NATIONAL FOREIGN TRADE COUNCIL, INC.

1625 K STREET, NW, WASHINGTON, DC 20006-1604

TEL: (202) 887-0278 FAX: (202) 452-8160

May 2, 2006

CC:PA:LPD:PR (REG-102144-04)
Room 5203
Internal Revenue Service
P.O. Box 7604
Ben Franklin Station
Washington, DC 20044

Re: Comments of the National Foreign Trade Council, Inc. on the Proposed Dual Consolidated Loss Regulations (REG-102144-04)

The proposed regulations issued May 24, 2005, under the dual consolidated loss provisions of IRC §1503(d) (the "DCL rules")[1] constitute a substantial revision of the current regulations. The National Foreign Trade Council (the "NFTC") appreciates this opportunity to provide comments.

The sweeping reach and uncertain application of the DCL rules, coupled with the draconian consequences of violating them, have long represented a significant source of concern for multinational businesses. The proposed regulations represent a significant improvement over the current regulations. The NFTC commends the Service for its thoughtful and comprehensive efforts to modernize and rationalize the DCL rules. The Service's efforts, however, highlight the capricious and inappropriate consequences of some of the rules.

The DCL rules as currently interpreted can apply to a diverse range of non-U.S. business activities, many of which are not motivated by, and do not implicate, the tax policy concerns underlying the enactment of the rules in 1986. It is perhaps ironic that the DCL rules have had virtually no consequences for their original intended target, double-dip financing arrangements to fund foreign acquisitions of U.S. companies (which were eventually restricted by other means).[2] The irony is reinforced by the proposed

---

1 Unless otherwise indicated, section references herein are to the Internal Revenue Code of 1986, as amended, or to the Treasury regulations promulgated there under.

2 *See, e.g.,* Treasury Regulation §1.894-1(d)(2).

regulations, which confirm that the DCL rules have no application to a significant class of double-dip financing arrangements for leveraged investments in non-U.S. companies.[3]

The NFTC believes that interpretive regulations whose application can have very severe consequences for taxpayers affected by them, and that can apply as often by accident as by design, should be drafted as narrowly as possible consistent with their statutory purpose. The NFTC is concerned that the proposed regulations will expand the circumstances in which the DCL rules can apply without narrowing their focus sufficiently to protect taxpayers from the risk of severe consequences in circumstances that are not abusive. The specific comments that follow are motivated by this concern.

The application of the DCL rules to the foreign operations of U.S. multinationals can have the effect of discouraging taxpayers from taking available measures to minimize foreign tax costs. This in turn has the long-term consequence of reducing U.S. tax revenues because the incremental foreign taxes can be applied as credits to reduce U.S. tax liability. The NFTC questions whether the policy objectives underlying the enactment of the DCL rules ever justified the creation of this incentive to increase foreign tax payments at the expense of the U.S. fisc. The withdrawal of Notice 98-11,[4] and the ratification by the proposed regulations of double-dip strategies involving the use of disregarded loans,[5] strongly suggests that the exploitation of inconsistencies between U.S. and foreign tax rules to achieve *foreign* tax savings is no longer thought to raise significant tax policy concerns. The NFTC recognizes that the compatibility with U.S. tax policy of the DCL rules ultimately raises issues that must be addressed by Congress. The NFTC hopes, however, that the Treasury Department's consideration of definitive regulations will provide an appropriate framework for a broader reevaluation of the DCL rules from a tax policy perspective.

Comment 1: *The new shorter recapture period should apply to existing DCLs.*

The proposed regulations recognize that the 15-year recapture period provided under the current regulations is inappropriately long in view of the extensive monitoring burden that taxpayers making a domestic use election must undertake, and the variety of ways in which recapture can be triggered inadvertently. The NFTC commends the Service for proposing to reduce the recapture period to 7 years,[6] and agrees with other commentators that a 5-year period would represent a significant further improvement.[7]

---

3 *See* Proposed Treasury Regulation §§1.1503(d)-3(b)(2)(i) and 1.1503(d)-5(c) Example (27).

4 1998-1 C.B. 433, withdrawn by Notice 98-35, 1998-2 C.B. 34.

5 See note 3, above.

6 *See* Proposed Treasury Regulation §1.1503(d)-4(d)(1)(v).

