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Report No. 1501
October 4, 2024

The Honorable Aviva Aron-Dine
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Re: NYSBA Tax Section Report No. 1501 - Report on Proposed Regulations Under Section 1503(d)

Dear Mses. Aron-Dine and Rollinson, and Mr. Werfel:

Please see attached Report No. 1501 of the Tax Section of the New York State Bar Association, which discusses proposed regulations issued under Section 1503(d).

We appreciate your consideration of our Report. If you have any questions or comments, please feel free to contact us and we will be glad to assist in any way.

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Report No. 1501

New York State Bar Association

Tax Section

Report on the Proposed Regulations Under Section 1503(d)

October 4, 2024

Report on the Proposed Regulations Under Section 1503(d)

I. Introduction 1

II. Summary of Principal Recommendations 1

III. Background 2

A. DCL Rules under the Current Regulations 2

B. The Proposed Regulations 4

i. Elimination of the "Inclusions on Stock" Rule 5

ii. Interaction of Intercompany Transaction Regulations and DCL Rules 6

iii. Disregarded payments to HESUs 7

iv. Interaction of the DCL and GloBE Model Rules 8

v. New DPL regime 10

a. Description of regime 10

b. Deemed Consent 11

c. Background regarding the CTB Regime 12

vi. Anti-avoidance rule 13

IV. Discussion 14

A. Deemed Consent Rule 14

i. No Affirmative CTB Election Requirement 14

ii. Indirect Ownership Rules 14

iii. Unclear Application for Multiple Specified Eligible Entities 15

iv. Prospects of Inconsistent Outcomes 15

B. Applying the DCL regime to disregarded and intercompany transactions, in general 16

C. Pillar Two Interactions 19

i. Rebuttable Presumption Approach 21

ii. Safe Harbor Approach 24

a. High-Tax Safe Harbor 24

b. Safe Harbor Based on Pillar Two Transitional Safe Harbors 26

D. Inclusions on Stock Rule 27

E. Anti-avoidance rule 29

F. Disregarded and intercompany transactions where the parties' items immediately offset (Examples 6-11) 30

G. Disregarded and intercompany transactions where the parties' items offset in amount but are not immediately taken into account (Example 12) 48

H. Disregarded and intercompany transactions where the parties' items do not offset (Example 13 and variations on Example 13): 51

I. Introduction[1]

On August 6, 2024, the Department of Treasury ("**Treasury**") and the Internal Revenue Service ("**IRS**") released proposed regulations (the "**Proposed Regulations**") under Section 1503(d), relating to dual consolidated losses ("**DCLs**").[2] The Proposed Regulations substantially revise the existing regulations ("**Current Regulations**")[3] relating to DCLs and, among other things, (i) create a new "disregarded payment loss" ("**DPL**") regime that would, in certain circumstances, require a domestic owner of certain disregarded entities and foreign branches to include in income an amount equal to the DPL, (ii) eliminate the "inclusions on stock" rule in the Current Regulations in all but very limited circumstances, (iii) modify the intercompany transaction regulations under Regulations §1.1502-13, (iv) clarify that a disregarded payment that results in income or deductions to a hybrid entity separate unit ("**HESU**") is disregarded for DCL purposes, (v) include a new anti-avoidance rule intended to apply to transactions that create double deduction outcomes that violates the purposes of the DCL rules, and (vi) address the application of the DCL rules in the context of certain foreign minimum tax regimes, such as those arising under Pillar Two (as defined below). This report ("**Report**") contains the suggestions and comments of the Tax Section of the New York State Bar Association regarding the Proposed Regulations.

This Report is intended to highlight significant issues under the Proposed Regulations that we have identified and, where appropriate, make recommendations intended to improve, alter, or replace such rules. Part II of this Report contains a summary of our principal recommendations. Part III of this Report provides a background of the DCL rules, including the Proposed Regulations. Part IV contains our comments and recommendations.

II. Summary of Principal Recommendations

1. Treasury and the IRS should replace the DPL regime with a new system that implements the following principles:

    a. Parity between disregarded transactions and transactions subject to Regulation §1.1502-13 **("-13 Transactions**")
    b. Parity between the calculation of the positive register under the principles of Regulations §§1.1502-21(c) and 1.1503(d)-4(c)(3) (the "**DCL SRLY Register**")[4] (income) and DCL (loss)

---

[1] The principal authors of this Report are Andrew Herman and Adam Kool, with substantial assistance from Devon Hero, Afshin Khan, and Dillon O'Connell, and with significant contributions from Adam Becker and Joshua Ruland. Helpful comments were received from Kim Blanchard, Kevin Glenn, Daniel Hanna, Douglas Holland, Jiyeon Lee-Lim, Michael Mollerus, John Narducci, Jason Sacks, Michael Schler, Wade Sutton, Joe Toce, and Shun Tosaka. This report reflects solely the views of the New York State Bar Association Tax Section and not those of the New York State Bar Association's Executive Committee or its House of Delegates.

[2] Unless otherwise indicated, all "**Section**" references are to the Internal Revenue Code of 1986, as amended as of the date hereof (the "**Code**"), and all "**Reg. §**" and "**Regulations**" references are to the Treasury Regulations promulgated thereunder.

[3] T.D. 9351, 2007-15 IRB 891.

[4] Reg. §§1.1502-21(c) and 1.1503(d)-4(c)(3).

c. Parity between different types of items (interest, royalties, fees, compensation, gain/loss from sales, other)
d. Required carryforward (but not carryback) of both favorable and unfavorable DCL attributes
e. Only dual loss for a year is subject to limitation, and only dual income for a year can be offset by another year's dual loss

2. One set of relatively simple rules that would implement the above principles would be as follows (there may also be other rules that would implement the above principles):

   a. For the year, calculate FDRE's income (loss) both with and without disregarded and intercompany items that offset in amount.
   b. From the "with and without" calculation, the smaller amount of income is dual income, and thus is the DCL SRLY Register (or the smaller amount of loss is dual loss, and thus is the DCL).
   c. The excess, whether favorable (excess income) or unfavorable (excess loss), is carried forward to the next year (but not carried back).

3. To the extent that Treasury and the IRS retain the DPL rules described in the Proposed Regulations, we recommend narrowing the deemed consent construct such that it applies only to entities that are controlled by the applicable taxpayer, and limit deemed consent to situations in which a taxpayer affirmatively files an entity classification election pursuant to Regulation §301.7701-3.

4. We recommend taking into account certain inclusions under Section 951 and 951A in measuring whether a taxpayer has dual inclusion income. Particularly, where a DRE or branch is located in the same jurisdiction as a CFC, we believe the prospects for abuse that Treasury and the IRS highlighted in the Proposed Regulations are limited, and the possibility of double taxation is substantial.

5. While we agree with Treasury and the IRS that losses taken into account for Pillar Two purposes should be subject to the DCL regime, we recommend exceptions and/or safe harbors where there is a low likelihood of a taxpayer in fact benefiting from a foreign loss under the Pillar Two regime.

III. Background

A. DCL Rules under the Current Regulations

The DCL rules of Section 1503(d) were enacted as part of the Tax Reform Act of 1986.[5] The policy goal of the DCL rules is to prevent losses used to reduce foreign tax on income not taxed in the U.S. from also being used to reduce U.S. tax (i.e., a double-deduction outcome).[6] Fundamentally, the DCL rules restrict double utilization of a loss that would otherwise reduce both

[5] Fed. Reg. Vol. 70, No. 99, p.29868.

[6] S. Rep. 313, 99th Cong., 2d Sess., at 419-20 (1986).

U.S. tax on U.S. income of a U.S. corporation and foreign tax on separate foreign income of a foreign corporation. Thus, the rules prevent a single economic loss from offsetting two separate streams of economic income.

Section 1503(d) and the Regulations thereunder generally provide that, unless an exception applies, a DCL of a hybrid entity or dual resident corporation (a "**DRC**") cannot reduce the taxable income of the direct or indirect U.S. owners (or consolidated group members) of the entity incurring the DCL (other than attributable to income of the entity that incurred the DCL) (such reduction, a "**domestic use**",[7] and the prohibition of using the DCL, the "**domestic use limitation**").[8] In other words, the domestic use limitation prevents the hybrid entity, e.g., a foreign entity disregarded as separate from its owner ("**FDRE**"), or a dual resident corporation from "sharing" the DCL with its owners or consolidated group members for U.S. federal income tax purposes.

A DCL is defined as a net operating loss of a dual resident corporation or the net loss attributable to a separate unit.[9] A separate unit is generally defined as a foreign branch or an interest in a hybrid entity.[10] Under Regulation §1.1503(d)-3(b)(3), a hybrid entity for purposes of Section 1503(d) is an entity that is not taxable as a corporation for U.S. federal income tax purposes but is taxable as a corporation (or at the entity level) under foreign law.

If a DCL is subject to the domestic use limitation, the DCL is treated as a loss incurred in a separate return limitation year ("**SRLY**").[11] The DCL is subject to the SRLY rules of Regulation §1.1502-21(c), as modified by Regulation §1.1503(d)-4,[12] and may be carried forward or back (after 2017, carrybacks are limited to specific types of corporations) for use in other taxable years. For this purpose, a separate unit is treated as a separate domestic corporation (subject to potential limits).[13] In general, the SRLY rules of Regulation §1.1502-21(c) provide that the aggregate amount of a member's SRLY net operating loss absorbed by a consolidated group may not exceed the member's cumulative contribution to the consolidated group's consolidated taxable income (i.e., the positive balance of the member's cumulative SRLY register). The cumulative SRLY register concept from Regulation §1.1502-21(c) applies to DCLs subject to the domestic use limitation.[14]

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[7] Reg. §1.1503(d)-2.

[8] Reg. §1.1503(d)-4(b).

[9] Reg. §1.1503(d)-1(b)(5).

[10] Reg. §1.1503(d)-1(b)(4).

[11] Reg. §1.1503(d)-4(c)(3).

[12] *Id.*; Reg. §1.1503(d)-4(c)(1) and (2).

[13] Reg. §1.1503(d)-4(c)(2). Treating the separate unit, i.e., FDRE, as a separate domestic corporation for purposes of the application of the SRLY rules informs, as a general matter, certain of the analysis and recommendations made by this Report. For example, in Part IV.H below, it is suggested that the principles of Reg. §1.1502-13 be used, and applied as if FDRE were a separate member of the consolidated group, to determine the timing and amount of FDRE's income or loss when FDRE engages in a disregarded or intercompany transaction with items that do not offset (e.g., if FDRE sells inventory to its regarded owner USP in Year 1 and then USP sells the inventory to an unrelated buyer in Year 2).

[14] *See* AM 2011-002 (Aug. 1, 2011).

There are a number of exceptions to the domestic use limitation. One of the primary exceptions is if a domestic use election agreement is filed pursuant to Regulation §1.1503(d)-6(d). Generally, in making a domestic use election, the owner of the dual resident corporation or separate unit certifies that there has not been and will not be a "foreign use" of the DCL during a certification period (i.e., that no double-deduction result has occurred or will occur).[15] A foreign use of a DCL occurs when *any portion* of the DCL is made available under foreign tax laws to offset or reduce, directly or indirectly, income or gain of a foreign corporation (or certain hybrid entities), other than income or gain of the relevant unit.[16] Foreign use also includes "indirect use", which is considered to occur if, with a principal purpose of avoiding the DCL rules, 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. federal income tax purposes, and such foreign tax deduction has the effect of making an item of deduction or loss composing the DCL available for a foreign use.[17]

A foreign use during the certification period is a triggering event with respect to a DCL,[18] and requires the U.S. owner to recapture the DCL and report it as ordinary income.[19] Furthermore, the domestic use election is unavailable if there is a triggering event in the year the DCL is incurred.

The fact that a foreign use, and thus a DCL triggering event, arises when "any portion" of a DCL is made available under foreign tax law, is often referred to as the "**All-or-Nothing Rule**". Under the All-or-Nothing Rule, if foreign tax law makes available even a small fraction of the DCL, this constitutes a foreign use of (and triggering event with respect to) the entire DCL. The triggering event results in the inability to make a domestic use election (i.e., the entire DCL is subject to the domestic use limitation and thus the SRLY limitation) or, in the case a domestic use election was previously made with respect to the DCL, the recapture of the entire DCL as ordinary income. We have previously recommended the elimination of the All-or-Nothing Rule.[20] While the All-or-Nothing Rule is not again discussed in this Report, that should not suggest a change in our view.

B. The Proposed Regulations

The Proposed Regulations take several important actions, including: (i) eliminate the "Inclusions on Stock Rule" (defined below) in the existing DCL regulations in all but very limited circumstances; (ii) modify the intercompany transactions regulations under Regulation §1.1502-

[15] The certification period is the period of time up to and including the fifth taxable year following the year in which the DCL that is subject of a domestic use agreement was incurred. Reg. §1.1503(d)-1(b)(20).

[16] Reg. §1.1503(d)-3(a)(1).

[17] Reg. §1.1503(d)-3(a)(2).

[18] Reg. §1.1503(d)-6(e)(i).

[19] Reg. §1.1503(d)-6(e).

[20] New York State Bar Association Report No. 1411, *Report on Proposed Regulations under Sections 267A, 245A(e) and 1503(d)* (February 26, 2019) ("**the 2019 Report**"); New York State Bar Association Report No. 1144, *Report on Final Dual Consolidated Loss Regulations* (January 23, 2008); New York State Bar Association Report No. 1100, *Report on Proposed Dual Consolidated Loss Regulations* (December 21, 2005).

13; (iii) "clarify" that a disregarded payment that results in income or deductions to a HESU is disregarded for DCL purposes;[21] (iv) include a new anti-avoidance rule that is intended to apply to transactions that create double deduction outcomes that avoid the purpose of the DCL rules; (v) address the application of the DCL rules in the context of certain foreign minimum tax regimes, such as those arising under Pillar Two (as defined below); and (vi) create a new DPL regime that would, in certain circumstances, require a domestic owner of certain disregarded entities and foreign branches to include in income an amount equal to the DPL.[22] Each of these actions is discussed in more detail below.

i. Elimination of the "Inclusions on Stock" Rule

Under the Current Regulations, in general, the income or DCL of a dual resident corporation for a taxable year is computed based on the dual resident corporation's items of income, gain, deduction, and loss for the taxable year.[23] The income or DCL of a separate unit is generally computed as if the separate unit were a domestic corporation and based solely on the items of income, gain, deduction, and loss of the domestic owner of the separate unit that are attributable to the separate unit.[24] For purposes of attributing items to a separate unit, only items of the domestic owner of the separate unit that are regarded for U.S. federal income tax purposes are taken into account.[25] Items of a domestic owner are generally attributable to a HESU to the extent they are reflected on the books and records of the HESU.[26] Pursuant to a special rule in the Current Regulations, any amount included in income of a domestic owner arising from ownership of stock in a foreign corporation through a HESU is attributable to the HESU, if an actual dividend from the foreign corporation would have been attributed (the "**Inclusions on Stock Rule**").[27]

The Proposed Regulations would eliminate the Inclusions on Stock Rule, except to the extent that a HESU owns "portfolio stock," which is generally defined as stock representing less than 10% of the value of the corporation.[28] The Proposed Regulations generally provide that items arising from the ownership of stock are not taken into account for purposes of computing income or a DCL.[29] Items arising from the ownership of stock that are not taken into account generally include: (i) gain recognized by a domestic owner on the sale or exchange of stock; (ii) dividends (including by reason of Section 1248); (iii) inclusions under Section 951(a) (including by reason of Section 245A(e)(2) or 964(e)(4)) or Section 951A(a), as well as deductions with respect thereto (including under Section 245A or 250(a)(1)(B)); and (v) foreign currency gain or loss under

[21] Further, no other general principle of U.S.U.S. federal income tax law, including Section 482, would attribute any of the regarded income of the domestic owner to that HESU.

[22] Notice of Proposed Rulemaking, 89 Fed. Reg. 64750 (August 7, 2024).

[23] *See* Reg. §1.1503(d)-5(b)(1).

[24] *See* Reg. §1.1503(d)-5(c)(1).

[25] *See* Reg. §1.1503(d)-5(c)(1)(ii).

[26] *See* Reg. §1.1503(d)-5(c)(3)(i). Under Reg. §1.1503(d)-1(b)(4)(i)(B), A HESU is an interest in a hybrid entity that is carried on or owned, directly or indirectly, by a domestic corporation (including a dual resident corporation).

[27] *See* Reg. §1.1503(d)(5)(c)(4)(iv).

[28] *See* Prop. Reg. §1.1503(d)-5(b)(2)(iv)(B) and (c)(4)(iv)(B) and (C).

[29] *See* Prop. Reg. §1.1503(d)-5(b)(2)(iv)(A) and (c)(4)(iv)(A).

Section 986(c).[30] As noted above, this proposed rule does not apply with respect to a dividend received by the dual resident corporation from a corporation, any other amount that the dual resident corporation includes in its gross income as a result of ownership of stock in a corporation, or any deduction with respect to either such amount, if the dual resident corporation owns less than 10% of the sum of the value of all classes of stock of the corporation (i.e., "portfolio stock").[31]

ii. Interaction of Intercompany Transaction Regulations and DCL Rules

The Current Regulations provide that the computation of income or DCL takes into account rules under Section 1502 regarding the computation of consolidated taxable income in the case of an affiliated dual resident corporation or an affiliated domestic owner acting through a separate unit (a "**Section 1503(d) Member**"). The regulations under Regulation §1.1502-13 (the "**Intercompany Transaction Regulations**") provide rules for taking into account items of gain, deduction, and loss of consolidated group members from intercompany transactions (as defined in Regulation §1.1502-13(b)(1)(i)). The purpose of the Intercompany Transaction Regulations is to provide rules to clearly reflect the taxable income (and tax liability) of the group as a whole by preventing intercompany transactions from creating, accelerating, avoiding, or deferring consolidated taxable income (or consolidated tax liability).[32] This purpose is achieved by treating the selling or lending member ("**S**") and the buying or borrowing member ("**B**") as separate entities for some purposes but as divisions of a single corporation for other purposes. Under Regulation §1.1502-13(b), S's income, gain, deduction or loss from an intercompany transaction is referred to its "intercompany item", while B's items from the transaction are referred to its "corresponding items." The attributes of an intercompany item or corresponding item are *all* of the item's characteristics, except amount, location, and timing, necessary to determine the item's effect on taxable income.[33] One of the principal rules implementing single entity treatment is the matching rule under Regulation §1.1502-13(c), which generally adopts a deferred approach to intercompany transactions. Under the matching rule, the separate entity attributes of S's intercompany items and B's corresponding items may be redetermined to the extent necessary to produce the same effect on consolidated taxable income (and consolidated tax liability) as if S and B were divisions of a single corporation, and the intercompany transaction were a transaction between divisions.

There have been differing views among practitioners as to how the intercompany transaction regulations interact with the DCL rules. The Proposed Regulations would amend the intercompany transaction regulations to clarify the treatment of items that are subject to the Section 1503(d) rules and the intercompany transaction regulations.

The Proposed Regulations would provide that the rules of Proposed Regulation §1.1502-13(j)(10) apply to an intercompany transaction if either party to the transaction is a "Section 1503(d) Member". In determining when the Section 1503(d) Member's intercompany item is taken

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[30] *Id.*

[31] *See* Prop. Reg. §1.1503(d)-5(b)(2)(iv)(B).

[32] Reg. §1.1502-13(a)(1).

