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DEPARTMENT OF THE TREASURY
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

FROM:

SUBJECT:

This Field Service Advice responds to your memorandum dated March 29, 2000. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

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LEGEND

Parent =

DSub1 =
DSub2 =

| | |
|---|---|
| DSub3 | = |
| DSub4 | = |
| DSub5 | = |
| DSub6 | = |
| DSub7 | = |
| DSub8 | = |
| DSub9 | = |
| DSub10 | = |
| Pship1 | = |
| Pship2 | = |
| Trust Bank1 | = |
| Trust Bank2 | = |
| Trust Bank3 | = |
| FGovA | = |
| FGovB | = |
| FGovBM1 | = |
| FGovBM2 | = |
| FC1 | = |
| FC2 | = |
| FLender1 | = |
| FLender2 | = |
| FLender3 | = |
| Country A | = |

Country B =
Country C =

Asset GroupA =

Asset GroupB =

Asset GroupC =

Asset GroupD =

Asset GroupE =

Trust EstateC =

Trust EstateD =

Trust EstateE =

Year 1 =

Year 2 =
Year 3 =

| | | |
|---|---|---|
| Year 4 | = | |
| a | = | |
| b | = | |

ISSUES

1. Whether the Internal Revenue Code ("Code") § 1503(d) dual consolidated loss ("DCL") provisions apply to a partnership or a trust that is not a member of a foreign tax group and that is ineligible to file any consolidated group relief election. In particular, whether an entity that does not have a permanent establishment in a foreign country under the foreign country's tax laws and that is not required to file income tax returns in the foreign country is exempt from the § 1503(d) DCL provisions.

2. Whether an entity that is subject to § 1503(d) mirror legislation and, thus, is subject to a foreign country's tax laws that prohibit the net operating losses of the dual resident corporation ("DRC") from offsetting the income of other persons in the foreign country is exempt from the § 1503(d) provisions.

3. Can Parent use the Year 3 and Year 4 net operating losses from the Leasing Arrangements (as described below) to offset the income of other persons within the Parent Consolidated Group?

CONCLUSIONS

1. A domestic corporation's foreign branch, interest in a partnership, or interest in a trust is subject to the § 1503(d) DCL provisions to the extent net operating losses are DCLs. Neither a domestic corporation's foreign branch nor a domestic corporation's interest in a partnership or in a trust is required to constitute a permanent establishment to be considered a DRC. Moreover, whether a foreign branch, a partnership, or a trust is able to file a consolidated tax return (or any tax return) in the foreign country is not determinative of the existence of a DRC.

   A DRC is defined as a separate unit of a domestic corporation or a domestic corporation that is subject to the income tax of a foreign country on its worldwide income or on a residence basis. Separate units include foreign branches, interests in partnerships, and interests in trusts. Whether a domestic corporation's foreign activities constitute a foreign branch is determined based on all the facts and circumstances.

2. An entity is not exempt from the § 1503(d) DCL provisions because it is subject to a foreign country's § 1503(d) mirror legislation tax laws that prohibit the net operating losses of the DRC from offsetting the income of another person in the foreign country. Instead, except when the United States and a foreign country have an agreement under § 1.1503-2(g)(1), when a foreign country's § 1503(d) mirror legislation applies to the DCLs of a DRC, the DCLs are treated as offsetting the income of another person under that foreign country's tax laws. There are no § 1.1503-2(g)(1) agreements into which the United States has entered with a foreign country.

3. Parent cannot use the Year 3 and Year 4 net operating losses derived from the Leasing Arrangements to offset the income of other persons within the Parent Consolidated Group. The Year 3 and Year 4 net operating losses derived from the Leasing Arrangements are DCLs to which the § 1503(d) loss limitation rules apply. Parent has not filed the § 1.1503-2(g)(2)(i) agreements for the Year 3 and Year 4 DCLs from the Leasing Arrangements. Furthermore, Parent has not established that the Year 3 and Year 4 DCLs from the Leasing Arrangements have not been used by any other person to offset income for foreign tax purposes.