7 This suggestion has been made in comment letters submitted by Ernst & Young LLP, the Tax Executives Institute, the American Petroleum Institute, and Baker & McKenzie LLP. In this

As currently proposed, the shorter recapture period would apply only to DCLs incurred in taxable years beginning after the proposed regulations enter into force. This proposal would have the unfortunate consequence of creating two separate “baskets” of DCLs for many taxpayers: one, under the current regulations, with 15-year recapture periods, and another, under the proposed regulations, with 5- or 7-year recapture periods. A taxpayer with pre- and post-effective date DCLs would be subject to duplicative and inconsistent compliance obligations, with the strange result that, for many years after new regulations enter into force, a taxpayer’s compliance obligations with respect to some (but not all) DCLs would be determined in large part by regulations that have long since been superseded.

In the preamble to the proposed regulations, the Service asked for comments regarding the application of the proposed regulations on a retroactive basis. The NFTC strongly recommends that the new recapture period apply to all DCLs in existence when the proposed regulations are finalized.[8] In this regard, the recapture period should be determined in all cases by reference to the year in which losses were incurred, so that, for example, an 8-year-old DCL would cease to be subject to compliance and certification obligations upon the entry into force of the final regulations.

<u>Comment 2</u>: *If foreign law does not provide ordering rules, any losses that are not subject to recapture should be deemed to be utilized before any losses that are subject to recapture, and losses should be recaptured thereafter on a LIFO basis. The same rule should apply to existing losses.*

The proposed regulations provide that, if foreign law does not contain a mechanism for determining the order in which loss carryovers and carrybacks from different taxable years are used,[9] the earliest losses are deemed to be used first for purposes of the “foreign use” definition.[10] An example in the proposed regulations

---

regard, the NFTC believes that a 5-year recapture period would be more consistent with other similar rules, including Treasury Regulation §1.367(a)-8(b)(3)(i), and that tracking DCLs and their potential use or deemed use for even a 5-year period would represent a significant administrative burden for most corporate taxpayers.

8 In so doing, the NFTC joins the comments previously submitted by Ernst & Young LLP, the Tax Executives Institute, the American Petroleum Institute, David B. Cubeta, Joel C. Weiss, and J. Michael Cornett, and Baker & McKenzie LLP. The extent of the differences between the current and the proposed regulations will make it impractical for many taxpayers to elect to apply the rules retroactively if such an election is made available. The shorter recapture period should apply to all DCLs, without regard to whether a taxpayer otherwise elects to apply the new regulations retroactively.

9 As the proposed regulations recognize, there is no reason to identify year-by-year tranches of losses in jurisdictions in which losses may be carried forward for an unlimited period. *See* Proposed Treasury Regulation §1.1503(d)-5(c) Example (13).

10 *See* Proposed Treasury Regulation §1.1503(d)-1(b)(14)(iv)(B).

appears to contemplate that this ordering rule will apply without regard to whether the utilization of a particular loss will trigger recapture.[11]

This proposed "first-in/first-out" rule has the virtue of simplicity, but the NFTC believes that it has the potential to produce significant unfairness. Consider the following scenarios:

Scenario 1: A disregarded foreign subsidiary of a U.S. corporate taxpayer incurs losses of 100 in each of years 1, 2, and 3 and operates on a break-even basis in year 4. The taxpayer makes a domestic use election in respect of the year 1 loss. The year 2 loss is a capital loss, and therefore does not constitute a DCL for U.S. tax purposes. The taxpayer does not make a domestic use election in respect of the year 3 loss. For foreign tax purposes, the disregarded subsidiary is treated as having an undifferentiated loss carryover of 300 to year 4. In year 4, the disregarded subsidiary surrenders 100 of its loss carryover to a related foreign corporation, and the related foreign corporation uses the loss carryover to shelter 100 of its own income from foreign tax. The application of the proposed FIFO rule would trigger recapture and interest charges, even though the taxpayer has 200 of more recent losses that are not subject to DCL recapture.