[33] See Reg. §1.1502-13(b)(6). Relevant to the DCL regime, "all of the item's characteristics" could reasonably be read to include the status of an item is affecting (or not affecting) the amount of a DCL or DCL SRLY Register (defined below). However, we are unaware of guidance on this point and understand that taxpayers take different positions.

into account, the DCL rules and Current Regulations do not apply to the relevant item until that item would otherwise be taken into account under the matching rule of Regulation §1.1502-13(c) or the acceleration rule of Regulation §1.1502-13(d). The Proposed Regulations would provide that a Section 1503(d) Member has special status under Regulation §1.1502-13(c)(5) with respect to its intercompany items for purposes of applying the DCL rules to those items.[34] However, Regulation §1.1502-13(c)(1)(i) does not apply to redetermine the attributes of the Section 1503(d) Member's intercompany items.[35] Additionally, the special status of a Section 1503(d) Member does not affect the application of the matching rule to the counterparty member in an intercompany transaction.[36]

The Proposed Regulations thus take a pure separate entity approach. The Preamble to the Proposed Regulations (the "**Preamble**") states that it is consistent with the policies of the DCL rules to take into account items arising from an intercompany transaction on a separate entity basis, to the extent of the application of Section 1503(d), because it is unlikely that a foreign jurisdiction would disregard an intercompany transaction.[37]

iii. Disregarded payments to HESUs

As discussed above, regarded items of a domestic owner generally are attributable to a HESU to the extent they are reflected on the books and records of the hybrid entity; these reflected items must be adjusted to conform to U.S. federal income tax principles.[38] The Treasury and IRS are aware that taxpayers may be taking the position that items not reflected on the books and records of a hybrid entity may nevertheless be attributable to the HESU by asserting that the adjustments necessary to conform to U.S. federal income tax principles can include an items that has not been (and will not be) reflected on the books and records of a hybrid entity.[39]

Thus, the Proposed Regulations clarify that an adjustment to conform to U.S. federal income tax principles does not include the attribution to a HESU of any items that have not and will not be reflected on the books and records of the hybrid entity or transparent entity.[40] Specifically, items that are reflected on the books and records of the domestic owner cannot be

[34] See Prop. Reg. §1.1502-13(j)(10)(iii).

[35] *Id.*

[36] See Prop. Reg. §1.1502-13(j)(10)(iv).

[37] As discussed below in Part IV.B, we agree with the idea that a foreign jurisdiction would generally be expected to tax an intercompany transaction entered into by FDRE, and similarly would generally be expected to tax a disregarded transaction entered into by FDRE. However, generally speaking, the U.S. does not tax either disregarded transactions, or, viewing the consolidated group as a single taxpayer, intercompany transactions. Thus, income (or loss) recognition in the foreign jurisdiction is only half of the analysis in determining whether a disregarded or intercompany transaction gives rise to a dual deduction that constitutes a DCL, or to dual income that allows a deduction for U.S. federal income tax purposes of the DCL. The foregoing informs this Report's recommended principles and rules for the treatment of disregarded and intercompany transactions under the DCL regime.

[38] *See* Reg. §1.1503(d)-5(c)(3)(i).

[39] Notice of Proposed Rulemaking, 89 Fed. Reg. 64750 (August 7, 2024).

[40] *See* Prop. Reg. §1.1503(d)-5(c)(3)(i).

attributed to a HESU as a result of disregarded payments made between the domestic owner and the hybrid entity or transparent entity.[41]

iv. Interaction of the DCL and GloBE Model Rules

On October 8, 2021, the OECD/G20 Inclusive Framework reached a general agreement on a new two-pillar plan to reform international tax rules addressing tax challenges from the digitalization of the global economy.[42] The OECD/G20 Inclusive Framework members approved the model rules (the "**GloBE Model Rules**")[43] on the second of two "pillars" ("**Pillar Two**")[44] on December 16, 2021, and such Model Rules have been supplemented with additional commentary since its original promulgation. On December 20, 2022, the OECD/G20 Inclusive Framework on BEPS published the Safe Harbours and Penalty Relief document, which includes guidelines on aspects of the design and operation of a Transitional CbCR Safe Harbor to the GloBE Model Rules.[45] On December 11, 2023, the Treasury and IRS released Notice 2023-80 which, among other things, described the interaction of the DCL rules with the GloBE Model Rules. In Notice 2023-80, the Treasury and IRS announced that they were studying the impact of the Pillar Two rules (including qualified domestic minimum top-up tax ("**QDMTT**"), income inclusion rule ("**IIR**") and Transitional CbCR Safe Harbors ("**TCSH**")) on the DCL rules.

The Proposed Regulations provide that the determination of whether a tax is an income tax is made without regard to whether the tax is intended to ensure a minimum level of taxation on income or computes income or loss by reference to financial accounting net income or loss.[46] Thus, an IIR or QDMTT may be an income tax for purposes of the DCL rules and a foreign use may occur under such tax by reason of a loss being used in the calculation of net GloBE income or to qualify for a TCSH.[47] The Proposed Regulations do not provide specific guidance on the

[41] *Id.*; see also Prop. Reg. §1.1503(d)-5(c)(1)(ii).

[42] On October 14, 2020, the OECD published a report on the status of the development of the Pillar Two rules. *See* OECD (2020), Tax Challenges Arising from the Digitalisation of the Economy – Report on Pillar Two Blueprint: Inclusive Framework on BEPS, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris, https://doi.org/10.1787/abb4c3d1-en.

[43] OECD (2021), *Tax Challenges Arising from the Digitalisation of the Economy – Global Anti-Base Erosion Model Rules (Pillar Two): Inclusive Framework on BEPS*, OECD, Paris, https://www.oecd.org/tax/beps/tax-challengesarising-from-the-digitalisation-of-the-economy-global-anti-base-erosion-model-rules-pillar-two.pdf.

[44] References to Pillar Two in this Report generally include both the legislation required to be implemented pursuant to the EU Directive, as well as local adoption of legislation based on the Model Rules, Commentary, Examples and Administrative Guidance in other jurisdictions. *See, e.g.*, the U.K.'s recent draft legislation contained in Finance (No. 2) Bill, Part 3, https://publications.parliament.uk/pa/bills/cbill/58-03/0310/220310.pdf. Additionally, this Report does not address whether and to what extent bilateral tax treaties may conflict with Pillar Two principles.

[45] *See* OECD (2022), Safe Harbours and Penalty Relief: Global Anti-Base Erosion Rules (Pillar Two), December 2022, OECD/G20 Inclusive Framework on BEPS, OECD, Paris.

[46] *See* Prop. Reg. §1.1503(d)-1(b)(6)(ii).

[47] Notice of Proposed Rulemaking, 89 Fed. Reg. 64750 (August 7, 2024); see also Prop. Reg. §1.1503(d)-7(c)(3)(ii), Example 3A for an application of the DCL rules with respect to QDMTT.

undertaxed profits rule ("**UTPR**") as the Treasury and IRS continue to analyze issues related to the UTPR.

The Proposed Regulations provide that a domestic corporation's directly or indirectly held interest in a foreign entity that is not taxed as an association for U.S. federal income tax purposes and the net income or loss of which is taken into account in determining the amount of tax under an IIR is a HESU.[48] Further, if a domestic owner (or two or more domestic owners that are members of the same consolidated group), have two or more individual separate units, then all individual separate units that are located or subject to an income tax either on their worldwide income or on a residence basis in the same foreign country are treated as a combined separate unit.[49] These aforementioned definitions do not apply to an interest in an entity that would otherwise qualify as a separate unit under the definitions included in the Current Regulations because a loss attributable to a separate unit is already a DCL and additional rules to prevent a double-deduction outcome are not necessary.[50] The Proposed Regulations also clarify that a foreign use may occur with respect to the application of the TCSH.[51] However, the Proposed Regulations provide a limited exception whereby no foreign use is considered to occur where the TCSH is satisfied and no foreign use occurs with respect to the TCSH due to the application of the duplicate loss arrangement rules.[52]

Under the Current Regulations, a foreign use of a DCL may also be deemed to occur pursuant to the "mirror legislation" rule if the foreign income tax laws would deny any opportunity for the foreign use of the DCL in the year in which the DCL is incurred, provided that the foreign use of the loss is denied under such laws for any of the following reasons: (i) dual resident corporation or separate unit that incurred the loss is subject to income taxation by another country on its worldwide income or residence basis; (ii) loss may be available to offset income under the laws of another country; or (iii) deductibility of any portion of a deduction or loss taken into account in computing the DCL depends on whether the amount is deductible under the loss of another country.[53] The mirror legislation rule prevents foreign jurisdictions from enacting laws that require a taxpayer to use a DCL to offset an affiliate's income in the U.S. and prevents foreign legislation from undermining the taxpayer's ability to choose.[54] The Proposed Regulations clarify that foreign law, including the GloBE Model Rules, does not constitute mirror legislation provided that it preserves a taxpayer's choice to put a DCL to a domestic use or a foreign use.[55]

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[48] *See* Prop. Reg. §1.1503(d)-1(b)(4)(i)(B)(2).

[49] *See* Prop. Reg. §1.1503(d)-1(b)(4)(ii)(A)

[50] Notice of Proposed Rulemaking, 89 Fed. Reg. 64750 (August 7, 2024).

[51] *See* Prop. Reg. §1.1503(d)-7(c)(3)(ii).

[52] *See* Prop. Reg. §1.1503(d)-3(c)(9).

[53] Reg. §1.1503(d)-3(e).

[54] *See* REG-102144-04 (70 FR 29868, 29873-74).

[55] *See* Prop. Reg. §1.1503(d)-7(c)(18)(iv) for an example illustrating a foreign law that provides a choice.

v. New DPL regime

a. Description of regime

In general, the DPL regime requires the regarded U.S. owner to include as ordinary income certain disregarded payments received from its foreign disregarded entity (i.e., FDRE). The DPL regime is completely separate from the DCL regime and operates as its own system. Thus, regarded deductions and income (including deductions and income from intercompany transactions) do not affect the amount of the DPL (or positive DPL register), and disregarded deductions and income do not affect the amount of the DCL (or DCL SRLY Register).[56]

The payments are expected to be deductible in the foreign jurisdiction. For computing the amount of a DPL, the payments include any item that is deductible under the relevant foreign tax law, is disregarded for U.S. federal income tax purposes as a transaction between a disregarded entity and its tax owner and, if regarded for U.S. federal income tax purposes, would be interest, a structured payment, or a royalty within the meaning of Regulation §1.267A-5(a)(12), (b)(5)(ii) or (a)(16), respectively.[57] Similar rules apply for determining disregarded items of income that reduce the DPL.[58]

Certain procedural elements of the DPL regime are similar to the DCL regime. In general, the specified domestic owner must include in gross income the DPL inclusion amount with respect to a DPL upon certain triggering events. A triggering event causes an inclusion if it occurs during the certification period (the "**DPL Certification Period**").[59] The triggering events are a foreign use of the DPL or a failure to comply with certification requirements.[60] These triggering events are generally consistent with the DCL triggering events. For purposes of identifying a triggering event, a foreign use of a DPL is determined in the same manner as a foreign use of a DCL is determined.[61]. As noted above, failure to comply with the certification requirements is a triggering event.

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[56] As discussed below in Part IV.B, this disconformity between disregarded and intercompany transactions results in traps for the unwary as well as the ability to manipulate the system by juxtaposing the different treatments for economically similar transactions.

[57] *See* Prop. Reg. §1.1503(d)-1(d)(6)(ii)(C).

[58] *See* Prop. Reg. §1.1503(d)-1(d)(6)(ii)(D). A DPL means, with respect to a disregarded payment entity and a foreign taxable year of the entity, the excess (if any) of the sum of items of deductions described in Prop. Reg. §1.1503(d)-1(d)(6)(ii)(C) (FDRE's relevant disregarded deductions) over the sum of items of income described in Prop. Reg. §1.1503(d)-1(d)(6)(ii)(D) (FDRE's relevant disregarded income). *See* Prop. Reg. §1.1503(d)-1(d)(6)(ii).

[59] *See* Prop. Reg. §1.1503(d)-1(d)(2)(i). The DPL Certification Period includes the foreign taxable year in which the disregarded payment loss is incurred, any prior foreign taxable year, and the subsequent 60-month period. *See* Prop. Reg. §1.1503(d)-1(d)(6)(iii).

[60] *See* Prop. Reg. §1.1503(d)-1(d)(3)(ii). Because a failure to satisfy the proper procedures may result in a substantive change in result, there is some overlap between procedure and substance. With this in mind, certain items that are outside the scope of this Report merit further study, including whether and how the DPL rules should apply to minority investments in partnerships.

[61] However, for purposes of determining whether a foreign use occurs, only persons that are related to the specified domestic owner are taken into account. *See* Prop. Reg. §1.1503(d)-1(d)(3)(i). This is unlike the approach under the DCL rules. Additionally, the specified domestic owner must file a statement certifying that no foreign use has occurred

For U.S. federal income tax purposes, the DPL inclusion amount is treated as ordinary income and characterized in the same manner as if the amount were interest or royalty income paid by a foreign corporation.[62] The DPL inclusion amount is computed by reducing the positive balance, if any, of the "DPL cumulative register."[63] The DPL cumulative register is similar to the cumulative SRLY register concept for DCL purposes. The DPL cumulative register reflects each DPL or amount of "disregarded payment income" (i.e., attributable to interest, royalties, etc.) of a disregarded payment entity. Similar to the DCL rules, the Proposed Regulations contain a combination rule whereby individual disregarded payment entities for which relevant foreign tax law is the same are aggregated into a combined disregarded payment entity.[64]

As noted above, the Proposed Regulations do not integrate the DPL and DCL rules. The DPL rules operate independently of the DCL rules, creating a disconformity between disregarded items and intercompany items, as the Proposed Regulations would subject intercompany items to the DCL regime, not the DPL regime.[65] Only items that are regarded for U.S. federal income tax purposes are taken into account in computing a DCL (or DCL SRLY Register), and only items that are disregarded for U.S. federal income tax purposes are taken into account in computing a DPL (or DPL cumulative register).

The Preamble states that structures involving payments from FDRE to its U.S. regarded owner give rise to deduction/no inclusion outcomes, which Treasury and the IRS consider to be a significant policy concern. The statutory text of Section 1503(d) refers only to the disallowance of losses, and not to the creation of income.

b. Deemed Consent

In implementing the DPL rules, the Proposed Regulations rely on a "deemed consent" approach that conditions the application of the DPL rules on the "check-the-box" ("**CTB**") regulations.[66] Under this construct, a domestic corporation is deemed to consent to application of the DPL rules to the extent it owns a direct or indirect interest in a specified eligible entity that is classified as a disregarded entity for U.S. federal income tax purposes. A specified eligible entity is a DRE (whether foreign or domestic) that is (i) tax resident in a foreign tax jurisdiction or (ii) owned by a domestic corporation that has a foreign branch.[67] A specified eligible entity also includes an eligible entity that is formed or acquired after August 6, 2024 and defaults to a DRE

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with respect to the DPL. *See* Prop. Reg. §1.1503(d)-1(d)(4). The statement must be filed for the foreign taxable year in which a DPL is incurred and for each subsequent taxable year within the DPL Certification Period.

[62] *See* Prop. Reg. §1.1503(d)-1(d)(2)(ii).

[63] *See* Prop. Reg. §1.1503(d)-1(d)(5)(i).

[64] Disregarded payment income with respect to a combined disregarded payment entity is treated as a single amount of disregarded payment income or treated as if a single DPL exists for a foreign taxable year. The amount is first computed on a single entity basis and then aggregated to determine the combined disregarded payment loss or income.

[65] As noted, this disconformity can result in traps for the unwary as well as taxpayer manipulation.

[66] Reg. §301.7701-3.

[67] Prop. Reg. §301.7701-3(c)(4)(i).

under the CTB rules, even if no election is made.[68] However, such "deemed consent" rules do not apply if the eligible entity elects to be classified as an association taxable as a corporation effective before August 6, 2025.[69]

According to the Preamble this deemed consent approach is based on existing Regulation §301.7701-3(c)(3). This provision in the CTB regulations provides that when a domestic eligible entity files a CTB election to be treated as a corporation for U.S. federal income tax purposes, the entity is deemed to consent to be subject to the Section 1503(d) rules related to DRCs. However, the Proposed Regulations are vastly broader than existing Regulation §301.7701-3(c)(3). In particular: (i) the Proposed Regulations do not actually require a CTB election to cause deemed consent—rather, it is sufficient that an entity simply be *eligible* to make a CTB election and (ii) the Proposed Regulations apply a "direct or indirect" ownership rule which would capture ownership of any size through a partnership, disregarded entity, or grantor trust (e.g., a limited partner with a 1% interest in a partnership may be deemed to provide consent if the partnership forms a specified eligible entity). The Proposed Regulations offer an election to avoid deemed consent if a specified eligible entity files a CTB election effective before August 6, 2025, but the Proposed Regulations are silent as to how this election would operate in the case of consolidated tax groups or situations in which a taxpayer owns multiple specified eligible entities and files CTB elections with respect to some but not all of the specified eligible entities.

c. Background regarding the CTB Regime

Prior to the adoption of the CTB regulations, taxpayers, Treasury and the IRS wrestled with significant uncertainty regarding the U.S. tax classification of business entities as corporations or partnerships. The first meaningful judicial attempt at clarification came in 1935, when the Supreme Court distinguished corporations from partnerships for tax purposes in *Morrissey v. Commissioner*.[70] There, the Supreme Court forged a "corporate resemblance" test that announced several factors that "have . . . attributes . . . distinguishing [corporations] from partnerships."[71] Among other factors, the Supreme Court took into account whether the organization could continue after the death of any member and whether the organization's owners had limited liability. Almost two decades later, in *United States v. Kintner*, the Ninth Circuit decided that a taxpayer was allowed to restructure from partnership form to corporation from in order to obtain the tax benefits of a pension plan.[72] In reaching this decision, the Tax Court relied on the factors announced in *Morrissey*. Treasury and the IRS disagreed with the result in *Kintner* and, in 1960, issued regulations known as the *Kintner* regulations, which refined the definition of a corporation and partnership.

The *Kintner* regulations focused on six characteristics "ordinarily found in a pure corporation": (i) the presence of associates; (ii) an objective to carry on business and divide the

[68] *Id*.

[69] Prop. Reg. §301.7701-3(c)(4)(iv).

[70] *Morrissey v. Commissioner*, 296 U.S. 344 (1935).

[71] *Id*.

[72] *United States v. Kintner*, 216 F.2d 418 (9th Cir. 1954).

gains; (iii) continuity of life; (iv) centralization of management; (v) liability for corporate debts limited to corporate property; and (vi) free transferability of interests.[73] However, because the first two of the six factors (i.e., presence of associates and an objective to carry on business and divide the gains) applied to both corporations and partnerships, taxpayers focused on the other four factors when organizing their businesses. Furthermore, because no weight was given as to each factor, taxpayers who sought corporate treatment for their organizations simply sought to satisfy three of the four factors laid out in the *Kintner* regulations (i.e., a majority of the factors).[74] These four factors, each of which are indicative of corporate characteristics, are discussed below.