<u>FACTS</u>

Parent is a domestic corporation and the common parent of an affiliated group of corporations that files a consolidated Federal income tax return (the "Parent Consolidated Group"). Parent is, directly and indirectly through its domestic subsidiaries, engaged in various leasing and subleasing arrangements in Country A and Country B.

A revenue agent has proposed § 1503(d) adjustments to the Parent Consolidated Group Year 3 and Year 4 Federal income tax returns that would disallow the use of the Parent DCLs (described below) to offset income of other members of the Parent Consolidated Group. The aggregate amounts of such proposed disallowances are $a for Year 3 and $b for Year 4. The revenue agent believes that Parent's leasing arrangements are tax avoidance transactions referred to as lease-in, lease-out transactions or LILO transactions or are sale leaseback transactions. The leasing arrangements are described below.

A. <u>Leasing Arrangement A</u>

DSub3 and DSub4, domestic corporations and members of the Parent Consolidated Group, are equal partners in Pship1, a domestic partnership. DSub1, a domestic corporation and member of the Parent Consolidated Group, owns both DSub3 and

DSub4. Pship1 signed a trust indenture as a Country A company in Year 1 and is a lessor in a lease arrangement with FGovA involving certain buildings used by FGovA in the industry ("Asset GroupA").

Parent has provided only a trust indenture as documentation related to the leasing arrangement involving Asset GroupA ("Leasing Arrangement A"). The trust indenture for Leasing Arrangement A provides that: (1) Pship1 (as lessor), the lessee, the vendor, the indenture trustee and the loan participants have entered into a participation agreement; (2) the vendor, lessee, and the guarantor have entered into an occupational lease; (3) Pship1 and the Guarantor have entered into a reversionary rights agreement; and (4) Pship1 will provide for the issuance of one or more secured notes to each loan participant.

B. <u>Leasing Arrangement B</u>

DSub5 and DSub6, domestic corporations and members of the Parent Consolidated Group, are equal partners in Pship2, a domestic partnership. Pship2 signed a trust indenture as a Country A company in Year 1, and is a lessor in a lease arrangement with FGovA involving certain buildings used by FGovA in the industry ("Asset GroupB").

Parent has provided only a trust indenture (that has provisions similar to those in the trust indenture for Leasing Arrangement A) as documentation related to the leasing arrangement involving Asset GroupB ("Leasing Arrangement B").

C. <u>Leasing Arrangement C and Leasing Arrangement D</u>

DSub7 and DSub8 are domestic corporations and members of the Parent Consolidated Group. DSub1, a domestic corporation and a member of the Parent Consolidated Group, owns DSub7. As the equity participant, DSub7 funded Trust EstateC, a trust estate established by Trust Bank1 (a domestic national banking association). Similarly, as the equity participant, DSub8 funded Trust EstateD, a trust estate established by Trust Bank1. Trust Bank1 serves as the trustee of both Trust EstateC and Trust EstateD. Trust EstateC and Trust EstateD are treated as grantor trusts for U.S. Federal income tax purposes.

In Year 3, Trust Bank1 entered into participation agreements with FC1, a Country B limited liability company, for leasing arrangements involving certain equipment ("Asset GroupC" and "Asset GroupD"). FGovB, FGovBM1, and FGovBM2, the federal government of Country B and two of its municipalities, own FC1. Under the Year 3 participation agreements, Trust Bank1 agreed to be lessee and sub lessor of both the Asset GroupC and the Asset GroupD properties, while

FC1 agreed to be lessor and sub lessee of such properties. Because FGovB, FGovBM1, and FGovBM2 own FC1, Trust Bank1's lease arrangements are effectively with FGovB, FGovBM1, and FGovBM2.