Scenario 2: A disregarded foreign subsidiary of a U.S. corporate taxpayer incurs a loss of 100 in year 1, operates on a break-even basis in years 2 and 3, incurs a loss of 100 in year 4, and operates on a break-even basis in year 5. The taxpayer makes domestic use elections in respect of the losses. For foreign tax purposes, the disregarded subsidiary is treated as having an undifferentiated loss carryover of 200 to year 5. In year 5, the disregarded subsidiary surrenders 100 of its loss carryover to a related foreign corporation, and the related foreign corporation uses the loss carryover to shelter 100 of its own income from foreign tax. In circumstances where a taxpayer has a much more recent loss, it would seem unreasonable to deem the taxpayer to have made a foreign use of a 4-year-old loss, and impose interest charges on that basis.

The NFTC believes that a fairer and more appropriate rule would be to deem any foreign use to occur first from the taxpayer's loss carryovers that are not subject to recapture (because the losses were not DCLs in the first place, the taxpayer did not make a domestic use election, or the recapture period has expired). In this regard, the NFTC does not believe that the policy of the DCL rules is implicated in a situation where

11 *See* Proposed Treasury Regulation §1.1503(d)-5(c) Example (13).

a taxpayer has not achieved a net double-dip benefit in respect of a pool of foreign losses.[12]

After a taxpayer's loss carryovers that are not subject to recapture have been exhausted, the NFTC then recommends that loss carryovers be deemed to be used on a last-in/first-out basis. Where foreign law does not expressly provide for the use of an old loss carryover as opposed to a more recent loss carryover, it seems quite unfair to subject a taxpayer to interest charges based on the old loss carryover when the situation could just as plausibly be described as a use of the more recent loss carryover.[13]

For the policy reasons discussed above, the NFTC also believes that any new loss utilization ordering rule should be applied retroactively to all DCLs in existence when the proposed regulations are finalized, so that taxpayers can make a consistent determination of the order in which all of their DCLs are subject to recapture.

Comment 3: *The administrative benefits of the "all or nothing" recapture rule clearly are outweighed by its potential to produce unfair and disproportionate consequences. The rule is unnecessary to achieve the statutory purpose, and should be replaced by a provision that measures recapture by reference to actual foreign tax benefits realized by each dual resident corporation and separate unit considered separately.*

The proposed regulations preserve the "cliff effect" feature of the current regulations, under which the impermissible foreign use of *any* portion of *any* item of loss or deduction can trigger the recapture of all of the losses previously claimed by the taxpayer.[14] Read literally, this "all or nothing" rule can impose extremely severe consequences—the recapture, with interest charges, of tens of millions of dollars of DCLs—as a result of an inadvertent, uncontrollable, and economically inconsequential footfault.[15]

---

12 In Scenario 1, above, the taxpayer has 300 of total foreign loss carryovers, 100 of which were previously used in the United States and 100 of which are being used to offset income of another person under foreign law. As a consequence, the taxpayer will not have made a net use of any losses both in the United States and to offset income of another person under foreign law.

13 A LIFO rule would also be consistent with the treatment of current year losses, which are deemed to be used before loss carryovers and carrybacks under the proposed regulations. *See* Proposed Treasury Regulation §1.1503(d)-1(b)(14)(iv)(A). Thus, in scenario 1 above, a loss surrender in year 2 or year 3 clearly would not trigger recapture of the year 1 DCL. There is no reason to apply a different rule if the loss is surrendered in year 4 (because, for example, the loss is attributed to that year for foreign tax purposes).

14 *See* Proposed Treasury Regulation §§1.1503(d)-4(e)(1)(i) and 1.1503(d)-1(b)(14)(i).

15 For example, if a taxpayer makes a domestic use election in respect of a $50 million loss in 2007, then the use of a single dollar of the deductions attributed for U.S. tax purposes to that year by another person in a different foreign tax year (for example, because a cost that is deductible for

The preamble to the proposed regulations indicates that the Service resisted encouragement to eliminate the "all or nothing" recapture rule because it was concerned that any less stringent standard would create unacceptable administrative burdens in connection with analyses of foreign law. In view of the potential for arbitrary and profoundly unfair consequences inherent in the "all or nothing" rule, the NFTC strongly encourages the Service to reconsider this judgment. In particular, the NFTC believes that concern about administrative burdens can be addressed by imposing the burden of proof on taxpayers to establish the amount of DCLs that have *not* been applied to produce foreign tax savings.[16]

In most cases, it should be possible to determine the amount of the "foreign use" of a DCL by referring to the relevant foreign tax returns or work papers. For example, the foreign use of DCL items generally should be reflected on such returns or work papers where the use of the relevant items under foreign law requires specific acts of surrender or is available under an elective consolidation or fiscal unity regime. The NFTC therefore recommends that, if a triggering event occurs with respect to a DCL for which a domestic use election has been made, the taxpayer should be allowed to rebut the presumption that the full amount of the loss has been made available for foreign use, and establish the amount appropriately subject to recapture, by reference to the dollar value of foreign use as evidenced by relevant foreign tax returns or work papers.