Under the *Kintner* regulations, an organization satisfied the continuity of life factor if the death, insanity, bankruptcy, retirement, resignation or expulsion of any member would not cause a dissolution of the organization.[75] An organization had centralized management if any person or group of persons that did not include all the organization's members had continuing exclusive authority to manage the business of the organization.[76] An organization offered limited liability protection to its members if no member was personally liable for claims against the organization.[77] Lastly, if an organization's interests were freely transferable, then this was an indication that the organization was a corporation and not a partnership.[78] As explained above, taxpayers who sought corporate treatment for their organizations would only seek to satisfy three of the four factors. The *Kintner* regulations created so much uncertainty and complexity with respect to critical tax issues that the IRS abandoned the regulatory regime in 1996. The check-the-box regulations ("**CTB Regulations**") supplanted the *Kintner* regulations and provided taxpayers with greater certainty and simplicity.

vi. Anti-avoidance rule

The Preamble states that Treasury and the IRS continue to learn of transactions, structures, or other avoidance transactions that may facilitate a double-deduction outcome by manipulating the computation of income or a DCL with items that are not included in income, or do not give rise to tax, in a foreign country.[79] The Preamble notes that even if these avoidance transactions were addressed by new rules in the Proposed Regulations, other avoidance transactions could continue to be developed.[80] Thus, the Proposed Regulations include a broad anti-avoidance rule that is intended to address additional transactions or interpretations that may attempted to avoid the purposes of the DCL rules, as well as transactions that attempt to avoid the purposes of the DPL rules (discussed in detail below).[81]

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[73] Reg. §301.7701-2(a)(1) (1960).

[74] See Federal Taxation of Partnerships & Partners by Hughes-Mills, Humphreys, Kehl and Rosow ¶3.03[B].

[75] Reg. §301.7701-2(b)(1) (1960).

[76] Reg. §301.7701-2(c)(1) (1960).

[77] Reg. §301.7701-2(d)(1) (1960).

[78] Reg. §301.7701-2(e)(1) (1960).

[79] Notice of Proposed Rulemaking, 89 Fed. Reg. 64750 (August 7, 2024).

[80] *Id.*

[81] *See* Prop. Reg. §1.1503(d)-1(f).

IV. <u>Discussion</u>

A. Deemed Consent Rule

As noted above, the deemed consent rule as described in the Proposed Regulations are overbroad and, we believe, difficult to justify in many cases. We specifically highlight four concerns below: (i) the lack of a requirement of a CTB election for deemed consent, (ii) the expansive concept of "indirect" ownership under the Proposed Regulations, (iii) uncertainty regarding the application of the deemed consent rules to multiple DREs and to members of consolidated groups, and (iv) the prospect of substantial confusion, uncertainty and inconsistent outcomes that the CTB rules were intended to eliminate. We believe these concerns could be addressed in large part (though not entirely) through an affirmative requirement that the relevant domestic corporation or DRC sign (or indirectly control the signing of) a CTB election before deemed consent arises, as discussed in further detail below. Where a DRE defaults to a fiscally transparent entity pursuant to Regulation §301.7701-3(b)(2) and neither the entity nor its owner(s) file a protective CTB election, there would be no deemed consent.

i. No Affirmative CTB Election Requirement

Where a foreign entity would otherwise be treated as a corporation under U.S. federal income tax law, conditioning an election to be treated as a DRE on consent to be subject to the DPL rules appears to be a fair exercise of Treasury and the IRS's regulatory authority. This is consistent with the deemed consent approach to the DRC rules, where an affirmative election to be treated as a corporation is required for deemed consent. However, the Proposed Regulations go substantially further and treat a taxpayer as consenting to the DPL rules simply by virtue of being described in Regulation §301.7701-3(a), without any further affirmative step on the part of the taxpayer. Where an entity would default to a partnership or disregarded entity under background tax law and no protective CTB election is filed to assure treatment as a fiscally transparent entity, we believe it is difficult to justify deemed consent to the DPL rules. In such a case the CTB regulations have essentially no effect on the tax classification of the entity, meaning that a taxpayer can be pulled into the DPL regime simply by virtue of an entity being formed or acquired after August 6, 2024. We find this result hard to justify since the taxpayer has not actually taken advantage of the CTB rules, and we believe that an affirmative CTB election should be required before the DPL rules apply to a taxpayer.

ii. Indirect Ownership Rules

We also struggle with the breadth of the deemed consent concept as it relates to indirect ownership. The deemed consent rules apply when a taxpayer owns interests in a specified eligible entity, without any specific ownership threshold. Under the Proposed Regulations, the term "indirectly" 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."[82] Thus, for example, it appears that if a taxpayer owns a 1% interest in a foreign partnership that forms a DRE after August 6, 2024, the taxpayer is deemed to consent to the DPL rules. This presents

[82] Prop. Reg. §301.7701-3(c)(4)(v)(E); Reg. §1.1503(d)-1(b)(19).

significant fairness and administrative concerns, since as a practical matter the taxpayer would not necessarily control (or even know about) their consent to the DPL rules. To address these concerns, we recommend, at a minimum, that (i) where a taxpayer owns a direct interest in a DRE, the taxpayer will be deemed to consent to the DPL regime only to the extent such taxpayer actually signs a CTB election, and (ii) for indirectly owned entities, the taxpayer must in fact have control over and knowledge of deemed consent (e.g., by requiring a 50% or greater ownership threshold for indirect ownership).

iii. Unclear Application for Multiple Specified Eligible Entities

The Proposed Regulations offer taxpayers the ability to elect out of the DPL regime if a specified eligible entity elects to be treated as a corporation effective before August 6, 2025. However, the Proposed Regulations are unclear regarding how this exception would apply where a domestic corporation owns multiple specified eligible entities. It would appear that unless all specified eligible entities owned by a taxpayer elect to be treated as corporations for U.S. federal income tax purposes before August 6, 2025, then all specified eligible entities owned by the taxpayer would be subject to the DPL regime until the effective date of their CTB elections, although the text of the Proposed Regulations is not entirely clear. This all-or-nothing approach seems contrary to the general intention of the Proposed Regulations to permit an election out of the DPL regime, and if the deemed consent construct is retained in final regulations, we recommend revising the election mechanics such that the DPL regime does not apply with respect to any specified eligible entity that elects to be treated as a corporation prior to August 6, 2025, even if the applicable domestic corporation owns direct or indirect interests in other specified eligible entities that do not so elect.

iv. Prospects of Inconsistent Outcomes

Finally, we have significant concerns about the inequitable outcomes and likely taxpayer reactions if the deemed consent regime is adopted. The deemed consent regime treats “true” branches (i.e., taxable presence in a foreign jurisdiction) different from hybrid branches that exist by virtue of ownership through a disregarded entity. Thus, taxpayers that for almost all other U.S. federal income tax purposes are treated identically would potentially suffer (or enjoy, depending on the taxpayer) vastly different results under the DPL regime. This will incentivize taxpayers to refrain from using DREs where the DPL regime would apply simply to avoid deemed consent. Taxpayers are also likely to structure their affairs such that certain domestic corporations in an affiliated group operate exclusively through true branches (and therefore avoid deemed consent) while other domestic corporations in the group operate through DREs and manage the potential application of the DPL regime. These types of inequitable and inconsistent outcomes are precisely the types of outcomes that the CTB regulations were enacted to minimize. The deemed consent regime deviates from this fundamental principle and, just like the *Kintner* regulations in place prior to the CTB regime, will incentivize tax planning and needless administrative cost while providing only modest benefits to the fisc.[83]

[83] We believe the approach described below in Parts IV.B, F, G, and H would permit Treasury and the IRS to do away with the deemed consent approach to the DPL rules.

B. Applying the DCL regime to disregarded and intercompany transactions, in general

Regarding disregarded transactions, Treasury and the IRS expressed greatest concern about the paradigmatic worst case where the only thing FDRE ever generates, in perpetuity, is interest expense paid to its regarded U.S. corporate owner (referred to herein as "**USP**").[84] Assume USP owns FDRE, which owns a controlled foreign corporation ("**CFC**"), and USP has no items other than $100 of disregarded interest received from FDRE, FDRE has no items other than the $100 disregarded interest paid to USP, and CFC generates $100 GILTI tested income. FDRE and CFC consolidate under foreign tax law. Thus, there is $100 of economic income in the system, which was earned by CFC.

Under current law, USP includes $100 under Section 951A ("**GILTI**"), and takes no foreign tax credits because no foreign tax was paid. FDRE and CFC (as a foreign consolidated group) pay no foreign tax, as FDRE's ($100) loss offsets CFC's $100 income for foreign tax purposes. USP increases its DCL SRLY Register by $100 (because the GILTI inclusion counts as a positive adjustment for this purpose, but FDRE's disregarded interest payment does not count as a negative adjustment for this purpose). In total, this results in the $100 economic income being included by USP as a $100 GILTI inclusion (potentially taxed at a lower effective rate by reason of the Section 250 deduction).[85] On the one hand, this allows a taxpayer to convert $100 taxed in the foreign jurisdiction (with respect to which the taxpayer might or might not be able to credit) to $100 taxed in the U.S. under the GILTI regime. On the other hand, there is $100 economic income in the system and the $100 is taxed in the U.S. under GILTI, which is generally the regime that taxes CFC's earnings.

Under the Proposed Regulations, the result would be that USP includes $100 under GILTI, and USP *also* includes $100 as a DPL item by reason of FDRE's $100 disregarded interest payment to USP. USP takes no foreign tax credits, as the FDRE/CFC foreign consolidated group pays no foreign tax. The FDRE/CFC foreign consolidated group pays no foreign tax, as FDRE's $100 loss offsets CFC's $100 income for foreign tax purposes. In total, the $100 of economic income in the system, which is the $100 income earned by CFC, results in USP including $200 of taxable income (which potentially is reduced to as low as $150 if a full Section 250 deduction is available). On the one hand, this prevents a taxpayer from converting income taxed in a foreign jurisdiction into income taxed in the U.S. under GILTI. On the other hand, it taxes USP on between 150% and 200% of the economic income.

As discussed below, the principles and rules recommended by this Report would lead to a "middle ground" result as compared to the results under current law and the Proposed Regulations. Similar to current law, the recommended approach would not subject USP to any amount of double

[84] This paradigmatic worst case is not entirely plausible, as FDRE needs to generate funds from some source (e.g., income) to service the debt, but for simplicity this description assumes this paradigmatic worst case.

[85] Without the $100 disregarded interest expense from FDRE to USP, (i) USP would have included the same $100 GILTI amount, (ii) foreign tax would have been imposed on CFC's $100 income, and (iii) USP would have taken a foreign tax credit for CFC's foreign tax to the extent that USP was eligible to do so and had sufficient foreign tax credit limitation. With the $100 disregarded interest expense from FDRE to USP, (i) USP includes the same $100 GILTI amount, (ii) no foreign tax is imposed on CFC and FDRE, and (iii) USP would take no foreign tax credit.

tax on the $100 of economic income in the example. But unlike current law, FDRE would be required to carryforward this attribute such that a DCL is potentially created in the future. This results in a neutral regime, which subjects only dual loss to limitation, and allows only dual income to be offset by dual loss.

As discussed further below, Treasury and the IRS should replace the DPL regime with a new system that implements the following principles:

1. Parity between disregarded transactions and -13 Transactions
2. Parity between the calculation of DCL SRLY Register (income) and DCL (loss)
3. Parity between different types of items (interest, royalties, fees, compensation, gain/loss from sales, other)
4. Required carryforward (but not carryback) of both favorable and unfavorable DCL attributes
5. Only dual loss for a year is subject to limitation, and only dual income for a year can be offset by another year's dual loss

One set of relatively simple rules that would implement the above principles (though there may also be others) is as follows:

1. For the year, calculate FDRE's income (loss) both with and without disregarded and intercompany items that offset in amount.
2. From the "with and without" calculation in No. 1, the smaller amount of income is dual income, and thus is the DCL SRLY Register (or the smaller amount of loss is dual loss, and thus is the DCL).
3. The excess, whether favorable (excess income) or unfavorable (excess loss), is carried forward to the next year (but not carried back).

Further below, this Report describes in greater detail the rationale supporting these principles and rules. In particular, the with/without calculation is premised on the idea that the relevant foreign jurisdiction is expected to currently tax disregarded and intercompany items, whereas the U.S. is not. Finally, this Report proposes mechanics to carry out the rules, including a modification in the case of disregarded or intercompany items that do not offset in amount.

The chart below illustrates, on a high level, the operation of the three rules listed above, as applied to six different fact patterns (each in its own row).

Operating income (loss)	Disregarded and -13 income (loss)	"With" (Foreign)	"Without" (U.S.)	DCL SRLY Register (DCL)	Carryforward of DCL attribute[86]
30	10	40	30	30	10
(30)	(10)	(40)	(30)	(30)	(10)
30	(10)	20	30	20	10
(30)	10	(20)	(30)	(20)	(10)

[86] The operation of the carryforward will be explained below.

30	(40)	(10)	30	0	(10), 30
(30)	40	10	(30)	0	10, (30)

Through a series of examples, Parts IV.F, G, and H of this Report illustrate the 5 principles and 3 rules listed above, and recommend these principles and rules instead of the approach taken by the Proposed Regulations in relation to the treatment of disregarded and intercompany transactions. While the examples might at first seem complex, the principles are relatively straightforward, and the suggested rules are relatively short, simple, and few in number, such that we believe they could be adopted with relative ease (nonetheless, we recognize further thinking and skilled Regulation drafting would of course be required).

The proposal herein would carry out the DCL regime's anti-duplication policy in a way that has several advantages over the Proposed Regulations. In particular, the principles and rules discussed recommended are simpler than the DPL regime of the Proposed Regulations, are more narrowly tailored to denying double deductions and giving credit for double inclusions, and offer parity between disregarded/intercompany transactions, [87] parity between income/loss, and parity between different types of income and deduction (e.g., interest, royalties, fees, compensation, gain/loss). In contrast, the Proposed Regulations treat disregarded and intercompany transactions differently, treat different types of items differently (e.g., interest vs. fees), and are underinclusive in allowing dual deductions and overinclusive in denying single deductions. Moreover, the proposal herein is consistent with the language of Section 1503(d), which refers only to the disallowance of losses, and not to the creation of income.

Parity is important because we expect that taxpayers will be in a variety of different postures. In many circumstances taxpayers will conduct borrowing through foreign DREs thus generating deductions, whereas in many circumstances a U.S. corporation will license technology, copyright rights or other intangibles to a foreign DRE which in turn will use those intangibles in its trade or business or embed those intangibles in products or services sold to customers, thus generating income. After the enactment of Section 59A in 2017, it is common for many taxpayers to have income-producing service providers that have elected to be disregarded from their U.S. corporate parents. If the DCL regime does not offer parity between disregarded/intercompany transactions, parity between income/loss, and parity between different types of income and deduction, then some taxpayers will have a windfall, or potentially plan into a windfall through manipulation of the different treatment of economically similar transactions, and others will suffer a detriment by reason of their foreign holding company structure, with seemingly arbitrary distinctions causing such differences. Finally, the principle of ensuring that only dual loss for a year is subject to limitation and only dual income for a year can be offset by another year's dual loss, is consistent with the statutory text of Section 1503(d).

With respect disregarded and intercompany transactions in particular, parity between the DCL regime's treatment of such transactions is consistent with the purpose and text of the Intercompany Transaction Regulations to clearly reflect the taxable income (and tax liability) of

[87] There may be other approaches to integrating the DCL and DPL rules. For example, it may be possible to borrow the principles of the branch reattribution rules and the principles of Regulations under Section 904, which has been adopted in other contexts, such as the rules for allocating and apportioning foreign income tax expense. However, we have not had a chance to study such other alternatives and recognize they may involve complexity.

the group as a whole. Regulations should provide that the effect of a -13 Transaction on DCL calculations is indeed an attribute, as it would be included in "all of the item's characteristics, except amount, location, and timing, necessary to determine the item's effect on taxable income."[88] Once it is established that the effect of a -13 Transaction on DCL calculations is an attribute within the meaning of Regulation §1.1502-13(b)(6), then attribute redetermination alters the attributes of USP's and USS's items (including USP's items generated through FDRE) as though USP and USS were divisions of a single entity.

Below, this Report discusses Pillar Two interactions, inclusions on stock, and the anti-avoidance rule, before returning to the examples illustrating disregarded and intercompany transactions.

C. Pillar Two Interactions

As noted above, the Proposed Regulations include provisions intended to clarify that foreign minimum taxes and taxes calculated by reference to financial accounting principles can qualify as an income tax for purposes of Section 1503(d) and the Regulations issued thereunder.[89] As reflected in the Preamble and Examples contained in the Proposed Regulations, a principal focus of these new provisions is the interaction of the DCL rules and certain Pillar Two taxes (specifically, the IIR and QDMTT).[90]

We believe that the characterization of the QDMTT and IIR as an income tax for purposes of the DCL rules is fundamentally appropriate. As suggested by the Preamble, a QDMTT or IIR clearly present the possibility of the type of double-dipping that the DCL rules were designed to prevent. We also generally agree with Treasury and the IRS's decision to treat as a "foreign use" any items of loss or deduction that are taken into account for purposes of qualifying for a Pillar Two transitional safe harbor. However, we also believe that the introduction of Pillar Two across the globe offers an opportunity to revisit certain aspects of the DCL rules relating to "foreign use" and the availability of a "domestic use election" with respect to Pillar Two taxes.

As noted above, under the current DCL regulations a "foreign use" occurs whenever a DCL is made available under the income tax laws of a foreign country to offset or reduce any item recognized as income or gain.[91] An item of loss or deduction results in a foreign use if the loss or deduction is made available under the applicable foreign tax law, regardless of whether an item of income or gain is actually offset and regardless of whether foreign tax is actually reduced.[92] The Preamble indicates that Treasury and the IRS believe this very broad concept of a foreign use is appropriate in light of concerns about administrative complexity if the Regulations were to apply a more targeted standard that sought to determine whether an item of loss or deduction actually

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[88] Whether the effect of a -13 Transaction on DCL calculations is an attribute, within the meaning of Reg. §1.1502-13(b)(6), under current law is beyond the scope of this Report.

[89] Prop. Reg. §1.1503(d)-1(b)(6)(ii).

[90] *See* the Preamble; Prop. Reg. §1.1503(d)-7(c)(3).

[91] Reg. §1.1503(d)-3(a)(1).

[92] Reg. §1.1503(d)-3(b).

reduced foreign tax liability. The Preamble also suggests that Treasury and the IRS believe the "all or nothing" principle with respect to foreign use (where if a single dollar of a DCL subject to a domestic use election is the subject of a foreign use, the entire DCL is recaptured) is appropriate given administrative complexity of any alternative, specifically noting that "to depart from this standard and determine the amount of recapture on actual foreign use, taxpayers and the IRS would need to undertake a complex analysis of foreign law and distinguish a permanent (or base) difference from a timing difference, to ensure that the portion of the dual consolidated loss that is not recaptured will not be available for a foreign use at some point in the future."

In practice, we expect the standard espoused by the Regulations to result in the widespread unavailability of exceptions to the domestic use limitation, including domestic use elections. The vast majority of countries across the globe have either already enacted or have announced plans to implement Pillar Two taxes, and the Regulations would treat any application of the Pillar Two taxes as a foreign use that would effectively prevent any domestic use of a DCL, even where there is no practical benefit to the taxpayer under an IIR or QDMTT. We believe this to be an overly punitive result that cannot necessarily be justified in the context of Pillar Two minimum taxes by appeals to concerns regarding administrability.

