to have the 2007 regulations apply to taxable years beginning on or after January 1, 2007. The IRS and Treasury Department issued regulations under section 1503(d) in 1992 which generally apply to DCLs incurred in taxable years beginning before the 2007 regulations apply. T.D. 8434.

- ii. USP is a domestic corporation that files a U.S. income tax return on a calendar year basis and is the common parent of a consolidated group.
- iii. USP owns 100 percent of USS, a domestic corporation that is a member of the USP consolidated group.
- iv. USP owns 100 percent of DE_X, a Country X entity subject to Country X tax on its worldwide income, that is disregarded as an entity separate from its owner for Federal tax purposes. DE_X 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 Treas. Reg. §1.367(a)-6T(g)(1). USP's interest in DE_X constitutes a hybrid entity separate unit.² USP's indirect interest in the Country X business operation conducted by DE_X constitutes a foreign branch separate unit.³
- v. USS owns 50 percent of HPS_X, a Country X entity subject to Country X tax on its worldwide income. FP_Y, an unrelated Country Y corporation, owns the remaining 50 percent of HPS_X. HPS_X is classified as a partnership for U.S. tax purposes and 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 Treas. Reg. §1.367(a)-6T(g)(1). USS's interest in HPS_X constitutes a hybrid entity separate unit.⁴ USS's indirect interest in the Country X business operation conducted by HPS_X constitutes a foreign branch separate unit.⁵
- vi. The following four individual separate units owned by USP and USS constitute a combined separate unit (Combined Separate Unit): USP's interest in DE_X, USP's indirect interest in the Country X business operation conducted by DE_X, USS's interest in HPS_X, and USS's indirect interest in the Country X business operation conducted by HPS_X.⁶
- vii. In year 1, Combined Separate Unit incurred a DCL.
- viii. USP made a timely domestic use election under Treas. Reg. §1.1503(d)-6(d) for the year 1 DCL attributable to Combined Separate Unit.
- ix. But for the application of Treas. Reg. §1.1503(d)-3(c)(4)(i) and (ii), there would be a foreign use of the year 1 DCL in year 2 as a result of FP_Y's ownership of an interest in HPS_X and the carry forward of an item of deduction or loss composing the year 1 DCL.

Scenario 1

At the end of year 2, USS sells half of its 50 percent interest in HPS_X to FB_Z, a Country Z corporation. As a result of the sale, USS's percentage interest in HPS_X was reduced by 50 percent (that is, from 50 percent to 25 percent); however, USP's and USS's percentage interest in the Combined Separate Unit was reduced by less than 10 percent.

² Treas. Reg. §1.1503(d)-1(b)(4)(i)(B).

³ Treas. Reg. §1.1503(d)-1(b)(4)(i)(A).

⁴ Treas. Reg. §1.1503(d)-1(b)(4)(i)(B).

⁵ Treas. Reg. §1.1503(d)-1(b)(4)(i)(A).

⁶ Treas. Reg. §1.1503(d)-1(b)(4)(ii).

Scenario 2

At the end of year 2, USS sells its entire interest in HPS_X to FB_Z, a Country Z corporation. As a result of the sale, USS's percentage interest in HPS_X was reduced by 100 percent (that is, from 50 percent to zero), and USP's and USS's percentage interest in the Combined Separate Unit was reduced by 10 percent or more.

Scenario 3

At the end of year 2, USS and FP_Y decide to terminate HPS_X, and, as a result, HPS_X distributes its property to USS and FP_Y in liquidation of their partnership interests. After the liquidation of HPS_X, the HPS_X assets distributed to USS in liquidation continue to constitute an individual separate unit that composes the Combined Separate Unit.