The NFTC also believes that the interaction between the "all or nothing" rule and the consistency rule, under which taxpayers must make uniform domestic use elections with respect to all dual resident corporations and separate units in the same jurisdiction, creates a particularly high potential for unreasonable consequences. The risk that the inadvertent and uncontrollable use of an item of loss or deduction of one separate unit will trigger the recapture of a much larger DCL of another separate unit is particularly acute when a U.S. group conducts business in a foreign country through a variety of separately managed subsidiaries, hybrid entities, and branches. To reduce the potential for unreasonable and disproportionate consequences, the NFTC recommends that the regulations continue to require consistency with respect to initial domestic use elections, but measure recapture based on the dollar value of actual foreign use by each dual resident corporation and separate unit considered separately.

Notwithstanding the foregoing, there may well be circumstances in which an "all or nothing" rule represents the only practical alternative. If a disregarded subsidiary is transferred out of U.S. ownership, for example, there may be no effective way to monitor subsequent loss utilization by a new foreign owner. But the Service should not allow the fact that it will sometimes be impossible to establish the amount of foreign use to preclude it from adopting a less severe rule for the much more common

---

U.S. tax purposes in 2007 is included in the acquisition cost of an asset for foreign tax purposes, and is taken into account when a related foreign corporation sells the carryover basis asset in 2012) could trigger the recapture, with interest charges, of the entire $50 million loss.

16 In this regard, the "foreign use" trigger already requires significant assessments of foreign law for the purpose of determining whether a foreign use has occurred.

circumstance in which a continuing U.S. owner can readily establish the extent (if any) of foreign use.

The NFTC commends the Service's efforts to develop more practical means of enabling taxpayers to rebut the presumption that a foreign use has occurred,[17] and shares the views of other commentators that further efforts in this direction would be desirable.[18] Consistent with this view, the NFTC strongly believes that, in cases where a dual resident corporation or separate unit continues to be controlled by the same U.S. taxpayer, the taxpayer should be given the opportunity to rebut the presumption that a foreign use has occurred with respect to the full amount of a DCL. If the taxpayer can establish that an inadvertent foreign use has produced foreign tax savings of $10, the recapture amount should be measured by reference to those actual savings, and not to the full amount of all of the DCLs of the taxpayer's dual resident corporations and separate units in the same jurisdiction.

Comment 4: *The new "anti-dilution" triggering event should be replaced with a more narrowly crafted anti-abuse rule.*

The proposed regulations would introduce a sweeping new recapture triggering event applicable to hybrid entities.[19] Under this proposed "anti-dilution" rule, *any* increase in the proportionate non-U.S. ownership of a hybrid entity would trigger a deemed foreign use of the entity's outstanding DCLs. This new triggering event represents an inappropriately blunt instrument that, particularly in combination with the "all or nothing" recapture rule, would have unreasonable consequences for a broad range of jointly owned businesses. The NFTC believes that the Service's legitimate policy objectives can be accomplished by a much more narrowly targeted rule.

In explaining the decision to propose a new, broader definition of "foreign use," the preamble to the proposed regulations correctly notes that the current regulations do not comprehensively address circumstances in which items of income or expense are attributed to different persons under U.S. and foreign law, and that these issues have become more prevalent since the adoption of the "check-the-box" regime. This observation may well justify increased attention to the use of special allocations and similar arrangements to achieve inappropriate results, but it does not support the adoption of a sweeping new rule in circumstances where the only difference in relevant treatment is that an entity is treated as a corporation for foreign tax purposes and as a partnership or disregarded entity for U.S. tax purposes.

The DCL rules are intended to restrict the use of losses by one person for U.S. tax purposes and a different person for foreign tax purposes. The classification of a

17 *See* Proposed Treasury Regulation §§1.1503(d)-4(e)(2) and 1.1503(d)-4(c).