As a result, we recommend that Treasury and the IRS consider a more nuanced and targeted approach to the concept of "foreign use" and the application of the "all or nothing" rule.[93] In particular, we recommend that Treasury and the IRS consider either (i) converting the "foreign use" and "all or nothing" rule to a series of rebuttable presumptions that would permit taxpayers in appropriate circumstances to demonstrate the absence of a foreign tax benefit with respect to a DCL or (ii) adopting one or more safe harbors for taxpayers intended to describe situations in which a foreign tax benefit from a DCL is particularly unlikely. We describe each approach in greater detail below.

These recommendations could be considered in the context of any foreign tax, but we find these recommendations especially compelling in the case of Pillar Two taxes. Pillar Two taxes are generally well understood by Treasury and the IRS (as reflected in both the Preamble and the content of the Proposed Regulations), and Pillar Two taxes are largely uniform across jurisdictions. While it is understandable that Treasury and the IRS cannot develop expertise in every foreign income tax across the globe, Treasury and the IRS have already demonstrated expertise in Pillar Two taxes. Writing and enforcing regulations that are specific to Pillar Two taxes presents much less administrative burden to the government as compared to broader principles that would apply to every income tax across the world.

Furthermore, we believe that minimum taxes (such as Pillar Two taxes) by their nature present a lesser administrative burden in demonstrating the absence of a foreign tax benefit. While Treasury and the IRS are correct that measuring actual foreign use requires a complex analysis of foreign law and details like timing differences, carryforwards and carrybacks, when it comes to a minimum tax, a simpler "with and without" calculation can be performed—the Regulations could simply measure in the current tax year (and in any prior or subsequent tax year) the taxpayer's

[93] Although Treasury and the IRS could consider adopting the approach described herein more broadly (e.g., to all non-U.S. minimum taxes or even to all non-U.S. tax regimes), we specifically focus on Pillar Two for purposes of this discussion.

actual minimum tax liability and the taxpayer's hypothetical minimum tax liability measured without regard to the DCL. In fact, Treasury and the IRS have already proposed a limited variation on a "with and without" calculation with respect to Pillar Two's duplicate loss arrangement provisions, which currently apply solely for purposes of measuring qualification for Pillar Two transitional safe harbors. Under Proposed Regulation §1.1503(d)-3(c)(9), if a duplicate loss arrangement results in the disallowance of a DCL for Pillar Two purposes, there is no foreign use so long as the taxpayer still qualifies for the transitional safe harbor after accounting for the disallowance. This is, at base, simply a "with and without" analysis that requires the taxpayer to demonstrate that no foreign tax benefit has been enjoyed for Pillar Two purposes with respect to the DCL.

i. Rebuttable Presumption Approach

Our primary recommendation with respect to Pillar Two taxes contemplates converting the "foreign use" and "all or nothing" rules in the DCL regulations to presumptions that a taxpayer has the ability to rebut, to the extent that the taxpayer can demonstrate some or all of an applicable DCL did not result in a reduction in Pillar Two taxes, measured on a "with and without" basis. Mechanically, we would expect a "with and without" approach to incorporate the following steps:

1. First, a taxpayer would determine the amount of Covered Taxes paid with respect to a particular jurisdiction (as determined for Pillar Two purposes).

2. Second, a taxpayer would determine its actual QDMTT or IIR liability in the applicable jurisdiction for any relevant taxable period based on its adjusted GloBE income.

3. Third, a taxpayer would determine its hypothetical adjusted GloBE income in the applicable jurisdiction or any relevant taxable period, determined without regard to DCLs in the applicable jurisdiction.

4. Fourth, a taxpayer would determine the extent to which a QDMTT or IIR would apply assuming the same amount of Covered Taxes as described in Step 1, but using the hypothetical adjusted GloBE income determined in Step 3.

5. Fifth, the taxpayer would subtract from the amount determined in Step 2 the amount determined in Step 4. If the difference is not a positive amount, the taxpayer did not obtain the benefit of any loss for Pillar Two purposes and thus no loss was put to a "foreign use". If the difference is a positive amount, the taxpayer would proceed to Step 6.

6. Sixth, the taxpayer would determine whether its ETR under Step 4 is less than the minimum tax rate (i.e., 15% in the case of the QDMTT and IIR). If it is greater than or equal to the minimum tax rate, the taxpayer did not obtain the benefit of any loss for Pillar Two purposes and thus no loss was put to a "foreign use". If it is less than the minimum tax rate, then the taxpayer would subtract from the minimum tax rate or the amount calculated in Step 2, whichever is smaller, the amount determined in Step 4. The taxpayer would then apply a gross-up by dividing the amount determined in Step

4 by the minimum tax rate (i.e., 15% in the case of the QDMTT and IIR). This step is necessary to convert the Pillar Two tax savings into a determinable amount of losses that were utilized for purposes of demonstrating the extent to which such losses were put to a "foreign use." If this amount is then divided by the amount of DCLs in a particular jurisdiction, the taxpayer would obtain a percentage of the total DCLs attributable to a particular jurisdiction that was put to a "foreign use" and only this amount should be unavailable for domestic use. The remainder should be deductible for U.S. federal income tax purposes.

The following example highlights the application of these mechanics:

Example 1: Application of Rebuttable Presumption

> USP, a domestic corporation that is not a dual resident corporation owns (i) DREX, an entity disregarded for U.S. federal income tax purposes and tax resident in Country X and (ii) CFCX, an entity treated as a corporation for U.S. federal income tax purposes and tax resident in Country X. DREX and CFCX are not eligible to consolidate for local income tax purposes. In Year 1, DREX generates a $100 net loss for U.S. federal income tax purposes, local income tax purposes, and for Pillar Two purposes, while CFCX generates a $1000 net gain for local income tax purposes and Pillar Two purposes. CFCX pays $300 of Covered Taxes (as determined for Pillar Two purposes) with respect to the $1000 of net income in Year 1. DREX and CFCX are subject to a Pillar Two QDMTT, but because the ETR of the group in Country X is 33.33% (i.e., $300 of Covered Taxes divided by $900 of adjusted GloBE income), no tax is payable under the Country X QDMTT. Additionally, no Country X QDMTT would be payable if the DREX $100 net loss were disregarded for purposes of Pillar Two, since the Country X ETR for Pillar Two purposes would be 30% (i.e., $300 of Covered Taxes divided by $1000 of hypothetical adjusted GloBE income). As a result, under this proposed approach there would be no foreign use of the $100 net loss of DREX since the group did not enjoy either a local tax benefit or a benefit under the Country X QDMTT.

One of the most significant complexities that arise under this proposed methodology relates to the treatment of deferred tax assets under the Pillar Two rules. For Pillar Two purposes, a net loss in excess of taxable income can potentially be carried forward in the form of a deferred tax asset, which may reduce future obligations with respect to Pillar Two taxes.[94] The Pillar Two rules do not establish a particular ordering rule for deferred tax assets arising from a net loss and the deferred tax asset can effectively be carried forward indefinitely.[95]

Despite the possibility of a carryforward for purposes of Pillar Two, we believe that a "with and without" approach is still viable so long as the taxpayer is willing to undertake the administrative burden associated with demonstrating that Pillar Two taxes have not been reduced

[94] OECD Model Rules, Articles 4.4 and 4.5.

[95] *Id.*

throughout the 5-year period required by virtue of a "domestic use election."[96] The steps described above can effectively be utilized in the same manner, but rather than focusing on a current year, the test would ask whether the applicable DRC or separate unit enjoyed a Pillar Two benefit as a result of a deferred tax asset that would not have existed but for the DCL in question. If the taxpayer used the deferred tax asset to reduce Pillar Two taxes within the 5-year certification period required by virtue of a "domestic use election," we believe current regulations could apply and require the taxpayer to recapture the portion of the deferred tax asset that was used in the year that the foreign use occurs, with an associated interest charge imposed.[97] The following example illustrates the application of these principles:

Example 2: Application of Rebuttable Presumption Across Multiple Tax Years

> USP, a domestic corporation that is not a dual resident corporation owns (i) DREX, an entity disregarded for U.S. federal income tax purposes and tax resident in Country X and (ii) CFCX, an entity treated as a corporation for U.S. federal income tax purposes and tax resident in Country X. DREX and CFCX are not eligible to consolidate for local income tax purposes. In Year 1, DREX generates a $100 net loss for U.S. federal income tax purposes, and for Pillar Two purposes but generates no income or loss for local tax purposes because the net loss in question is not deductible under the local income tax. CFCX generates a $0 net gain for local income tax purposes and Pillar Two purposes in Year 1. No tax is payable under the local income tax and because the Country X group does not have net GloBE income in Year 1, no amount is payable under the Country X QDMTT. The USP MNE group books a $15 deferred tax asset reflecting potential future tax savings from CFCX's $100 net loss.
>
> In Year 2, DREX generates a $0 net gain for U.S. federal, local income tax and Pillar Two purposes, while CFCX generates $200 of net gain for local income tax and Pillar Two purposes. CFCX pays $25 of Covered Taxes with respect to its $200 of Year 2 net gain and thus its ETR is 12.5% and its QDMTT is 2.5%. Although the $100 of net loss from Year 1 is unavailable under local income tax law, for Pillar Two purposes the deferred tax asset from Year 1 can effectively be utilized to eliminate any obligation under the Country X QDMTT. As a result, the Country X QDMTT would have been $5 (i.e., 2.5% of $200 or [$200 x 15%] - $25 of Covered Taxes), but was actually $0, because $5 of the DREX loss in Year 1 was utilized to offset the QDMTT. As a result, a portion of the DREX Year 1 loss should be treated as subject to a foreign use in Year 2. The amount of the DREX Year 1 loss treated as subject to a foreign use would be $33.33 (i.e., $5 / 15%), and the remaining $66.67 of the $100 net loss of DREX from Year 1 would not be treated as subject to a foreign use. Thus, $33.33 would be recaptured and USP would need to pay an interest charge calculated under the principles found in Regulation §1.1503(d)-6(h)(1)(ii).

[96] Reg. §1.1503(d)-1(b)(20).

[97] Reg. §1.1503(d)-6(h)(1)(ii).

Additional complexity arises with respect to deferred tax assets for Pillar Two purposes that are attributable to multiple separate units across multiple tax years. However, the DCL rules already include provisions regarding NOL carryforwards that can be applied equally to Pillar Two deferred tax assets.[98] These rules provide that:

1. First, any net loss or net income that the dual resident corporation or separate unit has in the current taxable year shall be used to offset net income or loss recognized by its affiliates in the same taxable year;

2. Second, 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 (within the meaning of Regulation §1.1503(d)-6(e) and (h)); and

3. Third, the dual resident corporation or separate unit shall be deemed to use the losses from the most recent taxable year from which a loss may be carried forward or back for foreign law purposes.

We believe that these conventions are equally thoughtful and appropriate for addressing Pillar Two deferred tax assets, and accordingly encourage their adoption in the event Treasury and the IRS consider the rebuttable presumption approach in drafting final DCL regulations.

ii. Safe Harbor Approach

The rebuttable presumption approach described above may be subject to certain pitfalls. There are significant timing differences between U.S. tax rules and financial accounting rules underlying Pillar Two. For example, a deduction may be deferred under Section 174 of the Code whereas financial accounting rules may allow the deduction immediately. That deduction may create DCLs in future years, but the potential "foreign use" would technically occur before the U.S. tax system recognizes the item of deduction. Timing differences, and other differences between U.S. tax and financial accounting rules may make the rebuttable presumption approach discussed above difficult to administer in practice.

As an alternative to the rebuttable presumption approach, Treasury and the IRS could also consider one or more safe harbors that substantially reduce the administrative complexity for Treasury, the IRS, and taxpayers associated with the rebuttable presumption approach. The key advantage of these safe harbors rests in their simplicity, but given their simplicity, the safe harbors also present a lesser degree of precision and a greater likelihood of an actual foreign use of a DCL. We present two potential variations on a safe harbor for Treasury and the IRS's consideration, although additional safe harbors could be considered as well.

a. High-Tax Safe Harbor

[98] *See* Reg. §1.1503(d)-3(d).

The first of the safe harbors we propose applies when a jurisdiction in question (i) has a corporate tax rate substantially in excess of the Pillar Two minimum tax rate; (ii) does not significantly reduce this rate through broad-based, tax-reducing investment incentives; and (iii) incorporates base erosion and profit shifting protections intended to ensure that taxable income earned in that jurisdiction is not subject to inappropriate taxpayer planning to shift profits away from the jurisdiction. Jurisdictions like the U.S., China, Germany, France, India, Brazil, Japan, and South Korea are examples of jurisdictions where the three foregoing requirements would likely be satisfied. Where these three requirements are satisfied for any applicable taxable period, it is highly unlikely that a taxpayer would enjoy the benefit of a deduction under Pillar Two as a result of a DCL if it is (i) shared for Pillar Two purposes through jurisdictional blending but (ii) not shared for regular income tax purposes through fiscal unity, consolidation, loss sharing, or otherwise.

The applicable corporate tax rate to be used for purposes of this potential safe harbor is a matter of judgment, but we believe a 20% minimum rate may be appropriate. This is consistent with minimum tax rate utilized in the OECD's the transitional safe harbor for the UTPR. The OECD's annual report on applicable tax rates could serve as a reference point, providing both statutory and "effective" rates.[99]

In terms of specific base erosion and profit shifting concepts to be included, we believe a standard that incorporates the definition of "hybrid mismatch rules" described in Regulation § 1.267A-5(a)(10) would provide suitable protection if this safe harbor is adopted, although additional protections could be considered if Treasury and the IRS believe further guardrails are necessary. If this approach were adopted, we believe it would be especially helpful for Treasury and the IRS to publish a "white list" of jurisdictions that, as of the date of the publication of the list, satisfy these requirements. Treasury and the IRS may also consider permitting individualized relief or confirmation to taxpayers through a Private Letter Ruling process permitting taxpayers to demonstrate that there is no Pillar Two benefit anticipated with respect to a specific jurisdiction or foreign loss.

Example 3: Application of High-Tax Safe Harbor

USP, a domestic corporation that is not a dual resident corporation owns (i) DREX, an entity disregarded for U.S. federal income tax purposes and tax resident in Country X and (ii) CFCX, an entity treated as a corporation for U.S. federal income tax purposes and tax resident in Country X. DREX and CFCX are not eligible to consolidate for local income tax purposes. In Year 1, DREX generates a $100 net loss for U.S. federal income tax purposes, local income tax purposes, and for Pillar Two purposes, while CFCX generates a $1000 net gain for local income tax purposes and Pillar Two purposes. CFCX is subject to a 30% tax rate and therefore pays $300 pursuant to the Country X local income tax. Country X has adopted, under its local income tax, substantial base erosion and profit shifting rules, including "hybrid mismatch rules" described in Regulation § 1.267A-5(a)(10).

[99] See OECD "Corporate Tax Statistics" (2024).

On these facts, the requirements for the high-tax safe harbor would apply, and the $100 of net loss incurred by DREX would be deemed not to result in a foreign use for purposes of the DCL regulations in Year 1 (or any subsequent taxable year where the requirements of the safe harbor are satisfied).

Furthermore, Treasury and the IRS could implement taxpayer-specific safe harbors. The IRS could consider safe harbors on a case-by-case basis through the private letter ruling process. This approach could (i) establish verifiable representations to ensure no Pillar Two benefit is obtained and (ii) allow Treasury and the IRS to study the issue closely before deciding on a generally applicable safe harbor.

Each of these approaches has its merits, and the choice may depend on administrative feasibility and the desired level of flexibility. It is worth noting that it seems unlikely a jurisdiction would alter its statutory corporate tax rate and incentive regime solely to take advantage of a safe harbor in the U.S. DCL regulations, unlike the potential motivations to change a tax regime to qualify for a safe harbor in the Pillar Two rules.

b. Safe Harbor Based on Pillar Two Transitional Safe Harbors

Alternatively, Treasury and the IRS could consider adopting safe harbors for purposes of the DCL rules that are grounded in the transitional safe harbors that the OECD has adopted for purposes of Pillar Two. As noted above, the transitional safe harbors for Pillar Two purposes apply on a temporary basis, and they are intended to describe situations in which material Pillar Two tax liabilities are unlikely. These safe harbors specifically cover three situations: (i) a de minimis safe harbor where total revenue is less than 10 million EUR and net profit is less than 1 million EUR, (ii) a safe harbor based on a simplified calculation of Covered Taxes and a minimum ETR that can be as high as 17%, and (iii) a safe harbor that applies where the overall profit with respect to a jurisdiction is equal to or less than the substance based-exclusions available under Pillar Two.

Although the transitional safe harbors are temporary measures for purposes of Pillar Two, we believe they could provide a basis for a longer-term safe harbor pursuant to the DCL regulations to guard against material risks of double-deduction outcomes, as illustrated by the following example:

Example 4: Application of Pillar Two-Based Safe Harbors

USP, a domestic corporation that is not a dual resident corporation owns (i) DREX, an entity disregarded for U.S. federal income tax purposes and tax resident in Country X and (ii) CFCX, an entity treated as a corporation for U.S. federal income tax purposes and tax resident in Country X. DREX and CFCX are not eligible to consolidate for local income tax purposes. In Year 1, DREX generates a $100 net loss for U.S. federal income tax purposes, local income tax purposes, and for Pillar Two purposes, while CFCX generates a $1000 net gain for local income tax purposes and Pillar Two purposes. CFCX pays $200 of "simplified covered taxes" (as determined for Pillar Two transitional safe harbor purposes) with respect to its $1000 of net income in Year 1. For purposes of applying the Pillar Two transitional safe harbor related to minimum ETR, the simplified ETR for Country X is 22% (i.e., $200 simplified covered taxes divided by $900 of net book income). Because the simplified ETR for Country X exceeds 17%, the MNE group would qualify for the simplified ETR safe harbor (if it were applicable), and as reflected in the facts of this example, a Pillar Two liability under a Country X QDMTT is highly unlikely. Accordingly, if the Pillar Two transitional safe harbor is adopted as a standard, there would be deemed to be no foreign use of the DREX $100 net loss for Pillar Two purposes (regardless of whether a Pillar Two benefit would be reflected using a "with and without" approach).

D. Inclusions on Stock Rule

The existing Regulations treat income, gain or loss from stock (including dividends, gains and inclusions of subpart F income and GILTI) as taken into account for DCL purposes. The Proposed Regulations would exclude these items, except in the case of certain portfolio stock.

The notice of proposed rulemaking provides the following discussion:

> The Treasury Department and the IRS recognize that certain amounts included in the income of a domestic owner arising from the ownership of stock in a foreign corporation (in the case of a separate unit, regardless of whether the stock of the foreign corporation is held through the separate unit) may reflect amounts that have been subject to tax, to some extent, by both the foreign jurisdiction and the United States. For example, where a domestic owner of a separate unit that is taxed as a resident in a particular foreign jurisdiction holds stock of a controlled foreign corporation that is also taxed as a resident in the same foreign jurisdiction, the controlled foreign corporation's income may be taxed, to some extent, under the income tax laws of the foreign jurisdiction and by the United States through inclusions under section 951(a) or 951A(a); this could occur regardless of whether the inclusion itself is taken into account by the same foreign jurisdiction. To the extent such amounts are taxed in the same manner and to the same extent as if they were earned directly by the domestic owner, they could be viewed as representing dual inclusion income (that is, items that are included in income in both the United States and the foreign country and not offset or reduced by certain amounts particular to the item) that could be taken into account when determining the dual consolidated loss attributable to the separate unit.