Parent has provided only the participation agreements as documentation related to the leasing arrangement involving Asset GroupC (“Leasing Arrangement C”) and the leasing arrangement involving Asset GroupD (“Leasing Arrangement D”). Under the Year 3 participation agreements for Leasing Arrangement C and Leasing Arrangement D, FLender1 (a Country B limited liability company) agreed to make secured loans to Trust Bank1; Trust Bank1 agreed to transfer the equity funds from DSub7 and DSub8 to Trust EstateC and Trust EstateD, respectively; and Trust Bank1 agreed to use the equity investments from DSub7 and DSub8 first, to pay all transaction expenses, second, to prepay the basic rents under the leases with FC1, and third, to remit the balances to FC1 as security deposits under the leases. In addition, under the Year 3 participation agreements, FC1 agreed to execute payment agreements and make payments to FLender2 (a Country B limited liability company); FC1 and Trust Bank1 agreed to execute and deliver debt security agreements; and DSub1 agreed to be a guarantor for Leasing Arrangement C and for Leasing Arrangement D.

D. <u>Leasing Arrangement E</u>

DSub9 and DSub10 are domestic corporations that are owned by DSub2, a domestic corporation. DSub2, DSub9, and DSub10 are members of the Parent Consolidated Group. DSub9 and DSub10 are equal equity investors in funding Trust EstateE, a trust estate established by Trust Bank2. Trust Bank2, a domestic national banking association, serves as Trust EstateE’s trustee. Trust EstateE is treated as a grantor trust for U.S. Federal income tax purposes.

FC2 is a Country B corporation that is owned by FGovB. In Year 2, Trust Bank2 entered into participation agreements with FC2 for a leasing arrangement involving certain (“Asset GroupE”). Under the Year 2 participation agreements, Trust Bank2 agreed to purchase Asset GroupE from FC2, to lease Asset GroupE to FC2, and to issue loan certificates. Because FGovB owns FC2, Trust Bank2's lease arrangement is effectively with FGovB.

Parent has provided only the participation agreements as documentation related to the leasing arrangement involving Asset GroupE (“Leasing Arrangement E”). Under the Leasing Arrangement E participation agreements, FLender3 (a joint stock company organized under an international convention in Country C) agreed to make a secured loan to Trust Bank2, and DSub2 and Trust Bank3 (a domestic corporation) agreed to be guarantors of Leasing Arrangement E. The participation agreements, through the definition sections, include a provision for FC2 to purchase Asset GroupE at the end of a specified term.

E. Other Leasing Arrangements

Other members of the Parent Consolidated Group are involved in leasing arrangements in Country A and Country B through partnerships and grantor trusts. The revenue agent has identified

as some of the property involved in such leasing arrangements (collectively, "Leasing Arrangement F"). Parent has provided incomplete documentation about Leasing Arrangement F.

F. Background of LILO Transactions

Considering the limited documentation provided by the Parent, the revenue agent believes that Leasing Arrangement A, Leasing Arrangement B, Leasing Arrangement C, Leasing Arrangement D, Leasing Arrangement E, and Leasing Arrangement F (collectively, the "Leasing Arrangements") have features of LILO transactions. As background, in a typical LILO transaction, a domestic pass-through entity, a partnership or grantor trust, leases an asset, like a power plant, an airplane, or a railroad from a foreign government, and then leases the property back to the foreign government. The main purpose of the LILO transaction is to produce rent deductions for U.S. investor taxpayers while providing funding to the foreign government. Taxpayers often structure a LILO transaction as described below. See Rev. Rul. 99-14, 1999-13 I.R.B. 3.

A domestic pass-through entity leases property from a foreign government under a long-term master lease (for a term of, for example, 35 years), simultaneously subleases the property back to the foreign government for a term shorter than under the master lease, and provides the foreign government/sub lessee with an option to renew the lease or buy its way out of the master lease. The LILO transaction is structured to use a pass-through entity as an investment vehicle to allow investor taxpayers to benefit from tax losses.

Under the master lease of a typical LILO transaction, the domestic pass-through entity has to make only two rental payments. The domestic pass-through entity makes the first rent payment at the beginning of the lease term in the form of a prepayment that approximately equals 90 percent of the then current fair market value of the property. Under the master lease, the domestic pass-through entity will make the second rental payment at the end of a specified period in the lease. Under the sublease, the foreign government will make level annual sublease rental payments to the domestic pass-through entity.