APPLICABLE LAW

Subject to certain exceptions, section 1503(d) and the regulations thereunder prevent a DCL from being made available to offset, directly or indirectly, the income of a domestic affiliate (domestic use).⁷ A domestic use occurs in the taxable year when the DCL is included in the computation of taxable income, even if no tax benefit results from such inclusion in that year.⁸ A DCL is a net operating loss of a dual resident corporation or the net loss attributable to a separate unit.⁹

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.¹⁰ A separate unit generally means either of the following that is carried on or owned, directly or indirectly, by a domestic corporation: (1) a business operation outside the United States that, if carried on by a U.S. person, would constitute a foreign branch within the meaning of Treas. Reg. §1.367(a)-6T(g)(1) (foreign branch separate unit); and (2) an interest in a hybrid entity (hybrid entity separate unit).¹¹ A domestic owner generally is a domestic corporation that has one or more separate units.¹² The term "indirectly," when used in reference to ownership, means ownership through a partnership, a disregarded entity, or a grantor trust.¹³ A 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

⁷ Treas. Reg. §§1.1503(d)-2 and -4(b).

⁸ Treas. Reg. §1.1503(d)-2.

⁹ Treas. Reg. §1.1503(d)-1(b)(5). See Treas. Reg. §1.1503(d)-5(b)(2) for certain items that are not taken into account for purposes of determining the income or DCL of a dual resident corporation.

¹⁰ Treas. Reg. §1.1503(d)-1(b)(2)(i). The definition of a dual resident corporation also includes certain foreign insurance companies that make an election to be treated as a domestic corporation pursuant to section 953(d). Treas. Reg. §1.1503(d)-1(b)(2)(ii).

¹¹ Treas. Reg. §1.1503(d)-1(b)(4)(i).

¹² Treas. Reg. §1.1503(d)-1(b)(9).

¹³ Treas. Reg. §1.1503(d)-1(b)(19).

corporation (or otherwise at the entity level) either on its worldwide income or on a residence basis.¹⁴

In general, 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 separate unit) in the same foreign country are treated as one separate unit (combined separate unit).¹⁵ Unless otherwise specifically provided, any individual separate unit composing a combined separate unit loses its character as an individual separate unit.¹⁶

A taxpayer may generally use a DCL to offset a domestic affiliate's income if a timely domestic use election is made.¹⁷ If a domestic use election is timely made and a triggering event occurs (and no exception applies) during the certification period,¹⁸ the taxpayer must generally recapture and report as gross income the total amount of the DCL on its U.S. income tax return for the taxable year in which the triggering event occurs, plus an applicable interest charge.¹⁹

One triggering event is the foreign use of a DCL.²⁰ Subject to certain exceptions, a foreign use of a DCL is deemed to occur when two conditions are satisfied. First, any portion of a deduction or loss that is taken into account in computing the DCL must be 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.²¹ Second, the item of income described in the prior sentence is, or would be, considered under U.S. tax principles, to be an item of a foreign corporation, or an item of a direct or indirect owner of an interest in a hybrid entity, provided the interest is not a separate unit.²²

One of the exceptions to the general definition of foreign use is provided under Treas. Reg. §1.1503(d)-3(c)(5) and applies to a de minimis reduction of an interest in a separate unit ("de minimis exception"). The de minimis exception generally provides that no foreign use shall be considered to occur as a result of an item of deduction or

¹⁴ Treas. Reg. §1.1503(d)-1(b)(3).

¹⁵ Treas. Reg. §1.1503(d)-1(b)(4)(ii).

¹⁶ *Id.*

¹⁷ Treas. Reg. §1.1503(d)-6(d).

¹⁸ The certification period is the period of time up to and including the fifth taxable year following the year in which the DCL was incurred. Treas. Reg. §1.1503(d)-1(b)(20).

¹⁹ Treas. Reg. §1.1503(d)-6(h). A taxpayer may not make a domestic use election if a foreign use triggering event occurs in the year in which the DCL was incurred, or in any prior year. See Treas. Reg. §1.1503(d)-6(d)(2).

²⁰ Treas. Reg. §1.1503(d)-6(e)(1)(i).

²¹ Treas. Reg. §1.1503(d)-3(a)(1).