> The proposed regulations do not provide a rule that would permit taxpayers to identify and take into account such amounts as dual inclusion income. Doing so would require complicated rules, and raise related administrability concerns, to isolate the amount of dual inclusion income with respect to a particular foreign jurisdiction (for example, where a controlled foreign corporation owns one or more disregarded entities that are subject to tax in different foreign jurisdictions). Such an approach would also need to take into account rate disparities (for example, as a result of the deduction allowed under section 250(a)(1)(B) with respect to inclusions under section 951A) and other differences that may result between income earned directly by a domestic owner and earned indirectly through a controlled foreign corporation.

Treasury and the IRS should consider whether, conceptually, income generated by a CFC and included by a U.S. shareholder (i.e., under Sections 951 and 951A) is dual inclusion income. If the answer is yes, then in the near-term Treasury and the IRS should provide an ability, in certain limited circumstances, to reflect inclusions on stock in the DCL calculations. The following example illustrates a case that we find particularly compelling with respect to potential dual inclusions arising under Section 951 and Section 951A:

Example 5: Illustration of Inclusions on Stock Rule

> USP, a domestic corporation that is not a dual resident corporation owns (i) DREX, an entity disregarded for U.S. federal income tax purposes and tax resident in Country X and (ii) CFCX, an entity treated as a corporation for U.S. federal income tax purposes and tax resident in Country X. CFCX owns DREY, an entity disregarded for U.S. federal income tax purposes and tax resident in Country Y. DREX has a DCL of $100, CFCX has income of $1,000 and DREY has income of $200. DREX and CFCX are subject to a fiscal unity, consolidated or loss sharing regime pursuant to which losses and expenses of DREX can offset the income of CFCX.

Historically, this arrangement created a "double dip" because the (i) DCL was available to offset USP's U.S. income and CFCX's income, but (ii) USP's income was subject to tax only in the U.S. and CFCX income was (usually) subject to tax only in Country X. Prior to 2017, a significant amount of CFCX income was deferred until a dividend was paid. However, the DCL regulations included a rule that reduces a DCL to the extent the CFCX income is included in the U.S. (and was converted from a single-jurisdiction inclusion to "dual inclusion income" that was subject to both U.S. and Country X tax). Specifically, CFCX dividends (before §245A) and subpart F inclusions reduced the amount of the DREX DCL because they were subject to taxation both in the U.S. (through a taxable dividend or subpart F inclusion) and Country X tax (because of CFCX's place of residence).

But the adoption of the GILTI regime changes the landscape in critical ways. In practice a CFC's income is now taxed on a current basis under the GILTI regime, and the deferral regime created by Subpart F carries much less significance. As a result, it is in fact the case that many domestic corporations or DRCs will be taxed on CFC income at the same time that a foreign jurisdiction taxes this income, resulting in two inclusions with respect to the same income and creating a situation that creates a traditional dual inclusion that would prevent application of the DCL rules. We believe that one of two approaches could be considered to address this potential dual-inclusion income.

Under a simplified approach, Treasury and the IRS could consider simply reversing the rule in the Proposed Regulations and going back to the position in the existing Regulations that inclusions on stock do potentially give rise to dual inclusion income. While this approach does not provide a solution for situations that are arguably abusive (as discussed in the Preamble), in practice we believe there are many more sympathetic fact patterns than abusive fact patterns and the rule under the Proposed Regulations, left unmodified, would likely result in substantial overbreadth in the application of the DCL rules.

Alternatively, under a targeted approach, Treasury and the IRS could consider maintaining the approach in the Proposed Regulations, subject to exceptions for sympathetic fact patterns. For example, Treasury and the IRS may permit inclusions on CFC stock to give rise to dual inclusion income where the relevant FDRE and CFC are tax resident in the same jurisdiction and are subject to a tax consolidation regime such that losses of FDRE are available to offset income of CFC. To address the GILTI regime, Treasury and the IRS may additionally consider adopting rules that take into account deductions available under Section 250, foreign tax credits, tracing of GILTI and foreign branch income, and any other consideration Treasury and the IRS deem appropriate. Adopting these safeguards presents substantial complexity, but we believe that existing framework in international tax regulations could be leveraged to make this process simpler (e.g., Treasury and the IRS may look to Regulations issued under Sections 904, 951A and Section 960 to address many of these concerns).

E. Anti-avoidance rule

The Proposed Regulations added an anti-avoidance rule that applies if a "transaction, series of transactions, plan, or arrangement is engaged in with a view to avoid the purposes of section 1503(d) …".[100]

If final Regulations do not adopt this Report's recommendations from Parts IV.B, F, G, and H, and thus retain the distinctions between disregarded/intercompany transactions, between income/loss, and between different types of income and deduction, then final Regulations should clarify that taxpayers are not subject to the anti-avoidance rule by reason of altering their structure to avoid such seemingly arbitrary distinctions when such distinctions produce an unfavorable

[100] The anti-abuse rule is different prior iterations of the rule, which focus on a principal purpose, rather than "a view to avoid the purposes".

whipsaw to the taxpayer. If the recommendations are adopted, then this clarification would not be necessary.

Consideration should be given to the traditional approach to foreign tax planning as viewed by the U.S. tax system; namely, that foreign tax savings can be a bona fide business purpose for certain transactions,[101] and that to achieve certain U.S. tax benefits, such as the foreign tax credit, foreign tax planning is in fact required to a certain extent.

In any case, the anti-avoidance rule should be narrowly-tailored to situations where the taxpayer generates a dual loss but artificially avoids the DCL regime.

F. Disregarded and intercompany transactions where the parties' items immediately offset (Examples 6-11)

This Part IV.F describes disregarded and intercompany transactions where the parties' items immediately offset; in other words, viewing the parties to the transaction as separate entities, cases where the payor would immediately deduct the entire payment and the recipient would immediately include the entire payment. For example, payments of interest, fees, royalties, and compensation would often fall into this category. As explored in detail below, the general concept informing the principles and rules put forward in this Report is that disregarded and intercompany income (or loss) is effectively not taxed in the U.S. but *is* expected to be taxed in the relevant foreign jurisdiction.

The analysis of each example describes the expected results under current law (to the extent known),[102] the results under the Proposed Regulations, and the results under the recommended rules. As summarized above, the recommended rules are (i) the calculation of FDRE's income (loss) "with and without" disregarded and intercompany items,[103] (ii) taking the lesser of the income amounts (or loss amounts) as the DCL SRLY Register (or DCL), and (iii) carrying forward the excess. Below are further details describing the rationale for each of the 3 rules, as well as illustrations of their operation. The examples in Parts IV.F, G, and H can be viewed as a "proof" to show the reasonable results achieved by the recommended principles and rules, and also can be used as a basis for examples in future Regulations.

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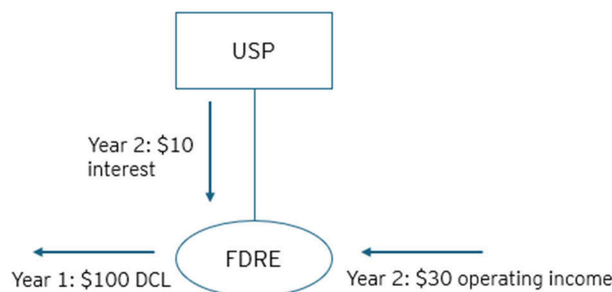
[101] See Reg. §1.701-2, ex. 3 ("Congress clearly contemplated that taxpayers could use a bona fide domestic partnership to subject themselves to the CFC regime, and the resulting application of the look-through rules of section 904(d)(3). Accordingly, under [the partnership anti-abuse rules], the Commissioner cannot treat [the applicable U.S. partnership] as an aggregate of its partners for purposes of determining [the] foreign tax credit limitation [of its indirect U.S. corporate owner under the old indirect foreign tax credit rules].")

[102] Any interpretation of current law herein is of a general nature and is for purposes of discussion.

[103] "With" disregarded and intercompany items reflects expected foreign tax law treatment pursuant to simplifying assumptions that the relevant foreign jurisdiction would tax such items currently, and "without" disregarded and intercompany items reflects the idea that such items do not themselves have a net effect on U.S. taxable income.

Example 6: Operating income and disregarded income
Annual Foreign Income in excess of Annual U.S. Income; Annual Dual Income limited to Annual U.S. Income.[104]



Assumption: FDRE owns CFC; CFC income offset by FDRE loss (if FDRE has a loss)

Year 2:
- US income: $30
- Foreign income: $40
- Dual Income: $30

FDRE carries forward a $100 DCL from Year 1. Throughout, these examples in Parts IV.B, F, G, and H (dealing with disregarded and intercompany transactions) assume that there has been a foreign use of the DCL and thus that the DCL is subject to the domestic use limitation, except when specified otherwise. In Year 2, FDRE generates $30 of operating income,[105] which would, if it were the only item, create a positive register under the principles of Regulations §§1.1502-21(c) and 1.1503(d)-4(c)(3) (i.e., a DCL SRLY Register) of $30, thus allowing $30 of the Year 1 DCL to be deducted. In addition, USP pays $10 interest to FDRE.[106]

As described below, a result consistent with anti-duplication policy underlying the DCL regime would be as follows: FDRE's DCL SRLY Register for the year is $30, as opposed to $40, for Year 2; the DCL SRLY Register is not increased by the $10 interest income paid by USP to

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[104] This terminology, which will be defined and explained below, is derived from the "with/without" calculation relating to disregarded and intercompany transactions. The "with" calculation includes foreign items of income and deduction, and leads to annual foreign amounts of income or loss, because of the expectation that the foreign jurisdiction will tax such transactions. The "without" calculation includes U.S. items of income and deduction, and leads to annual U.S. amounts of income or loss, because the U.S. effectively does not tax such transactions.

[105] Except where indicated otherwise, when this Report refers to "operating income" or "operating loss", it refers to the annual income or loss, respectively, generated from transactions with unrelated parties (i.e., excluding disregarded transactions and intercompany transactions).

[106] As noted above, the examples in this Part IV.F examine cases where, for U.S. federal income tax purposes, the disregarded item or intercompany item on each side of the transaction is immediately taken into account (or would be immediately taken into account if it were a regarded transaction) and the amount of one party's item offsets the other party's item (or would do so if it were a regarded transaction). For example, this Example 6 assumes that USP's $10 interest payment to FDRE, if it were a regarded transaction, would be immediately taken into account by USP as a $10 interest deduction and by FDRE as $10 of interest income that offsets in amount. In Parts IV.G and IV.H below, this Report describes cases where the items offset but are not immediately taken into account (e.g., an intercompany sale of depreciable property), or do not offset (e.g., an intercompany sale of inventory followed by the sale of the inventory to an unrelated party in a following year). An additional consideration applies to such cases; however, one can view all transactions described herein using the same methodology.

FDRE in a disregarded transaction. Thus, $30 of FDRE's Year 1 DCL is deductible in Year 2, not $40.

Results under current law

The Current Regulations simply exclude all disregarded items. This results in a $30 DCL SRLY Register in Year 2, allowing USP to deduct $30 of FDRE's Year 1 DCL. FDRE's taxable income for foreign tax purposes as a result of its receipt of $10 of disregarded interest from USP is permanently eliminated from the DCL calculations, with no potential future benefit. Examples below will illustrate the disparities caused by completely ignoring all disregarded items.

Results under the Proposed Regulations

The Proposed Regulations subject certain disregarded items (but not others) to the DPL regime, which is completely separate from the DCL regime.[107] Thus, this Example 6 would result in a $30 DCL SRLY Register, and a $10 DPL register. The DCL SRLY Register and DPL register are tracked separately and cannot be aggregated. Examples below will illustrate the disparities caused by this separate tracking.

Results under the recommended principles and rules

To explain the rationale behind the recommended principles and rules, it is necessary to summarize the expected foreign and U.S.U.S. federal income tax treatment of disregarded and intercompany items, and to define certain terminology used herein. This rationale relates to the "with/without" calculation described above, and the resulting U.S. federal income tax law items and expected foreign tax law items.

FDRE's interest income is likely included in taxable income for purposes of the tax laws of FDRE's home jurisdiction (or other relevant jurisdiction) (such item, a "**Foreign Income Item**", and FDRE's annual taxable income or loss for such purposes, its "**Annual Foreign Income**" or "**Annual Foreign Loss**", respectively). In calculating the amount of a DCL or DCL SRLY Register, the DCL regime does not attempt to determine whether an item of income is *actually* a Foreign Income Item or whether it *actually* creates or increases Annual Foreign Income or decreases Annual Foreign Loss. Rather, a set of simplifying assumptions about how foreign tax law applies is implicit in the DCL regime (the "**Foreign Tax Law Assumptions**"). The Foreign Tax Law Assumptions follow many conventions and methods of the U.S.U.S. federal income tax law, but with some modifications in certain areas. Most of what constitutes, or what does not constitute, a Foreign Tax Law Assumption, is beyond the scope of this Report, but where relevant, this Report notes such items or makes recommendations.

In this Example 6, it seems appropriate to include as a Foreign Tax Law Assumption that FDRE's $10 of disregarded interest income is a Foreign Income Item and creates or increases FDRE's Annual Foreign Income or decreases its Annual Foreign Loss (in this case, increasing its Annual Foreign Income from $30 to $40). That is because we would generally expect the foreign

[107] Prop. Reg. §1.1503(d)-1(d)(6)(ii)(B) and (C)

jurisdiction to tax FDRE on its $10 of interest income, and that this result would not be impacted at all by the fact that the U.S. views the transaction as disregarded. Similarly, if the transaction went in the other direction and FDRE had paid disregarded interest to USP (see Examples 8, 9, and 11 below), it would be appropriate to include as a Foreign Tax Law Assumption that FDRE's interest deduction (although disregarded for U.S. federal income tax purposes) is deductible in FDRE's jurisdiction (or other relevant foreign jurisdiction) (a "**Foreign Deduction**") and thus would decrease FDRE's Annual Foreign Income or create or increase its Annual Foreign Loss.

In this Example 6, FDRE's $10 of disregarded interest income does not create net taxable income in the U.S., and thus it is not a "**U.S. Income Item**" (and similarly, regarded intercompany interest income would, in effect, not create net taxable income in the U.S. for the consolidated group, and thus would not be a U.S. Income Item). Because FDRE's $10 of interest income is not a U.S. Income Item, it does not create or increase USP's (or its consolidated group's) taxable income for the year or decrease USP's (or its consolidated group's) taxable loss for the year (such annual taxable income or loss of USP or its consolidated group, its "**Annual U.S. Income**" or "**Annual U.S. Loss**", respectively). Rather, FDRE's interest income is earned in a transaction that is disregarded for U.S. federal income tax purposes. Similarly, if the direction of the transaction were reversed and FDRE had paid disregarded interest to USP (see Examples 8, 9, and 11 below), FDRE's interest deduction would not be regarded deduction in the U.S. and thus would not be a "**U.S. Deduction**", and intercompany interest paid would similarly not be a U.S. Deduction. Since disregarded or intercompany expense would not be a U.S. Deduction, it would not reduce Annual U.S. Income or create or increase Annual U.S. Loss.

The terminology introduced herein is to facilitate discussion of the "with/without" calculation. The terms relating to the application of foreign tax law (Foreign Income Item, Foreign Deduction, Annual Foreign Income, and Annual Foreign Loss) represent the "with" prong, reflecting disregarded and intercompany transactions. The terms relating to the application of U.S.U.S. federal income tax law (U.S. Income Item, U.S. Deduction, Annual U.S. Income, and Annual U.S. Loss) represent the "without" prong, ignoring disregarded and intercompany transactions.

To be consistent with DCL anti-duplication policy, the positive DCL SRLY Register for a year (which gives a taxpayer the benefit of deducting a DCL) should be comprised of income only to the extent that it is taxed both in the U.S. and in the separate unit's (or dual resident corporation's) jurisdiction (or other relevant foreign jurisdiction). In other words, the positive DCL SRLY Register for a year should be the lesser of the year's Annual U.S. Income and Annual Foreign Income (the lesser amount of such income determinations, "**Annual Dual Income**", and analogously, the lesser loss as between Annual Foreign Loss and Annual U.S. Loss, "**Annual Dual Loss**"). This reflects the lesser amount of income amounts resulting from the "with/without" calculation. This implements the anti-duplication principle of allowing only dual income (as opposed to income taxed only in one jurisdiction) for a year to be offset by another year's dual loss (the Year 1 DCL).

The history of Section 1503(d) informs the anti-duplication policy. 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 (i) subject to U.S.U.S. federal

income tax (but not foreign tax), and (ii) a second time to offset income subject to foreign tax (but not U.S. tax).[108] In other words, the perceived abuse was using the same loss a tax loss in each of two separate jurisdictions. Congress was concerned that this "double-dipping" of a single economic loss could result in undue tax advantages and worldwide economic income could be rendered partially or fully exempt from current taxation.

Due to such policy concerns, Treasury and the IRS issued Regulations under Section 1503(d) in 2007 (i.e., the Current Regulations) which generally limit the domestic use of a DCL unless certain exceptions apply.[109] As discussed above, as part of the Current Regulations, Treasury and the IRS generally adopted the SRLY rules under Regulation §1.1502-21(c) applying such rules to DCLs.[110] However, the concept of the DCL SRLY Register was initially unclear in the Current Regulations, and it was not clarified until 2011 when the Service issued AM 2011-002 ,[111] in which the Service outlined how the SRLY rules apply to the DCL regime. AM 2011-002 explains that although the Current Regulations do not explicitly adopt the cumulative register concept of Regulation §1.1502-21(c), such concept is implicitly referenced in Regulation §1.1503(d)-4(c)(3)(ii), and Example 40 of Regulation §1.1503(d)-7(c).[112]

Applying the SRLY rules and the concept of the DCL SRLY Register to a DCL of a foreign separate unit defers the deduction of such DCL for U.S. federal income tax purposes until such separate foreign unit generates enough positive income to create a positive DCL SRLY Register. The positive DCL SRLY Register represents income that is subject both to U.S. taxation and foreign taxation. Thus, there is no "double-dipping" of the original economic loss; rather, loss can be deducted in two jurisdictions to offset income that would be taxed in two jurisdictions (double deduction offsetting double income).

Without an adequate set of rules in place, taxpayers might attempt to manipulate the DCL SRLY Register, by engaging in transactions that appear to increase the DCL SRLY Register by income that is only taxed in a single jurisdiction. Such income is not Annual Dual Income (i.e., it is either Annual U.S. Income or Annual Foreign Income, but it is not both), and increasing the DCL SRLY Register by income that is not Annual Dual Income implicates the same policy concerns motivating the enactment of Section 1503(d).

Applying this to Example 6, because FDRE's interest income is a Foreign Income Item but not a U.S. Income Item (i.e., the income would be expected to be taxed in FDRE's jurisdiction or other relevant foreign jurisdiction, and would not be taxed in the U.S.), it increases the Annual Foreign Income from $30 to $40, but does not increase the Annual U.S. Income, which remains at $30. It is not appropriate to increase the DCL SRLY Register by $40 for the year, since only $30

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[108] See Notice of Proposed Rulemaking, Fed. Reg. Vol. 70, No. 99, p. 29868.

[109] See Reg. §1.1503(d)-4(b).

[110] See Reg. §1.1503(d)-4(c)(3).

[111] (Aug. 5, 2011).