18 See the comment letters submitted by the American Petroleum Institute and David B. Cubeta, Joel C. Weiss, and J. Michael Cornett.

19 *See* Proposed Treasury Regulation §1.1503(d)-1(b)(14)(iii)(C).

foreign entity for *U.S.* tax purposes has no bearing on whether another person can use that entity's losses for foreign tax purposes. In the absence of other unfavorable facts, the derivative benefit that a shareholder might be considered to derive solely by reason of its ownership of shares in a loss company has never been treated as a use of the company's losses by the shareholder. Losses incurred by a dual resident corporation that is treated as a corporation for foreign tax purposes and that is not eligible for any form of foreign tax consolidation are not treated as available for use by any other person for foreign tax purposes under the current or the proposed regulations. Under the proposed as well as the current regulations, the dilution of a U.S. taxpayer's interest in such a non-hybrid dual resident corporation normally would not trigger recapture, even though the new shareholder would participate to the same extent as the historic shareholders in the economic benefit of the use of existing loss carryovers to shelter future taxable income.[20] The regulations appropriately do not provide that this derivative benefit constitutes an impermissible foreign use. There is no reason to distinguish between corporations and hybrid entities for this purpose.

The DCL rules have been in force for almost 20 years. In the absence of a clear showing that the adoption of a sweeping anti-dilution rule for the first time now is consistent with the legislative intent and is required to curtail identified abuses, the proposed anti-dilution rule should be replaced with a more limited anti-abuse rule targeted at tax-motivated arrangements.

To implement such a rule, the NFTC recommends that the final regulations extend the definition of "foreign use" to include circumstances in which special allocations or other arrangements have the effect of inappropriately segregating losses from income, with the principal purpose of streaming duplicative losses to U.S. and foreign owners of interests in a partnership or hybrid entity. By contrast, the adoption of a sweeping new triggering event, that provides limited exceptions in the proposed regulations will have severe U.S. tax consequences and runs the risk of dramatically increasing the potential for changes in conventional, non-tax motivated ownership structures, which may be completely outside the control of a U.S. shareholder. [21]

Comment 5: *Permanent differences that have the effect of reducing a branch's income for U.S. tax purposes relative to its income for foreign tax purposes should be eliminated in determining the existence and amount of a DCL.*

[20] For example, if a dual resident corporation issues common stock representing 20 percent of its outstanding equity to foreign investors, those investors may derive an indirect economic benefit (solely by reason of their status as shareholders) if the corporation can apply existing loss carryovers to shelter future income.

[21] In order to minimize the potential for triggering events that are outside a taxpayer's effective control, the final regulations should provide that a dilution that results from the exercise of a right or the performance of an obligation that existed prior to the entry in force of the regulations (for example, the exercise of an option or conversion right) will not constitute a triggering event under the anti-abuse rule.

The proposed regulations provide that the existence and amount of a DCL at the level of a true foreign branch should be determined under U.S. tax principles, allocating "home office" interest expense to the branch under the (otherwise not directly relevant) principles of Treasury Regulation §1.882-5.[22] The NFTC acknowledges the convenience of relying on income determined in accordance with U.S. tax principles as a starting point.[23] In order to reduce the potential for unfairness, however, the NFTC recommends that the regulations permit taxpayers to make adjustments to eliminate the effect of permanent differences in the measurement of income for U.S. and foreign tax purposes in determining the existence and amount of a DCL. Such permanent differences could arise, for example, because a foreign taxing jurisdiction allocates home office interest expense to branches on a basis that differs from the principles of Treasury Regulation §1.882-5,[24] or because a foreign taxing jurisdiction respects interbranch loans and hedging transactions that are disregarded for U.S. tax purposes.

The DCL rules operate to restrict the use of losses to produce duplicative and inconsistent tax benefits in the United States and another taxing jurisdiction. To the extent that a loss is deemed to exist for U.S. but not foreign tax purposes as a result of a permanent difference between U.S. and foreign tax principles, that portion of the loss should not create any potential for such an inconsistent use.