²² *Id.* See also Treas. Reg. §1.1503(d)-3(a)(2) for the definition of an indirect foreign use.

loss composing the DCL being made available solely as a result of certain reductions in the domestic owner's interest in the separate unit.²³

The de minimis exception does not apply, however, if the domestic owner's percentage interest in the separate unit is reduced by more than a certain amount ("de minimis limitation"). Under the de minimis limitation, the de minimis exception shall not apply if the domestic owner's percentage interest in the separate unit is reduced by either: (1) 10 percent or more during any 12-month period, as determined by reference to the domestic owner's interest at the beginning of the 12-month period; or (2) 30 percent or more, as determined by reference to the domestic owner's interest at the end of the taxable year in which the DCL was incurred.²⁴

Treas. Reg. §1.1503(d)-3(c)(4) provides another exception to foreign use for certain interests in partnerships or grantor trusts ("(c)(4) exception"). The (c)(4) exception applies to a DCL 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.²⁵ Under this exception, 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 the DCL as a result of such ownership.²⁶

The (c)(4) exception to foreign use does not apply if, at any time from the year in which the DCL is incurred, there is more than a de minimis reduction in the domestic owner's percentage interest in the partnership or grantor trust ("(c)(4) limitation"), as described in Treas. Reg. §1.1503(d)-3(c)(5).²⁷

The (c)(4) exception also applies to a DCL attributable to a combined separate unit that includes an individual separate unit to which the (c)(4) exception would apply but for the application of the separate unit combination rule of Treas. Reg. §1.1503(d)-1(b)(4)(ii).²⁸ In such a case, the (c)(4) exception applies to the portion of the DCL of such combined separate unit attributable to the individual separate unit that is a component of the combined separate unit.²⁹

For purposes of both the de minimis exception and the (c)(4) exception, a reduction in interest may result from another person acquiring through a sale, exchange, contribution, or other means an interest in the foreign branch or hybrid entity.³⁰ In the case of a hybrid entity partnership or a separate unit all or a portion of which is carried

²³ Treas. Reg. §1.1503(d)-3(c)(5).

²⁴ Treas. Reg. §1.1503(d)-3(c)(5)(ii)(A) and (B).

²⁵ Treas. Reg. §1.1503(d)-3(c)(4)(i).

²⁶ *Id.*

²⁷ Treas. Reg. §1.1503(d)-3(c)(4)(iii).

²⁸ Treas. Reg. §1.1503(d)-3(c)(4)(ii).

²⁹ *Id.*

³⁰ Treas. Reg. §1.1503(d)-3(c)(5)(iii).

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.³¹

ANALYSIS

Treasury Reg. §1.1503(d)-3(c)(4) contains two operative provisions: the (c)(4) exception and the (c)(4) limitation. As applicable, the (c)(4) exception prevents what would otherwise be a foreign use that results from ownership of a separate unit, in whole or in part, by reason of a partnership interest. The (c)(4) limitation, however, prevents the application of the (c)(4) exception upon certain reductions in the partnership interest such that a foreign use will no longer be considered as not occurring. In other words, the (c)(4) limitation is "an exception to the exception" to foreign use.

Both the (c)(4) exception and the (c)(4) limitation can apply with respect to a separate unit that is held solely by reason of a partnership interest. For example, they can apply when the domestic owner holds an interest in a hybrid entity partnership and such interest constitutes the entire separate unit.³² In such a case, a reduction in the partnership interest generally results in a corresponding reduction in the separate unit. Accordingly, the de minimis reduction rule contained in Treas. Reg. §1.1503(d)-3(c)(4)(iii) would generally provide the same result without regard to whether it is applied with respect to the partnership interest or the separate unit. For example, if a separate unit consists solely of an interest in a hybrid entity partnership, then a ten-percent reduction in the domestic owner's interest in the hybrid entity partnership will also result in a ten-percent reduction in the separate unit.

The (c)(4) exception and the (c)(4) limitation also can apply to a separate unit that is held only in part by reason of a partnership interest. For example, they can apply when the domestic owner directly holds an individual separate unit and also indirectly holds, through an interest in a partnership, an individual separate unit, and both individual separate units comprise a combined separate unit. Treasury Reg. §1.1503(d)-3(c)(4)(ii) provides how the (c)(4) exception applies in such a case.³³ However, there is no rule that explicitly provides how the (c)(4) limitation applies to a separate unit held only in

³¹ *Id.* 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. *Id.*

³² The (c)(4) exception and (c)(4) limitation would also apply if the hybrid entity partnership carries on a business operation constituting a foreign branch separate unit in the same country that subjects the hybrid entity partnership to an income tax on its worldwide income or on a residence basis, and both the hybrid entity separate unit and the foreign branch separate unit are combined and constitute the entire separate unit.