[112] The cumulative register approach was introduced as a part of a proposed Section 1502 regulatory package in 1991 (CO-132-87 (1991-1 C.B. 728), CO-077-90 (1991-1 C.B. 749), and CO-078-90 1991-1 C.B. 757), and as a temporary and final regulation in 1996 (Temp. Reg. §1.1502-21T(c)(1), T.D. 8677). These regulations were replaced with final regulations in 1999 (T.D. 8823).

was Annual Dual Income. The excess $10 from FDRE's disregarded interest income was Annual Foreign Income but not Annual U.S. Income and thus should not be part of the DCL SRLY Register (although the taxpayer should get some "credit" for this $10 of excess Annual Foreign Income; the recommended principles and rules provide for that through the carryforward mechanism discussed further below). The $100 Year 1 DCL that was disallowed and subject to the SRLY limitation was deducted both in the U.S. and in the relevant foreign jurisdiction, and allowing income that is Annual Foreign Income but not Annual U.S. Income to free up such DCL would be a windfall to the taxpayer. The same principle applies in the case of income that is not a U.S. Income Item because it is intercompany income (as opposed to disregarded income), as discussed below in Examples 7 and 8.

The excess $10 of Annual Foreign Income from this Example 6 should be carried forward to the following year, whether it arises out of timing differences, an unusual quantity of disregarded and/or intercompany transactions in a given year, or otherwise. Similarly, if there were excess loss (i.e., excess Annual Foreign Loss or excess Annual U.S. Loss), such excess should be carried forward. While a carryforward regime results in further complexity, it would be a neutral way to minimize the pro-taxpayer or anti-taxpayer anomalous results from timing and similar differences.

Therefore, if in the following year (Year 3), FDRE generated $10 or more of excess Annual U.S. Income, e.g., from $10 of operating income and $10 of disregarded deductions, then there would be a $10 positive DCL SRLY Register in that following year.[113] This would allow an extra $10 of the $100 Year 1 DCL to be deducted in Year 3 (in addition to the $30 deducted in Year 2).

On these facts, there is a $100 DCL in Year 1, $40 of Annual Foreign Income and $30 Annual U.S. Income in Year 2, and then assuming the reverse fact pattern in Year 3, with $30 Annual Foreign Income and $40 Annual U.S. Income, the results would be as follows: $30 DCL SRLY Register in Year 2 with $10 excess Annual Foreign Income carryover to Year 3, and $40 DCL SRLY Register in Year 3 ($30 looking at Year 3 independently, plus $10 taking into account the $10 carryover from Year 2). Altogether, in Years 2 and 3, FDRE has generated $70 of Annual Foreign Income and $70 of Annual U.S. Income, and has generated an aggregate $70 DCL SRLY Register, allowing USP to deduct $70 of the $100 Year 1 DCL. In this way, the carryforward mechanism allows for the "with/without" calculation relating to disregarded and intercompany transactions to ultimately isolate dual loss and dual income, which we view as the correct principle and as consistent with the statutory text of Section 1503(d).

The lack of a carryback rule would, in certain limited cases, prevent a taxpayer from receiving a benefit (or detriment) in a timely manner from the excess income (or loss) amount, because in the carryover regime the excess amount would be an attribute utilized only in a future year (and not in a prior year) when the attribute is matched with the future year's results. However, a carryback rule for the excess income benefit (or excess loss detriment) would often require amended returns and other complications that we do not believe are justified. Moreover, the Code does not allow (or require) carrybacks for all attributes (e.g., most net operating losses generated

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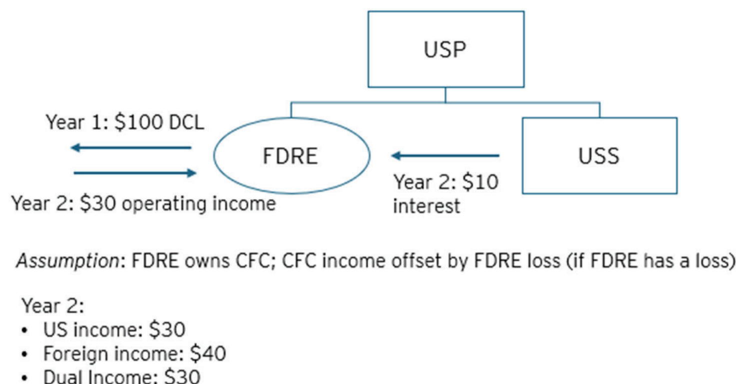
[113] A carryforward of excess Annual Foreign Income can also, for example, reduce a subsequent year's Annual Foreign Loss. A chart of examples illustrating the carryover mechanism is displayed below, following Example 11.

after 2017 cannot be carried back), and so the system can tolerate this lack of symmetry between carryforwards and carrybacks.

Example 7: Operating income and intercompany income
Annual Foreign Income in excess of Annual U.S. Income; Annual Dual Income limited to Annual U.S. Income.



FDRE carries forward a $100 DCL from Year 1. In Year 2, FDRE generates $30 of operating income, which, if it were the only item, would create a positive DCL SRLY Register of $30, thus allowing $30 of the Year 1 DCL to be deducted. In addition, USS, another member of the USP consolidated group, pays $10 interest to FDRE in a transaction described in Regulation §1.1502-13 (i.e., a "-13 Transaction").

Similar to Example 6, a result consistent with anti-duplication policy would be as follows: FDRE's DCL SRLY Register for the year is $30, and not $40, allowing $30, not $40, of FDRE's DCL from Year 1 to be deducted. The DCL SRLY Register is not increased by the $10 intercompany income paid by USS to FDRE in an intercompany transaction.

Results under current law

We understand that taxpayers take different positions as to the effect of a -13 Transaction on DCL calculations, and which position is correct under current law is outside the scope of this Report. Some taxpayers apply Regulation §1.1502-13(c) attribute redetermination to treat a -13 Transaction effectively the same as a disregarded transaction and thus ignore the -13 Transaction for DCL purposes, and other taxpayers, through one or more arguments involving the nature of the DCL regime and the extent of Regulation §1.1502-13(c) attribute redetermination, take the position that -13 Transactions are still regarded for U.S. federal income tax purposes and thus are not subject to the DCL regime's exclusion of disregarded transactions. Allowing taxpayers to take either position can lead to whipsaw that is favorable to the taxpayer (and unfavorable to the fisc).

Results under the Proposed Regulations

The Proposed Regulations would reflect all FDRE items taken into account from -13 Transactions in calculating FDRE's DCL SRLY Register (or the amount of its DCL). This would

result in a $40 DCL SRLY Register, comprised of the $30 operating income and the $10 intercompany interest income. There are several disadvantages of applying the Proposed Regulations here. First, they cause income (such as FDRE's interest income received from USS in a -13 Transaction) that is Annual Foreign Income but not Annual U.S. Income (and thus not Annual Dual Income) to increase the DCL SRLY Register, when the DCL SRLY Register should only be increased for Annual Dual Income. This violates the principle of isolating dual loss and dual income, and only allowing dual income for a year to be offset by another year's dual loss. Second, the Proposed Regulations create a mismatch between disregarded transactions and -13 Transactions.[114] Whereas the Proposed Regulations would create a separately tracked DPL regime to track certain disregarded items (but not other disregarded items), all items from -13 Transactions would simply be aggregated with the rest of FDRE's items as part of FDRE's DCL SRLY Register, or DCL. Thus, if FDRE transacts with its regarded owner USP, it could result in completely different DCL consequences than if FDRE transacts with USS in a -13 Transaction. Example 8 below further explores this disparity in treatment between disregarded transactions and -13 Transactions.

<u>Results under the recommended principles and rules</u>

The "with/without" calculation results in $10 more income "with" the intercompany transaction as compared to "without" the intercompany transaction. While the $10 of interest income is included by USP (through its ownership of FDRE) on a separate entity basis for U.S. federal income tax purposes, it is not a meaningful inclusion, in that USP's inclusion is offset in amount and timing by USS's interest deduction. Moreover, as a general matter (and putting aside the "special status" rule in the Proposed Regulations, which is not at issue here), USP's and USS's attributes are determined as if USP and USS were divisions of a single entity.[115] Thus, there is no net inclusion or net item, and the transaction should not affect the USP consolidated group's consolidated taxable income or consolidated tax liability.[116] Therefore, FDRE's interest income should not be considered a U.S. Income Item. FDRE's interest income should be considered a Foreign Income Item, as we would expect, pursuant to the Foreign Tax Law Assumptions, that the tax laws of FDRE's jurisdiction (or other relevant foreign jurisdiction) would cause FDRE to include the interest in income. FDRE's Annual Foreign Income would be $40, reflecting the $30 operating income and the $10 intercompany interest income, but its Annual U.S. Income would only be $30, reflecting only the operating income, and not the intercompany item. Accordingly, FDRE's Annual Dual Income is $30, and not $40, and so FDRE's DCL SRLY Register should increase by $30, not $40.

The excess $10 of Annual Foreign Income from this Example 7 should be carried forward to the following year. . Therefore, if in the following year, FDRE generated $10 or more of excess Annual U.S. Income, e.g., from $10 of operating income and $10 of disregarded deductions, then there would be a $10 positive DCL SRLY Register in that following year.[117] Altogether, if there is

[114] Whether this type of mismatch exists under current law is outside the scope of this Report.

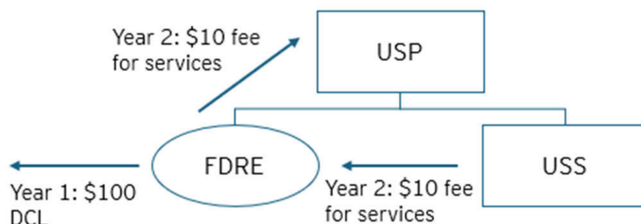
[115] See Reg. §1.1502-13(c)(1)(i).

[116] See Reg. §1.1502-13(a).

[117] A carryforward of excess Annual Foreign Income can also, for example, reduce a subsequent year's Annual Foreign Loss. A chart of examples illustrating the carryover mechanism is displayed below, following Example 11.

$40 of Annual Foreign Income and $30 Annual U.S. Income in Year 2, and then assuming the reverse fact pattern in Year 3, with $30 Annual Foreign Income and $40 Annual U.S. Income, there would be $30 DCL SRLY Register in Year 1 with a $10 excess Annual Foreign Income carryover, and $40 DCL SRLY Register in Year 3 ($30 looking at Year 3 independently, plus $10 taking into account the $10 carryover from Year 2).

Example 8: Disregarded deduction and intercompany income
$0 Annual U.S. Income and $0 Annual Foreign Income; $0 Annual Dual Income and $0 Annual Dual Loss.



Assumption: FDRE owns CFC; CFC income offset by FDRE loss (if FDRE has a loss)

Year 2:
- US income: $0
- Foreign income: $0
- Dual Income: $0

FDRE carries forward a $100 DCL from Year 1. In Year 2, (i) FDRE pays $10 to USP in a disregarded transaction as a fee for services, and (ii) USS, another member of the USP consolidated group, pays $10 to FDRE in a –13 Transaction as a fee for services.

As described below, a result consistent with anti-duplication policy would be as follows: FDRE has neither a DCL nor DCL SRLY Register for the year.

Results under current law

Under current law, FDRE's $10 disregarded payment to USP is not reflected in DCL calculations. The proper treatment under current law of USS's $10 intercompany payment to FDRE is outside the scope of this Report, but to the extent that taxpayers take the position that -13 Transactions are reflected in the calculation of a DCL/DCL SRLY Register, then such taxpayers would receive a windfall in this Example 8 under current law, in that they would report a positive $10 DCL SRLY Register notwithstanding that FDRE did not generate dual income for the year (in fact, in this pattern FDRE did not generate positive income for the year in either jurisdiction). The positive register would be comprised of the $10 intercompany payment from USS to FDRE, and would not reflect the $10 disregarded payment from FDRE to USP pursuant to Regulation §1.1503(d)-5(c)(1)(ii). This illustrates how an approach of reflecting -13 Transactions but not reflecting disregarded transactions can lead to elimination of DCLs and creation of DCL SRLY Register without any net impact to U.S. taxable income or taxable income in the foreign jurisdiction. Current law does not properly identify dual income, if taxpayers take the position described above.

Results under the Proposed Regulations

The Proposed Regulations appears to result in a windfall benefit to a taxpayer. As noted above, DPLs only include certain items, and do not appear to include a fee for services (or other deductions not explicitly listed). Therefore, FDRE's disregarded fee payment to USP in this Example 8 is not reflected in FDRE's DCL calculations (i.e., it is not part of FDRE's DCL or its DCL SRLY Register), and similarly it is not part of FDRE's DPL calculations. In contrast, FDRE's receipt of intercompany fee income from USS in a -13 Transaction *is* reflected in FDRE's SRLY Register, because the Proposed Regulations would reflect all -13 Transactions in DCL calculations. The result in this case is a windfall to the taxpayer as it creates a net \$10 positive DCL SRLY Limitation from the \$10 intercompany fee from USS to FDRE, without reduction for the \$10 disregarded fee from FDRE to USP. A disadvantage of the Proposed Regulations is that they would provide positive DCL SRLY Register in a year for which there is no Annual Dual Income.

Putting aside for the moment the policy question of what the DCL SRLY Register *ought* to be on the facts of this Example 8, there is also a technical question of whether the Intercompany Transaction Regulations allow the disparate treatment of disregarded transactions and -13 Transactions that the Proposed Regulations would require.[118] The Proposed Regulations attempt to explain this dichotomy through the creation of a "special status" under Regulation §1.1502-13(c)(5), which provides that notwithstanding the application of the matching rule under Regulation §1.1502-13(c)(1), to the extent an item's attributes are permitted or not permitted to a member (e.g., in this case, USP through FDRE) under the Code or Regulations by reason of the member's "special status," the attributes required under the Code or Regulations apply to that member's items (but not the other member). This limits the single-entity principles of Regulation §1.1502-13 when a member has a special status.

While treating USP's items attributable to FDRE as a special status is a possible approach, and while this Report takes no position on whether such an approach is the better interpretation of existing law, reliance on the creation of a special status has the disadvantage from a policy perspective of affirmatively creating disparate treatment between disregarded and intercompany transactions. Parity between disregarded and intercompany transactions is a key principle, for the reasons noted above. Also, while possible, treating USP's activities as a special status only to the extent conducted through FDRE is atypical, as normally a special status is a status of the member corporation in its entirety, as opposed to a status of a division thereof. For example, a member that is subject to special treatment under the Code because it is a bank or an insurance company has a special status. Finally, the Proposed Regulations would have a special status alter the *timing* of when intercompany items are taken into account, by requiring the group to reflect intercompany income currently despite the counterparty's intercompany deduction being deferred under the SRLY limitation. This is a highly unusual application of the special status rule, which normally (and literally) applies only to attributes (e.g., causing a bank member's intercompany sale of securities to be an ordinary item while the non-bank counterparty's item upon disposition of the securities outside the consolidated group is capital).

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[118] As noted earlier, whether such disparate treatment is allowed or required under current law is beyond the scope of this Report.

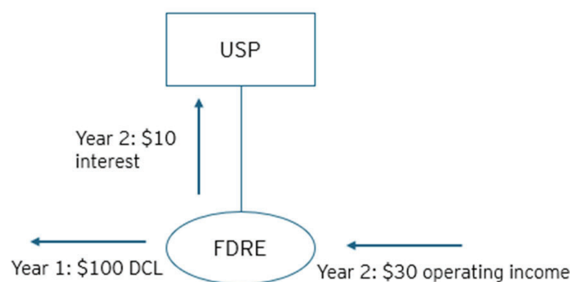
Moreover, creation of a special status is not necessary if instead of the Proposed Regulations' DPL regime, Treasury and the IRS instead adopt the principles and rules recommended by this Report. Such principles include parity between disregarded and intercompany items, and thus a special status to affirmatively create disparity would in fact be anathema to the recommendations herein.

Results under the recommended principles and rules

In this Example 8, FDRE generates zero Annual Foreign Income in Year 2, because pursuant to the Foreign Tax Law Assumptions, FDRE's jurisdiction (or other relevant foreign jurisdiction) would be expected to give effect to FDRE's receipt of $10 from USS as a Foreign Income Item and also to give effect to FDRE's $10 fee payment to USP as a Foreign Deduction. The $10 income and $10 deduction would offset and result in $0 Annual Foreign Income. Similarly, in Year 2 FDRE generates zero of Annual U.S. Income, as FDRE receives $10 from USS in a -13 Transaction giving rise to offsetting items, which has no net effect on U.S.U.S. federal income tax liability of the USP consolidated group and thus is not a U.S. Income Item, and FDRE pays $10 to USP in a disregarded transaction that is not a U.S. Deduction. Thus, for U.S. federal income tax purposes, FDRE does not engage in any transaction for the year that give rise to a net deduction or net income. Because there is $0 Annual Foreign Income and $0 Annual U.S. Income, there should not be Annual Dual Income (in fact, there is not positive income *either* for U.S. federal income tax purposes or for foreign tax purposes), and there should not be positive DCL SRLY Register for FDRE in Year 2.

There would be no carryover to the following year of excess U.S. or foreign income or loss, because as noted above, there was $0 Annual Foreign Income and $0 Annual U.S. Income.

Example 9: Operating Income and Disregarded Deduction
Annual U.S. Income in excess of Annual Foreign Income; Annual Dual Income limited to Annual Foreign Income.



Assumption: FDRE owns CFC; CFC income offset by FDRE loss (if FDRE has a loss)

Year 2:
- US income: $30
- Foreign income: $20
- Dual Income: $20

FDRE carries forward a $100 DCL from Year 1. In Year 2, FDRE generates $30 of operating income, which, if it were the only item, would create a positive DCL SRLY Register of $30, thus allowing $30 of the Year 1 DCL to be deducted. In addition, FDRE pays $10 interest to USP in a disregarded transaction.

As discussed below, a result consistent with anti-duplication policy would be as follows: FDRE's DCL SRLY Register is $20, and not $30, allowing $20, not $30, of FDRE's DCL from Year 1 to be deducted.

Results under current law

Under current law, the amount of the DCL or DCL SRLY Register does not reflect disregarded transactions.[119] This would result in a full $30 of DCL SRLY Register, giving a windfall to the taxpayer, since only $20 was taxed twice.

Results under the Proposed Regulations

The Proposed Regulations would allow a full $30 of DCL SRLY Register for the operating income, but would also require USP to include $10 of ordinary income for the $10 interest payment from FDRE pursuant to the DPL regime.

There are several disadvantages to applying the Proposed Regulations to the facts of this Example 9. First, the Proposed Regulations would only apply to interest, royalties, and structured payments, when the payment from FDRE to USP might instead be a fee for services or other deductible payment (similarly, in creating positive DPL register, payments from USP to FDRE might be fees or other includible payments, and such other payments are not counted in the DPL regime). Second, the Proposed Regulations would not allow the positive $30 DCL SRLY Register

[119] *See* Reg. §1.1503(d)-5(c)(1)(ii).

for the year (from FDRE's $30 of operating income) to offset FDRE's disregarded $10 interest payment to USP. Such result seems at odds with the fact that FDRE in fact earns income for the year (in this Example 9, FDRE earns income whether from a foreign perspective or a U.S. perspective). A more intuitive outcome would be to effectively net the $30 operating income with the $10 disregarded deduction to result in a $20 positive DCL SRLY Register, because the Annual Dual Income is $20. Third, the Proposed Regulations create a mismatch between disregarded transactions and -13 Transactions, as an intercompany interest deduction paid by FDRE to USS (instead of a disregarded interest payment from FDRE to USP) would be reflected under the normal DCL rules and thus, on these facts, would decrease FDRE's DCL SRLY Register from $30 to $20. This is in contrast to the special DPL regime for disregarded transactions, which would result in $10 ordinary income and $30 of DCL SRLY Register.