Scenario 3: A U.S. corporate taxpayer conducts operations through a branch in country X. The branch incurs a loss of 1 for country X tax purposes. Its gross income of 5,000 includes 100 of interest on loans made to its U.S. home office. There are no other differences in the computation of income and expense for U.S. and country X tax purposes. For U.S. tax purposes, the interbranch interest income is disregarded, and the branch incurs a loss of 101. The different treatment of interbranch interest constitutes a permanent difference. The 100 of loss that is attributable to the permanent difference should not present the potential for inconsistent and duplicative use that the DCL rules were designed to address, and should not be subject to potential recapture.

22 *See* Proposed Treasury Regulation §1.1503(d)-3(b)(2)(ii). By contrast, the allocation of interest expense to a deemed branch attributable to a U.S. taxpayer's conduct of business through a disregarded subsidiary is determined by reference to non-U.S. tax principles. The preamble indicates that the rationale for this different treatment of situations that are the same from a U.S. tax perspective is that foreign law generally can be expected to provide for a proportionate allocation of home office interest expense to a true branch, but not to a disregarded entity.

23 The preamble suggests that the Service provided for the use of U.S. rather than foreign allocation principles in order to avoid having to make determinations under foreign law.

24 *Cf*. Paragraph 18.2 of the Commentary to Article 7 of the OECD Model Tax Convention on Income and on Capital (July 15, 2005) (acknowledging the difficulty of achieving consistent allocations of home office interest expense to branches).

Although the proposed regulations in principle would permit taxpayers to establish that there is no possibility of foreign use in the case of a DCL that exists solely by reason of a permanent difference between U.S. and foreign tax principles,[25] this exception is a narrow one, and its availability and scope are open to significant uncertainty. The NFTC believes that is would be preferable for permanent differences, which have no potential to produce duplicative benefits, to be disregarded in determining the existence and amount of a DCL from the outset. A broader rule would in particular reduce the potential for unfairness where a DCL exists for multiple reasons, but the bulk of the DCL is attributable to permanent differences. The potential for such unfairness would be particularly acute if the "all or nothing" recapture rule were retained.

As noted at the inception of this letter, the proposed regulations confirm that interest payments that are disregarded for U.S. tax purposes (because they are made by a disregarded subsidiary to its sole shareholder) will not be taken into account in determining the existence and amount of a DCL. By the same token, the portion of a loss that is considered to exist because the United States will never take account of an item of income that is fully subject to foreign tax (for example, interest income on an interbranch loan), or because the United States attributes expenses to a branch that will never be deductible for foreign tax purposes, should not be taken into account in determining the existence and amount of a DCL. The administrative burdens associated with making determinations under foreign law can be addressed by requiring taxpayers to establish that a particular difference in treatment represents a permanent difference. Where, as will often be the case, the difference relates to a payment that is respected in accordance with its form for foreign tax purposes (and is reflected on a duly filed foreign tax return) but is disregarded for U.S. tax purposes, this should be straightforward.

Comment 6: *The preamble to the final regulations should confirm that the treatment of the interaction between the consistency rule and the mirror legislation rule is a clarification of existing law.*

The NFTC commends the Service for confirming in the proposed regulations that a deemed foreign use of a DCL pursuant to the mirror legislation rule will not trigger a deemed foreign use of all related DCLs attributable to dual resident corporations and separate units in the same jurisdiction pursuant to the consistency rule.[26] Such a result would be needlessly harsh, since the anti-"cherry picking" policy of the consistency rule is not implicated in situations where a foreign use occurs for reasons that are outside a taxpayer's control.

Although the NFTC believes that the current regulations should be construed to produce the same result as the proposed regulations, some taxpayers have expressed concern regarding this issue. In order to reduce the potential for confusion, and because it would be consistent with both the policy and text of the current regulations, the NFTC recommends that the preamble to the final regulations describe the

[25] *See* Proposed Treasury Regulations §§1.1503(d)-4(c) and 1.1503(d)-5(c) Example (38).

[26] *See* Proposed Treasure Regulation §1.1503(d)-1(b)(14)(v).

limitation on the interaction between these two rules as a clarification of the current regulations.

Thank you again for the opportunity to provide this submission. The NFTC and its interested members look forward to continuing discussions on these and other matters.

Sincerely,

Judy Scarabello

Judy Scarabello
Vice President for Tax Policy

cc: Hal Hicks, International Tax Counsel
Steve Musher, Associate Chief Counsel International