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One Elk Street, Albany, New York 12207 • 518/463-3200 • http://www.nysba.org

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Mr. Eric Solomon
Acting Deputy Assistant Secretary (Tax Policy)
Department of the Treasury
Room 3104 MT
1500 Pennsylvania Avenue, N.W.
Washington, D.C. 20220

The Honorable Mark W. Everson
Commissioner
Internal Revenue Service
Room 3000 IR
1111 Constitution Avenue, N.W.
Washington, D.C. 20224

Dear Acting Deputy Assistant Secretary Solomon and Commissioner Everson:

I am pleased to submit the New York State Bar Association Tax Section's Report No. 1100 (the "Report") on the recently proposed treasury regulations dealing with dual consolidated losses (the "Proposed Regulations"). We greatly appreciate the work that the IRS and Treasury have undertaken to revise and improve the relevant rules in light of the check-the-box regulations and other recent developments.

We think the Proposed Regulations modify the current regulations in many positive ways.[1] Moreover, the expanded hybrid entity

[1] These include, but are not limited to: (i) rationalizing the branch combination rule, (ii) reducing "SRLY'd" items resulting from a dual consolidated loss to a proportionate share of the deductions constituting the loss instead of all items, (iii) shortening the certification period for domestic use elections to seven years from fifteen years, and (iv) expanding opportunities for the rebuttal of domestic use election recapture.

definitions and the 52 numbered examples set out in Proposed Regulation § 1.1503(d)-5 help resolve many unanswered questions.

Our Report makes one over-arching recommendation concerning the relevance of foreign law: The dual consolidated loss rules are fundamentally concerned with "double dipping" – that is, with using losses to reduce both the U.S. tax imposed on related U.S. entities and the foreign taxes imposed on related foreign entities. For reasons of administrability, however, the Proposed Regulations (like the current regulations) avoid any reference to foreign tax law. This decision not to rely on foreign tax law denies some U.S. taxpayers the use of U.S. losses even though there is no actual foreign use of those losses, and it permits other taxpayers to double dip losses in a manner that is contrary to the policies underlying the statute. For reasons more fully discussed in our Report, we believe that foreign tax law should be made more relevant for purposes of applying the dual consolidated loss rules. We would address the IRS's legitimate concerns about basing the application of U.S. tax laws on the purported application of foreign tax laws by placing the burden of proof on taxpayers to demonstrate foreign tax law and foreign tax consequences to the satisfaction of the IRS. In line with this over-arching recommendation, we make the following more specific recommendations:

First, in connection with a domestic use election, we recommend that the so-called "all or nothing" recapture rule be eliminated and that a U.S. taxpayer be permitted to avoid recapture of some of its losses to the extent that the taxpayer can demonstrate to the satisfaction of the IRS that the losses are not in fact used under foreign tax law.[2]

Second, the Proposed Regulations would attribute interest expense of a U.S. corporation, under the principles of Regulation § 1.882-5, to its foreign natural branches, but not to its hybrid branches. We believe that if a taxpayer can demonstrate to the satisfaction of the IRS that foreign tax law in fact does not attribute interest expense of the taxpayer to the taxpayer's natural foreign branch, then the interest expense should not be attributed to the branch. Conversely, we believe that interest expense should be attributed to a hybrid branch if foreign tax law in fact attributes such interest expense to the hybrid branch.

Third, under the Proposed Regulations, consistent with the consolidated return rules, distributions from a lower tier separate unit to a higher tier separate unit are

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[2] The Proposed Regulations would define foreign use to include certain "dilution" transactions. We understand this rule to be a change from the current regulations, rather than a mere clarification, and believe that this rule is appropriate if the "all or nothing rule" is eliminated. If the "all or nothing rule" is retained, however, we recommend that a dilution not require recapture if the taxpayer demonstrates to the satisfaction of the IRS that the dilution event does not permit the foreign holder to use the losses of the dual resident corporation or unit.

excluded from income either as branch remittances or as excluded dividends. As a result, when a recipient unit uses distributions from a lower tier separate unit to service interest on debt financing, a dual consolidated loss results. We recommend that the Proposed Regulations either include distributions from a lower-tier separate unit or (consistent with our over-arching recommendation) permit the taxpayer to demonstrate to the satisfaction of the IRS that the distribution received by a separate unit from a lower-tier separate unit is taxable under foreign tax law.

Apart from the application of foreign law, we have two significant recommendations:

First, we recommend that the separate unit rules be extended to foreign-owned U.S. units. More specifically, the 1988 statutory amendments extended the dual consolidated loss rules to foreign separate units of U.S. corporations. At that time, it was not necessary to extend the rules to U.S. units of foreign corporations because they could not consolidate with their U.S. affiliates. Now that the check-the-box rules have been promulgated, U.S. units of foreign corporations may effectively consolidate with their U.S. affiliates. Recognizing this, we recommend that the Proposed Regulations be extended to U.S. units owned by foreign persons. This change would restore the consistent application of the dual consolidated loss rules to both inbound and outbound transactions.

Second, under the so-called "mirror rule", if a foreign jurisdiction enacts legislation that "mirrors" the U.S. dual consolidated loss rules and disallows foreign use of a loss, a dual resident corporation is deemed to have engaged in a foreign use of the loss that prevents a domestic use election or causes recapture of a previous domestic use election loss. We recommend that this rule be eliminated. We think a taxpayer should be allowed to make a domestic use election for such loss. We recommend that the Treasury promulgate a mandatory competent authority procedure or similar arbitration to prevent the United States from bearing the entire amount of a dual consolidated loss in such instances.

We appreciate your consideration of the recommendations, comments and proposals we have made in the Report. As always, we would be pleased to discuss these matters with you further.

Respectfully submitted,

David P. Hariton

David P. Hariton
Chair

cc: Michael J. Desmond, Tax Legislative Counsel,
Department of the Treasury
Harry J. Hicks III, International Tax Counsel,
Department of the Treasury
Donald L. Korb, Chief Counsel,
Internal Revenue Service
Steven A. Musher, Deputy Associate Chief Counsel (International),
Internal Revenue Service
John J. Merrick, Special Counsel (International),
Internal Revenue Service
Kathryn T. Holman, Office of Associate Chief Counsel (International),
Internal Revenue Service