To fund its first rent payment to the foreign government under the master lease, the domestic pass-through entity typically borrows most of the rent from a large foreign bank. The foreign government then deposits the first rent payment with the foreign bank that made the loan to the domestic pass-through entity (or one of the foreign bank's affiliates). The domestic pass-through entity's first rent payment is structured to take care of everyone's obligations in the LILO transaction, as all other payments, including the sublease rent, are part of a circular cash flow.

For U.S. Federal income tax purposes, the U.S. investor taxpayers claim rent and interest deductions related to the domestic pass-through entity's rental payments under the master lease and the related loan. The investor taxpayers include in gross income the rents the domestic pass-through entity receives under the sublease and, if and when exercised, the payment the domestic pass-through entity receives on the fixed payment option. The LILO is structured to generate a stream of substantial net deductions in the early years of the transaction, followed by net income inclusions on or after the conclusion of some specified period under the sublease term. Consequently, the U.S. investor taxpayers anticipate a substantial net after-tax return from a LILO transaction.

LAW AND ANALYSIS

The Treasury Department and the Service have taken the position that LILO transactions may be tax avoidance transactions. See Notice 2000-15, 2000-12 I.R.B. 826, and Rev. Rul. 99-14, 1999-13 I.R.B. 3. Consequently, the Service may disallow the deductions arising from the Leasing Arrangements based on statutory or regulatory tax avoidance provisions or economic substance judicial doctrines. This document does not analyze such legal suppositions. The analysis below considers only the legal bases of using the § 1503(d) DCL limitation provisions to disallow the Year 3 and Year 4 net operating losses arising from the Leasing Arrangements.

A. Parent's Assertions

Parent takes the position that the § 1503(d) provisions do not apply to the Year 3 and Year 4 net operating losses arising from the Leasing Arrangements because such net operating losses are not DCLs. In addition, Parent argues that it does not have to make any filings under § 1.1503-2(g)(2)(i) in Year 3 or in Year 4 related to the Leasing Arrangements.

Although Parent has not provided a comprehensive legal analyses of its assertions considering both the relevant tax laws of Country A or Country B and of the United

States, Parent supports its claimed tax treatment of Leasing Arrangement A and Leasing Arrangement B as follows:

(1) Because Pship1 and Pship2 are not members of a Country A tax group and are currently unable to file group relief elections, any net operating losses incurred by Pship1 and Pship2 cannot offset the income of any other person in Country A. Parent further notes that under the Country A tax laws, Country A group companies must file an election to obtain group relief (i.e., consolidation), and because Pship1 and Pship2 are not members of a Country A tax group, the group relief election is not possible.

(2) Pship1 and Pship2 are not permitted under the income tax laws of Country A to use their losses to offset the income of any other person that is recognized in the same taxable year in which the losses are incurred. Parent further notes that under Country A's tax laws, the Pship1 and Pship2 net operating losses cannot be used to offset the income of any other member's future or prior year's income.

(3) Pship1 and Pship2 file "stand alone" Country A tax returns, and are exempt from the § 1503(d) provisions under the stand alone exception.

Parent supports its claimed tax treatment of Leasing Arrangement C, Leasing Arrangement D, Leasing Arrangement E, and Leasing Arrangement F by asserting that because the various companies (i.e., Trust EstateC, Trust EstateD, Trust EstateE, and Leasing Arrangement F partnerships and trusts) are not regarded as permanent establishments in Country A or Country B, the companies are not required to file foreign tax returns and are not DRCs.

## B. General Background of the Dual Consolidated Loss Provisions

The United States taxes the worldwide income of domestic corporations. The United States generally allows domestic corporations to file consolidated returns with other commonly owned domestic corporations. When two or more domestic corporations file a consolidated return, losses that one corporation incurs generally may reduce or eliminate tax on income that another corporation earns.