³³ Treasury Reg. §1.1503(d)-3(c)(4)(ii) makes clear that the (c)(4) exception only applies to the portion of the DCL attributable to individual separate units composing the combined separate unit that are held by reason of the partnership interest (or grantor trust interest).

part by reason of a partnership interest, such as the Combined Separate Unit held by USP and USS.

In contrast to a separate unit held solely by reason of a partnership interest, when a separate unit is held only in part by reason of a partnership interest, a reduction in the interest in the partnership will not correspond to an equal percentage reduction in the separate unit. For example, in the case of USP and USS, a ten-percent reduction in USS's interest in HPS_x will not correspond to an equal reduction in the Combined Separate Unit. In such a case, it must be determined whether the de minimis reduction rule contained in Treas. Reg. §1.1503(d)-3(c)(4)(iii) is applied based on the percentage reduction in the partnership interest, or the percentage reduction in the combined separate unit.

Treasury Reg. §1.1503(d)-3(c)(4)(iii) provides that the (c)(4) limitation applies if “there is more than a de minimis reduction in the domestic owner’s percentage interest in the partnership . . .” It further provides that, for this purpose, the de minimis reduction is determined by reference to the de minimis limitation provided in Treas. Reg. §1.1503(d)-3(c)(5). The de minimis limitation in Treas. Reg. §1.1503(d)-3(c)(5) applies to the extent of certain reductions in the percentage interest of the separate unit; it does not apply based on reductions in the percentage interest in a partnership interest. As a result of the language specifying a reduction in the partnership interest, along with the reference to Treas. Reg. §1.1503(d)-3(c)(5), the (c)(4) limitation should be applied based on a reduction in the percentage interest in the partnership interest, but only to the extent that the reduction in the partnership interest has the effect of more than a de minimis reduction in the entire separate unit (which would include other individual separate units composing a combined separate unit that are not held by reason of the partnership interest). This interpretation applies the (c)(4) limitation in a manner consistent with the application of the de minimis limitation, the application of which depends on the extent of a reduction in the percentage interest in the separate unit.³⁴

CONCLUSIONS

Under the facts of *Scenarios 1* and *2*, the (c)(4) limitation only applies if the reduction in USS's interest in HPS_x results in a reduction to USP's and USS's percentage interest in the Combined Separate Unit equal to or greater than 10 percent.

Accordingly, in *Scenario 1*, because the sale of half of USS's 50 percent interest in HPS_x resulted in a reduction in USP's and USS's percentage interest in the Combined Separate Unit of less than 10 percent, the (c)(4) limitation does not apply. As a result, the (c)(4) exception prevents the sale from resulting in a foreign use of the year 1 DCL. This is the case even though the sale resulted in a 50 percent reduction in USS's interest in HPS_x.

³⁴ When a combined separate unit is at issue, there is no policy reason to interpret the de minimis limitation based on the entire combined separate unit, and the (c)(4) limitation based only on the individual separate units of the combined separate unit that are held by reason of the partnership interest.

In *Scenario 2*, however, because the sale of USS's entire interest in HPS_x resulted in a reduction of 10 percent or more in USP's and USS's percentage interest in the Combined Separate Unit, the (c)(4) limitation applies. As a result, the (c)(4) exception does not prevent the sale from resulting in a foreign use of the year 1 DCL.

Finally, in *Scenario 3*, because the liquidation of HPS_x did not result in a reduction of USP's and USS's percentage interest in the Combined Separate Unit, the (c)(4) limitation does not apply and the (c)(4) exception prevents the distribution from resulting in a foreign use of the year 1 DCL. This is the case even though the distribution resulted in a 100 percent reduction in USS's interest in HPS_x.

CAVEAT

This memorandum only addresses the (c)(4) exception to foreign use. It does not address other triggering events, or exceptions thereto, that may apply to the transactions described in *Scenarios 1* through *3*.

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