Results under the recommended principles and rules

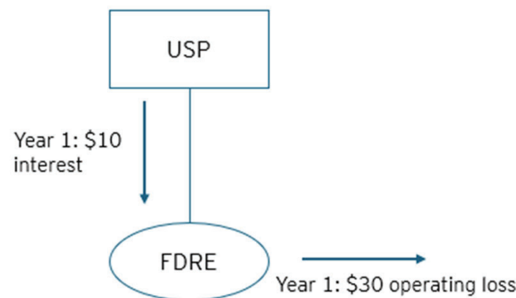
FDRE's interest payment is a Foreign Deduction, as it would be expected, pursuant to the Foreign Tax Law Assumptions, to be deducted from taxable income for purposes of the tax laws of FDRE's home jurisdiction (or other relevant foreign jurisdiction). FDRE's $10 disregarded interest payment is not deductible in the U.S. and thus is not a U.S. Deduction.

The positive DCL SRLY Register should only be increased by income to the extent of Annual Dual Income (i.e., the lesser of Annual Foreign Income and Annual U.S. Income). Because FDRE's interest payment reduces its Annual Foreign Income from $30 to $20, the extent to which FDRE's net income for the year is Dual Income is $20, not $30. Although FDRE's disregarded interest payment to USP does not reduce Annual U.S. Income, which remains at $30, because such interest payment is disregarded for U.S. federal income tax purposes, the Annual Dual Income is only $20, because only $20 of FDRE's income is taxed both in the U.S. and in FDRE's jurisdiction (or other relevant jurisdiction). The excess $10 of income for U.S. purposes (because the U.S. does not see the $10 interest deduction) should not increase the DCL SRLY Register, because the Year 1 DCL that was disallowed and subject to limitation was deducted both in the U.S. and in the relevant foreign jurisdiction, and allowing the $10 excess income taxed only in the U.S. (and not in the foreign jurisdiction) to free up such losses would be a windfall to the taxpayer.

The excess $10 of Annual U.S. Income from this Example 9 should be carried forward to the following year. Therefore, if in the following year, FDRE incurred $10 or more of excess Annual Foreign Income, e.g., from $10 disregarded income and no other items, then there would be a $10 positive DCL SRLY Register in that following year.[120] Altogether, if there is $30 of Annual U.S. Income and $20 Annual Foreign Income in Year 2, and then assuming the reverse fact pattern in Year 3, with $20 Annual U.S. Income and $30 Annual U.S. Income, there would be $20 DCL SRLY Register in Year 2 with a $10 excess Annual U.S. Income carryforward, and $30 DCL SRLY Register in Year 3 ($20 looking at Year 3 independently, plus $10 taking into account the $10 carryover from Year 2).

[120] A carryforward of excess Annual U.S. Income can also, for example, reduce a subsequent year's Annual U.S. Loss. A chart of examples illustrating the carryover mechanism is displayed below, following Example 11.

Example 10: Operating Loss and Disregarded Income
Annual U.S. Loss in excess of Annual Foreign Loss; Annual Dual Loss limited to Annual Foreign Loss.



In Year 1, FDRE generates $30 of operating loss, which, if it were the only item, would create a DCL of $30. In addition, USP pays $10 interest to FDRE in a disregarded transaction.

As discussed below, a result consistent with anti-duplication policy would be as follows: FDRE's DCL is $20, and not $30, subjecting $20, not $30, to the SRLY limitation.

Results under current law

Current law, the amount of the DCL does not reflect disregarded transactions,[121] and thus would be $30, even though there was only a $20 Annual Dual Loss (because it would be limited by the $20 Annual Foreign Loss). A disadvantage of current law is that it does not as precisely define the parameters of the DCL to reflect only Annual Dual Loss.

Results under the Proposed Regulations

Under the Proposed Regulations, there would be a $30 DCL and $10 of positive DPL register for the year. There are several disadvantages to the Proposed Regulations in this case. First, the disparity between different types of items; second, the Proposed Regulations would cause the entire $30 of FDRE's Annual U.S. Loss to be treated as a DCL even though there is only $20 of loss duplication; third, a mismatch between disregarded transactions and -13 Transactions.

Results under the recommended principles and rules

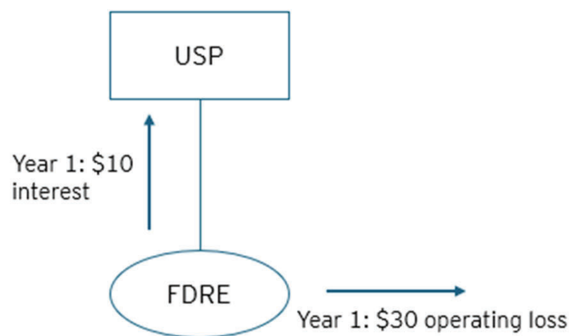
FDRE's receipt of $10 interest is a Foreign Income Item. It is paid in a transaction that is disregarded for U.S. federal income tax purposes, and thus is not a U.S. Income Item. FDRE's DCL for the year should reflect the Annual Dual Loss. FDRE's receipt of interest from USP reduces FDRE's Annual Foreign Loss from $30 to $20. A $20 Annual Foreign Loss and a $30

[121] See Reg. § 1.1503(d)-5(c)(1)(ii).

Annual U.S. Loss create a $20 Annual Dual Loss, because only to the extent of $20 is the loss both taken in the U.S. and, pursuant to the Foreign Tax Law Assumptions, taken in FDRE's jurisdiction or other relevant foreign jurisdiction. Thus, the DCL would be $20.[122]

The excess $10 of Annual U.S. Loss from this Example 10 should be carried forward to the following year. Therefore, if in the following year, FDRE incurred $10 or more of excess Annual Foreign Loss, e.g., from $10 disregarded deductions and no other items, then there would be a $10 DCL in that following year.[123] Altogether, if there is $30 of Annual U.S. Loss and $20 Annual Foreign Loss in Year 1, and then assuming the reverse fact pattern in Year 2, with $20 Annual U.S. Loss and $30 Annual Foreign Loss, there would be a $20 DCL Year 1 with a $10 excess Annual U.S. Loss carryover, and a $30 DCL in Year 2 ($20 looking at Year 2 independently, plus $10 taking into account the $10 carryover from Year 1).

Example 11: Operating Loss and Disregarded Deduction
Annual Foreign Loss in excess of Annual U.S. Loss; Annual Dual Loss limited to Annual U.S. Loss.



Assumption: FDRE owns CFC; CFC income offset by FDRE loss (if FDRE has a loss)

Year 1
- US loss: ($30)
- Foreign loss: ($40)
- Dual Consolidated Loss: ($30)

In Year 1, FDRE generates $30 of operating loss, which, if it were the only item, would create a DCL of $30. In addition, FDRE pays $10 interest to USP in a disregarded transaction.

[122] This analysis and result is consistent with the 2019 Report, in which we said "Treasury and the Service should consider redefining the net loss attributable to a separate unit by taking into account disregarded items to the extent they can offset regarded items of the separate unit, but *we caution against affirmatively creating notional items by disaggregating items that are generally disregarded into a regarded deduction and a regarded item of income*." (emphasis added). While the mechanics of such issues were not described in detail in the 2019 Report (in which the primary focus was Sections 245A(e) and 267A), conceptually the recommended principles and rules in this Report generally follow the quoted passage.

[123] A carryforward of excess Annual U.S. Loss can also, for example, reduce a subsequent year's Annual U.S. Income. A chart of examples illustrating the carryover mechanism is displayed below, following Example 11.

As discussed below, a result consistent with anti-duplication policy would be as follows: FDRE's DCL is $30, and not $40, subjecting $30, not $40, to the SRLY limitation, with no ordinary income inclusion of $10.

Results under current law

Under current law, the amount of the DCL does not reflect disregarded transactions.[124] Current law would result a $30 DCL. However, current law would not require any of the excess Annual Foreign Loss to be carried forward, and so the disregarded payment gives the taxpayer a permanent benefit, as opposed to a temporary benefit that would unwind in a future year.

Results under the Proposed Regulations

The Proposed Regulations would impose the DPL Regime on disregarded payments, and thus would require USP to include $10 of ordinary income in addition to subjecting $30 of FDRE's loss to the SRLY limitation, for an aggregate $40 detriment notwithstanding that there was only $30 of Annual Dual Loss. For the reasons stated previously, there are several disadvantages to the Proposed Regulations as applied to this Example 11; namely, they would create disconformity between a disregarded transaction and a -13 Transaction (for example, a larger DCL created by an intercompany deduction could be unlocked by any positive DCL SRLY Register, whereas the separately tracked DPL register would require FDRE to earn income only from disregarded transactions), and would create disconformity between different types of items (interest and royalties versus fees etc.).

Results under the recommended principles and rules

FDRE's payment of $10 interest is expected to deductible for purposes of the tax laws of FDRE's jurisdiction (or other relevant foreign jurisdiction) pursuant to the Foreign Tax Law Assumptions, and thus represents a Foreign Deduction. It thus increases the Annual Foreign Loss from $30 to $40. It is paid in a transaction that is disregarded for U.S. federal income tax purposes, and thus is not a U.S. Deduction, as it has no impact on U.S. taxable income or U.S. tax liability. The disregarded payment does not increase the Annual U.S. Loss, which remains at $30. FDRE's DCL for the year should reflect the loss for the year to the extent that it is both an Annual U.S. Loss and an Annual Foreign Loss (i.e., an Annual Dual Loss). The Annual Dual Loss is the lesser of the $40 Annual Foreign Loss and the $30 Annual U.S. Loss, and so the DCL should be $30. It would be inconsistent with DCL anti-duplication policy to increase the DCL to the extent ($10) that the Annual Foreign Loss ($40) exceeds the Annual U.S. Loss ($30), because DCL policy is to prevent the deduction of an Annual Dual Loss for a year, except to the extent it offsets another year's Annual Dual Income. No $10 ordinary income inclusion (as would be required by the DPL regime, applied to these facts below) is necessary in order to carry out the DCL regime's anti-duplication policy.

The excess $10 of Annual Foreign Loss from this Example 11 should be carried forward to the following year. Therefore, if in the following year, FDRE incurred $10 or more of excess

[124] See Reg. § 1.1503(d)-5(c)(1)(ii).

Annual U.S. Loss, e.g., from $10 of operating loss and $10 of disregarded income, then there would be a $10 DCL in that following year.[125] Altogether, if there is $40 of Annual Foreign Loss and $30 Annual U.S. Loss in Year 1, and then assuming the reverse fact pattern in Year 2, with $30 Annual Foreign Loss and $40 Annual U.S. Loss, there would be a $30 DCL in Year 1 with a $10 excess Annual Foreign Loss carryover, and a $40 DCL in Year 2 ($30 looking at Year 2 independently, plus $10 taking into account the $10 carryover from Year 1).

Summary of Results under for Examples 6-11 under recommended principles and rules

	Facts	U.S. income (loss)	Foreign income (loss)	SRLY Register (DCL)	Carryforward
Example 6	$30 operating income, $10 disregarded income	$30	$40	$30	$10 foreign income
Example 7	$30 operating income, $10 intercompany income	$30	$40	$30	$10 foreign income
Example 8	($10) disregarded loss, $10 intercompany income	$0	$0	$0	$0
Example 9	$30 operating income, ($10) disregarded loss	$30	$20	$20	$10 U.S. income
Example 10	($30) operating loss, $10 disregarded income	($30)	($20)	($20)	($10) U.S. loss
Example 11	($30) operating loss, ($10) disregarded loss	($30)	($40)	($30)	($10) foreign loss

To illustrate the operation of the carryforward, assume the taxpayer had Example 6's results in Year 1, and Example 9's results in Year 2. The Year 2 standalone result would be $20 DCL SRLY Register, but with the $10 Annual Foreign Income carryforward from Year 1, there would be $30 DCL SRLY Register in Year 2. In aggregate there would be a $60 DCL SRLY Register.

Similarly, assume the taxpayer had Example 10's results in Year 1, and Example 11's results in Year 2. The Year 2 standalone result would be a $30 DCL, but with the $10 Annual U.S. Loss carryforward from Year 1, there would be a $40 DCL in Year 2. In aggregate there would be a $60 DCL.

Examples illustrating the operation of the carryforward mechanism

Below are 4 different scenarios illustrating the operation of the proposed carryforward mechanism. Each scenario involves 3 taxable years, and does not necessarily correlate with any of the Examples 6-11 above.

[125] A carryforward of excess Annual Foreign Loss can also, for example, reduce a subsequent year's Annual Foreign Income. A chart of examples illustrating the carryover mechanism is displayed below, following this Example 11.

Carryforward Scenario 1:

	U.S. income (loss)	U.S. c/f from prior year	F Income (loss)	Foreign c/f from PY	Register (DCL)	C/f to next year
Y1	30	-	40	-	30	10 foreign
Y2	35	-	20	10	30	5 U.S.
Y3	0	5	5	-	5	-
Tot.	**65**		**65**		**65**	

Carryforward Scenario 2:

	U.S. income (loss)	U.S. c/f from prior year	F Income (loss)	Foreign c/f from PY	Register (DCL)	C/f to next year
Y1	(30)	-	(20)	-	(20)	(10) U.S.
Y2	(30)	(10)	(45)	-	(40)	(5) foreign
Y3	(5)	-	0	(5)	(5)	-
Tot.	**(65)**		**(65)**		**(65)**	

Carryforward Scenario 3:

	U.S. income (loss)	U.S. c/f from prior year	F Income (loss)	Foreign c/f from PY	Register (DCL)	C/f to next year
Y1	10	-	(10)	-	0	10 U.S., (10) F
Y2	(15)	10	(10)	(10)	(5)	(15) foreign
Y3	(10)	-	5	(15)	(10)	-
Tot.	**(15)**		**(15)**		**(15)**	

Carryforward Scenario 4:

	U.S. income (loss)	U.S. c/f from prior year	F Income (loss)	Foreign c/f from PY	Register (DCL)	C/f to next year
Y1	(30)	-	(45)	-	(30)	(15) foreign
Y2	(30)	-	10	(15)	(5)	(25) U.S.
Y3	5	(25)	(20)	-	(20)	-
Tot.	**(55)**		**(55)**		**(55)**	

Summary of rules to implement the recommended principles

Below is a repetition of the three rules laid out at the beginning of this Part IV.F, with annotations to reflect the terminology and rationale developed.

1. For the year, calculate FDRE's income (loss) both with and without disregarded and intercompany items that offset in amount.[126]
2. From the "with and without" calculation in No. 1, the smaller amount of income is dual income, and thus is the DCL SRLY Register (or the smaller amount of loss is dual loss, and thus is the DCL).[127]
3. The excess, whether favorable (excess income) or unfavorable (excess loss), is carried forward to the next year (but not carried back).[128]

G. Disregarded and intercompany transactions where the parties' items offset in amount but are not immediately taken into account (Example 12)

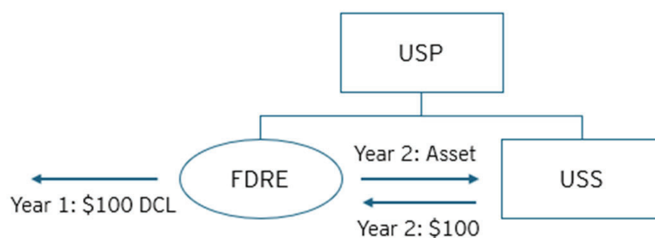
This Part IV.G describes a case where the parties' items offset in amount but are taken into account over time, as opposed to immediately. A prototypical case would be where the sale of a depreciable asset in a -13 Transaction gives rise to seller gain and buyer stepped-up basis, with seller's gain taken into account over time to match to the buyer's increased depreciation deductions under the Regulation §1.1502-13(c) matching rule. The principles and rules described in Parts IV.B and IV.F above for immediately offsetting items can still be applied.

[126] The "with" prong calculates Foreign Annual Income (or Foreign Annual Loss) by reflecting the net aggregate Foreign Income Items (or Foreign Deductions) from all disregarded transactions and -13 Transactions for the year. The "without" prong calculates U.S. Annual Income (or U.S. Annual Loss) by ignoring disregarded and intercompany items that offset, because such items are not U.S. Income Items (or U.S. Deductions).

[127] The smaller of Annual U.S. Income and Annual Foreign Income (or the smaller loss as between the Annual U.S. Loss and Annual Foreign Loss) is the Annual Dual Income (or Annual Dual Loss) for the year. That amount is the DCL SRLY Register (or DCL) for the year. For the avoidance of doubt, if there is Annual U.S. Income and Annual Foreign Loss (or Annual U.S. Loss and Annual Foreign Income), then there is neither Annual Dual Income nor Annual Dual Loss, and thus neither a DCL nor DCL SRLY register for the year. This makes sense, because no income was taxed in both jurisdictions, and no loss was deducted in both jurisdictions.

[128] Taxpayers carry forward to the next year the excess Annual U.S. Income, Annual U.S. Loss, Annual Foreign Income, or Annual Foreign Loss, as the case may be. It is possible to carryforward two such attributes, see Carryforward Example 8, Year 1, above.

Example 12: Intercompany gain on depreciable asset
Annual Foreign Income in excess of Annual U.S. Income



Assumption: FDRE owns CFC; CFC income offset by FDRE loss (if FDRE has a loss)

Year 2:
- US income: $0
- Foreign income: $100
- Dual Income: $0

FDRE carries forward a $100 DCL from Year 1. At the beginning of Year 2, FDRE sells a $0 basis depreciable asset to USS for $100 in a -13 Transaction, and the asset has a 10-year depreciation schedule. USS depreciates the asset $10 per year, during Years 2-11. For U.S. federal income tax purposes, the consolidated return rules would work as follows (before taking into account any DCL implications). Under Regulation §1.1502-13(c), USP (through FDRE) takes into account each year a $10 portion of its $100 recognized gain that matches to USS's increased depreciation deductions by reason of USS's stepped-up basis under Section 1012. More specifically, in each year from Years 2-11, USP takes into account a portion of its $100 recognized gain equal to the difference between (i) $0, which is the item that USP and USS would have if USP and USS were divisions of a single entity (i.e., the "recomputed item"), and (ii) -$10, which is the amount of USS's actual depreciation deduction (i.e., USS's "corresponding item"). USP's gain would be ordinary, to match USS's ordinary depreciation deductions.

Results under current law

We understand that taxpayers take different positions on whether or not intercompany items are reflected in DCL calculations, and this Report takes no position on the issue. The recommended principles and rules would solve for this by explicitly providing parity between disregarded and intercompany items.

Results under the Proposed Regulations

Under the Proposed Regulations, items from a -13 Transaction, including ordinary income or ordinary loss from asset dispositions) would be subject to the DCL regime just like any other item, and would follow the normal Intercompany Transaction Regulation timing rules (with some modifications not relevant to this fact pattern). In contrast, if the transaction was between FDRE and USP, asset gain or asset loss from a disregarded asset sale from FDRE to USP would not be reflected in the DPL regime, as the DPL regime only applies to certain items, such as interest and royalties. As noted previously, several disadvantages of the Proposed Regulations are that it provides different treatment for disregarded transactions as opposed to -13 Transaction, and it

provides different treatment for certain types disregarded items (interest and royalties, versus fees, asset sales, etc.) These disparities can cause traps for the unwary or inappropriate manipulation.

Results under the recommended principles and rules

As described below, the same principles and rules as discussed in Part IV.F above dealing with immediately offsetting items can be applied. For the reasons stated in earlier examples, USP's gain (through FDRE) should not give rise to a U.S. Income Item, either in the year of the sale (Year 2) or in the years that USP's gain (through FDRE) is taken into account (Years 2-11). USP's gain is offset in amount, timing, and character by USS's depreciation deductions. The fact that this occurs over 10 years (during Years 2-11) instead of all at once should not cause these items to be U.S. Income Items (or U.S. Deductions). Moreover, USP's and USS's attributes are determined as if USP and USS were divisions of a single entity. Thus, there is no net inclusion or net item, and the transaction should not affect the USP consolidated group's consolidated taxable income or consolidated tax liability. The same analysis would apply if FDRE had sold the asset to USP in a disregarded transaction.[129]

Accordingly, the "without" prong of the "with/without" calculation, which corresponds to Annual U.S. Income (or Annual U.S. Loss), should apply the same in this case involving items offsetting over time as it applied in Part IV.F to items that offset immediately.

Although USP's (through its interest in FDRE) $10 of gain each year is not a U.S. Income Item, FDRE's $100 gain is a Foreign Income Item, as we would expect, pursuant to the Foreign Tax Law Assumptions, that the tax laws of FDRE's jurisdiction (or other relevant foreign jurisdiction) would cause FDRE to include the $100 gain in income. It follows that such gain should be reflected as creating or increasing FDRE's Annual Foreign Income (or decreasing its Annual Foreign Loss).

All $100 of FDRE's income from the asset sale to USP should be a Foreign Income Item in the year of the sale, Year 2, as opposed to matching the timing of FDRE's income to USS's increased depreciation deductions. That is because there is little reason to believe that the foreign jurisdiction would defer FDRE's income (or loss) under any sort of Regulation §1.1502-13 matching system. Although the Foreign Tax Law Assumptions typically follow U.S. tax accounting rules (i.e., for most items, the U.S. tax accounting rules apply for DCL calculations), immediately reflecting FDRE's income (or loss) from a disregarded or intercompany transaction (as opposed to reflecting them over time) for determining Annual Foreign Income (or Annual Foreign Loss) appears to be a reasonable exception to the general rule. This would achieve greater accuracy in isolating dual income and dual loss, and in some cases is a simpler approach.[130] This should apply in the same way to a disregarded sale from FDRE to USP as it does to this Example 12, which involves an intercompany sale from FDRE to USS.

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[129] In a disregarded transaction, it is even simpler, as there is no change to USP's basis in the property in any case, and so there is no matching to USP's increased depreciation (USP takes the same depreciation deductions that FDRE was taking). Thus, there is no U.S. item whatsoever from FDRE's sale of the asset.

[130] For example, in cases where an asset is successively transferred in multiple disregarded transactions or -13 Transactions, it is simpler to reflect FDRE's items immediately in determining FDRE's Annual Foreign Income (or Annual Foreign Loss).

Applying the recommended rules to the facts of this Example 12, FDRE's Annual Foreign Income for Year 2 would be $100, as its entire $100 gain from the intercompany asset sale to USS would be a Foreign Income Item. FDRE's Annual U.S. Income would still be $0, because there would be no net U.S. income or tax arising from the transaction. Accordingly, FDRE's DCL SRLY Register for Year 2 would be $0 (the lesser of the $100 Annual Foreign Income and $0 Annual U.S. Income), and none of FDRE's $100 DCL from Year 1 could be deducted yet. There would be the same result under this approach if FDRE sold the depreciable asset to USP in a disregarded transaction instead of selling to USS in a -13 Transaction.

The excess $100 of Annual Foreign Income from this Example 12 should be carried forward to the following year. Therefore, if in the following year, FDRE incurred $100 or more of excess Annual U.S. Income, e.g., from $100 operating income and $100 disregarded deductions, then there would be a $100 DCL SRLY Register in that following year.[131] Altogether, if there is $100 of Annual Foreign Income and $0 Annual U.S. Income in Year 1, and then assuming the reverse fact pattern in Year 2, with $0 Annual Foreign Income and $100 Annual U.S. Income, there would be a $0 DCL SRLY Register in Year 1 with a $100 excess Annual Foreign Income carryover, and a $100 DCL SRLY Register in Year 2 ($0 looking at Year 2 independently, plus $100 taking into account the $100 carryover from Year 1).

Summary of rules to implement the recommended principles

Below is a repetition of the three rules laid out at the beginning of Part IV.F, with annotations to reflect the discussion in this Part IV.G (but not repeating the annotations to these rules provided at the conclusion of Part IV.F).

1. For the year, calculate FDRE's income (loss) both with and without disregarded and intercompany items that offset in amount.[132]
2. From the "with and without" calculation in No. 1, the smaller amount of income is dual income, and thus is the DCL SRLY Register (or the smaller amount of loss is dual loss, and thus is the DCL).
3. The excess, whether favorable (excess income) or unfavorable (excess loss), is carried forward to the next year (but not carried back).

H. Disregarded and intercompany transactions where the parties' items do not offset (Example 13 and variations on Example 13):

This Part IV.H describes transactions where the parties' items do not offset. A prototypical case would be a sale of inventory in a disregarded transaction or a -13 Transaction followed by a further sale of the inventory to an unrelated person. The parties' items do not offset because

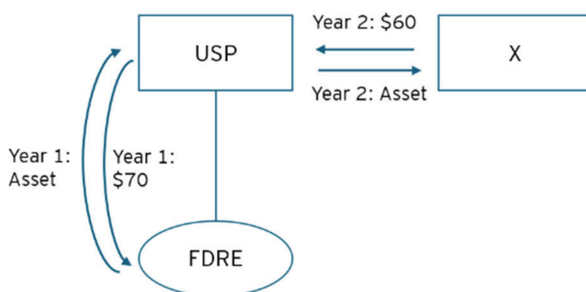
[131] A carryforward of excess Annual Foreign Income can also, for example, reduce a subsequent year's Annual Foreign Loss. A chart of examples illustrating the carryover mechanism is displayed above, following Example 11.

[132] For the "with" prong (relating to foreign items), disregarded or intercompany items that offset over time are Foreign Income Items (or Foreign Deductions) at the time of the transaction (i.e., they otherwise follow normal U.S. federal income tax accounting principles but are not deferred under Reg. §1.1502-13).

FDRE's items from a first-step disregarded sale to USP have no relation in amount to USP's items from a second-step sale to the unrelated person. Similarly, FDRE's items from a first-step intercompany sale to USS have no relation in amount to USS's items from a second-step sale to the unrelated person. The concept is similar when USP (or USS) sells the inventory to FDRE in a disregarded (or intercompany) transaction. This is in contrast to immediately offsetting items discussed above in Part IV.F, which often include interest, royalties, and fees, and is in contrast to items that offset over time discussed above in Part IV.G, such as intercompany sales of depreciable property.

As discussed below, the principles and rules described in Parts IV.B, F, and G above should be applied to non-offsetting items, but with a modification (although a single methodology can be applied to all examples described herein).

Example 13: Disregarded sale at loss and then regarded sale at further loss.



FDRE has a $100 basis in an asset that constitutes inventory. In Year 1, FDRE sells the asset to USP in exchange for $70 in a disregarded transaction, and in Year 2 USP sells the asset to unrelated X in exchange for $60.

As described below, a result consistent with anti-duplication policy would be as follows: in Year 1, FDRE has no DCL, and in Year 2, FDRE is treated as generating a $30 DCL.

Results under current law

Under current law, the amount of the DCL or DCL SRLY Register does not reflect disregarded transactions.[133] Therefore, FDRE's loss never creates a DCL, nor does it result in an attribute that could become a DCL in a later year.

[133] *See* Reg. § 1.1503(d)-5(c)(1)(ii).

Results under the Proposed Regulations

Under the Proposed Regulations, only certain types of items (interest, royalties, etc.) are subject to the DPL regime. Therefore, FDRE's loss never creates a DPL (or a DCL), nor does it result in an attribute that could become a DPL (or DCL) in a later year.

Results under the recommended principles and rules

Although FDRE's sale of the inventory asset to USP is a disregarded transaction, because USP's item and FDRE's item do not offset, FDRE's item *is* a U.S. Deduction. This is in contrast to immediately offsetting items such as interest, royalties, fees, or compensation (discussed in Part IV.F above), and also is in contrast to items that offset over time such as seller gain matched with buyer increased depreciation (discussed in Part IV.G above). In those earlier cases dealing with offsetting items, the transaction has no net effect on U.S. taxable income and thus is neither a U.S. Income Item nor a U.S. Deduction. But where items do not offset such as the sale in this Example 13, the transaction *can* have a net effect on U.S. taxable income and U.S. tax liability depending on subsequent events, such as a sale of the inventory by USP to an unrelated person (the timing of such net effect, and thus the timing of the U.S. Deduction, is the second question, discussed further below). Thus, in this Example 13, FDRE's $30 loss ($100 basis and $70 sales proceeds) on its disregarded sale of inventory to USP is a U.S. Deduction.[134] Accordingly, a modification to the "without" prong of the "with/without" calculation is necessary; normally, the U.S. items are determined without disregarded or intercompany transactions, but in this limited case, U.S. items should indeed reflect disregarded or intercompany items pursuant to the timing and manner described below.

The next question is the timing of FDRE's $30 U.S. Deduction, i.e., whether FDRE's $30 loss should be reflected in its Annual U.S. Income (or Annual Loss) for the year of the sale (Year 1), or should it be reflected in the year that USP sells the inventory to the unrelated person (Year 2), pursuant to a matching rule such as Regulation §1.1502-13(c). There is no effect on U.S. taxable income or U.S. tax liability at the time of the Year 1 disregarded sale. The Year 2 regarded sale by USP to the unrelated person causes the U.S. tax impact. Therefore, a result consistent with anti-duplication policy would be to treat the U.S. Deduction as occurring in Year 2.

Pursuant to the Foreign Tax Law Assumptions, FDRE's $30 loss would be deductible in FDRE's jurisdiction (or other relevant foreign jurisdiction). Therefore, FDRE's $30 loss is also a Foreign Deduction, and for the reasons described in Part IV.G, it is a Foreign Deduction in the year of the transaction (Year 1) (namely, because there is little reason to believe that the foreign tax law would apply a matching rule).

[134] Note that the amount of the U.S. Income Item (or U.S. Deduction) from disregarded items that do not offset in amount should be limited by the total amount of income (or loss) recognized by USP. Similarly, the amount of the U.S. Income Item (or U.S. Deduction) from intercompany items that do not offset in amount should be limited by the total amount of income (or loss) recognized by the USP consolidated group. The concept is that this net amount is the total amount taxed in the U.S., and so only that amount (or a lesser amount) can be a U.S. Income Item (or U.S. Deduction). See the discussion in the variation below, Example 13(a).

Applying the rules above to the facts of this Example 13, there would be a Year 1 $30 Annual Foreign Loss, resulting in no DCL and a $30 carryforward of excess Annual Foreign Loss. In Year 2, there would be a $30 Annual U.S. Loss. Thus, for Year 2, there would be a $30 DCL, which is the lesser of (i) the $30 Annual U.S. Loss in Year 2, and (ii) the $0 foreign item in Year 2 increased by the excess $30 Annual Foreign Loss carried forward from Year 1. This result is accurate and also practical, as Year 2 is the year when the duplicated loss is recognized in the U.S., and so Year 2 is the only year where there is a loss than can be made subject to the SRLY limitation.

Variations on Example 13

Below is a brief discussion, in summary form, of several variations on the facts of Example 13.

Example 13a:

FDRE has a $100 basis in an asset that constitutes inventory. In Year 1, FDRE sells the asset to USP in exchange for $70 in a disregarded transaction, and in Year 2 USP sells the asset to unrelated X in exchange for $80.

Analysis: FDRE incurs a $30 Annual Foreign Loss in Year 1 but no Annual U.S. Loss. In Year 2, USP recognizes a $20 loss ($100 basis minus $80 sales proceeds), all of which is economically attributable to FDRE. Therefore, a result consistent with anti-duplication policy would be as follows: in Year 1, FDRE has no DCL and a $30 Annual Foreign Loss carryforward, and in Year 2, FDRE is treated as generating a $20 DCL, with a $10 remaining excess Annual Foreign Loss carried forward to Year 3. FDRE's Year 2 Annual U.S. Loss is only $20 because the U.S. tax system sees only $20 of aggregate loss, and so a maximum of $20 loss can be attributable to FDRE.

Conceptually, capping FDRE's disregarded or intercompany item at USP's item (in this case, capping FDRE's U.S. Deduction at $20, which was USP's loss on its sale to the unrelated person for $80) is attribute redetermination under Regulation §1.1502-13(c), by treating FDRE as a separate member of the consolidated group. The attribute here is the creation of a dual loss, and the maximum dual loss is the loss of the USP-FDRE "group", because that is the only amount deducted in the U.S.. This is analogous to how Regulation §1.1502-13 treats Section 1248 (where a member sells CFC stock to another member),[135] Section 382 recognized built-in gain (where a member subject to a Section 382 limitation sell built-in gain property to another member),[136] installment sale reporting (where a member sells an asset eligible for the installment method to

[135] If group member S has $0 basis in CFC stock, and S sells CFC stock to B for $100, and then B sells CFC stock to unrelated person for $90, the maximum amount of S's $100 gain recharacterized as a dividend under Section 1248 gain is $90. Since Section 1248 only applies to the extent of gain, the group's Section 1248 amount is capped at the group's $90 gain. See Reg. §1.1502-13(c)(7)(ii) Example 15.

[136] If group member S is subject to a Section 382 limitation and has $0 basis in asset with $100 net unrealized built-in gain, and S sells asset to B for $100, and then B sells asset to unrelated person for $90, the amount of S's recognized built-in gain is $90. Since recognized built-in gain only includes gain, the amount of S's $100 gain that constitutes Section 382 recognized built-in gain is capped at the group's $90 gain. See Reg. §1.1502-13(c)(7)(ii) Example 10(b).

another member),[137] among others. Since USP recognized a $20 loss, a maximum of $20 loss can give rise to a dual loss. Therefore, as noted above, FDRE's U.S. Deduction in Year 2 is $20. Subjecting USP to limitation on a $30 DCL (as opposed to a $20 DCL) would be unjustly punitive, as there was a dual loss only to the extent of $20 (similarly, in the case where income is generated by the group, FDRE's U.S. Income Item should be capped at the income recognized by USP or the USP consolidated group, and any excess would be a an unjustified windfall to USP). Moreover, capping the U.S. Income Item (or U.S. Deduction) at the amount USP's net item limits the ability for taxpayers to pick an artificial transfer price for the disregarded or intercompany transaction.

Example 13b: Same facts as Example 13a, except FDRE sells the inventory asset to USS in a -13 Transaction (instead of to USP in a disregarded transaction).

Analysis: Same result.

Example 13c: FDRE owns a depreciable asset with a $100 basis and 10-year depreciable life; in Years 1 and 2, FDRE takes $10 depreciation in each year; at the beginning of Year 3 FDRE sells the asset to USP for $95 in a disregarded transaction; at the beginning of Year 4, USP sells the asset to an unrelated person for $98.

Analysis: in Years 1 and 2, FDRE generates a $10 DCL each year attributable to the depreciation. In Year 3, FDRE generates $15 Annual Foreign Income ($95 proceeds - $80 basis = $15 recapture income), but no Annual U.S. Income (because the sale is a disregarded transaction), so FDRE has no positive DCL SRLY Register, but FDRE carries forward $15 excess Annual Foreign Income into Year 4. In Year 4, there is $15 of Annual U.S. Income (FDRE takes into account its $15 gain under the principles of Regulation §1.1502-13), which, together with the $15 Annual Foreign Income carryforward from Year 3, results in a $15 positive DCL SRLY Register. This allows $15 of FDRE's $20 DCL from Years 1 and 2 to be deducted without limitation.

Example 13d: Same facts as Example 13c, except in Year 3 FDRE sells the depreciable asset to USS in a -13 Transaction (instead of to USP in a disregarded transaction), and in Year 4 USS sells the asset to an unrelated person for $98.

Analysis: Same result.

Example 13e: Same facts as Example 13c, except in Year 3 FDRE *distributes* the depreciable asset to USP (instead of selling the asset to USP) in a disregarded distribution, which would be covered by Sections 301 and 311 if FDRE were a corporation, and in Year 4 USP sells the asset to an unrelated person for $98.

Analysis: Same result. The results should also be the same if FDRE distributes property to USP that would give rise to an ordinary loss (although this an uncommon fact pattern). Similar to Regulation §1.1502-13(f)(2)(iii), in order to properly isolate FDRE's dual income and dual

[137] If group member S has $0 basis in asset that is eligible for installment reporting, and S sells asset to B for $100, and then B sells asset to unrelated person for $90, the amount of S's $100 gain that is eligible for installment reporting is $90. Since installment method is only available for gain, it is capped at the group's $90 gain. See Reg. §1.1502-13(c)(7)(ii) Example 5(d).

inclusion, both gain and loss should be recognized under Section 311(b) principles, treating FDRE as a consolidated group member for this purpose.

Summary of rules to implement the recommended principles

Below is a repetition of the three rules laid out at the beginning of Part IV.F, with an annotation to reflect the discussion in this Part IV.H (but not repeating the annotations to these rules provided at the conclusion of Part IV.F or Part IV.G).

1. For the year, calculate FDRE's income (loss) both with and without disregarded and intercompany items that offset in amount.[138]
2. From the "with and without" calculation in No. 1, the smaller amount of income is dual income, and thus is the DCL SRLY Register (or the smaller amount of loss is dual loss, and thus is the DCL).
3. The excess, whether favorable (excess income) or unfavorable (excess loss), is carried forward to the next year (but not carried back).

[138] For the "without" prong (relating to U.S. items), disregarded or intercompany items that do *not* offset in amount can be viewed as an exception. Such items *are* part of the "without" calculation, and are reflected by applying the principles of Reg. §1.1502-13 as if FDRE were a consolidated group member. Integrating Part IV.F (immediately offsetting items), Part IV.G (items that offset over time), and this Part IV.H (items that do not offset) in a single approach, all transactions in such categories can be viewed as giving rise to a U.S. Income Item (or U.S. Deduction) to the extent of the lesser income (or loss) as between (i) FDRE's item, and (ii) the aggregate item of USP (or USS) and FDRE, in each case by treating FDRE as a separate consolidated group member and applying Reg. §1.1502-13. Using the terminology of Reg. §1.1502-13, the U.S. Income Item (or U.S. Deduction) is capped at the "recomputed item" (i.e., the aggregate item). Because items that offset (described in Parts IV.F and G) result in a $0 aggregate item, this Report uses this $0 as the "without" prong of the "with/without" calculation described above. For items that do *not* offset (described in this Part IV.H), the aggregate item is not necessarily $0, thus the lesser of FDRE's item and the aggregate USP/USS/FDRE item might be positive (or negative); accordingly, such items are not prevented from being a U.S. Income Item (or U.S. Deduction). In summary, the "without" prong of the "with/without" calculation of Rule No. 1 can be thought of as the lesser of FDRE's item and the aggregate USP/FDRE item (or USS/FDRE item), applying Reg. §1.1502-13.