Because other countries may apply a different standard for determining the residence and taxability of a corporation (e.g., based on the management and control of the corporation), some domestic corporations are DRCs and, as such, are also subject to the income tax of a foreign country on their worldwide income or on a residence basis (and not on a source basis). Also, some foreign countries have provisions that permit commonly controlled entities to combine their income and losses though consolidation or some other form of combination.

Prior to the Tax Reform Act of 1986, if a DRC were a resident of a foreign country with tax laws that permitted the losses of the corporation to offset the income of another person (e.g., under a consolidated return provision), then the DRC could use a single economic loss to offset two separate items of income in two jurisdictions: once to offset the income of affiliates resident in the United States (but not abroad), and again to offset the income of affiliates resident only in the other country. Congress expressed concerns that this type of dual use of a loss could result in an undue tax advantage to certain foreign investors that made investments in domestic corporations and could create an undue incentive for certain foreign corporations to acquire domestic corporations and for domestic corporations to acquire foreign rather than domestic assets. Staff of Joint Committee on Taxation, 99th Cong., 2nd Sess., General Explanation of the Tax Reform Act of 1986, at 1064 - 1065 (1987). As part of the Tax Reform Act of 1986, Congress enacted § 1503(d) to prevent this type of "double dipping."

Under § 1503(d), except as provided in regulations, a DCL of a DRC may not be used to reduce the taxable income of any other member of the corporation's domestic affiliated group for any taxable year. Section 1503(d) generally defines a DCL as a net operating loss of any domestic corporation that is subject to the income tax of a foreign country (without regard to country source) or on a residence basis. I.R.C. § 1503(d)(2).

The U.S. Treasury Department and the Service issued temporary regulations under § 1503(d) in 1989 (T.D. 8261, 1989-2 C.B. 220), and final regulations in 1992 (T.D. 8434, 1992-2 C.B. 240). The final regulations, contained in § 1.1503-2, generally are effective for taxable years beginning on or after October 1, 1992; the temporary regulations, contained in § 1.1503-2A, are effective for taxable years beginning after December 31, 1986, and before October 1, 1992.[1] Because Year 3 and Year 4 are taxable years beginning after October 1, 1992, the final regulations found in § 1.1503-2 would apply to the Year 3 and Year 4 Parent Consolidated Group net operating losses arising from the Leasing Arrangements.

C. Dual Resident Corporations

Section 1.1503-2(c)(2) of the final regulations defines the term "dual resident corporation" to include a separate unit of a domestic corporation, including a hybrid entity separate unit, and a domestic corporation that is subject to the income tax of a foreign country on its worldwide income or on a residence basis. A domestic corporation's separate unit is treated as if it were a wholly-owned subsidiary of the corporation. Treas. Reg. § 1.1503-2(b)(1).

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[1] The temporary regulations were initially designated as § 1.1503-2T, but were redesignated as § 1.1503-2A by the final regulations. T.D. 8434, 1992-2 C.B. 240.

Foreign branches (as defined in § 1.367(a)-6T(g)), interests in partnerships, interests in trusts, and interests in hybrid entity separate units are separate units. Treas. Reg. § 1.1503-2(c)(3). A hybrid entity separate unit is an interest held by a domestic corporation in an entity that is not taxable as an association for U.S. tax purposes but is subject to income tax in the foreign country at the entity level or on a residence basis. Treas. Reg. § 1.1503-2(c)(4).

Section 1.367(a)-6T(g)(1) defines the term “foreign branch” as follows:

> The term “foreign branch” means an integral business operation carried on by a U.S. person outside the United States. Whether the activities of a U.S. person outside the United States constitute a foreign branch operation must be determined under all the facts and circumstances. Evidence of the existence of a branch includes, but is not limited to, the existence of a separate set of books and records, and the existence of an office or other fixed place of business used by employees or officers of the U.S. person in carrying out business activities outside the United States. Activities outside the United States shall be deemed to constitute a foreign branch for purposes of this section if the activities constitute a permanent establishment under the terms of a treaty between the United States and the country in which the activities are carried out. Any U.S. person may be treated as having a foreign branch for purposes of this section, whether that person is a corporation, partnership, trust, estate, or individual.

Parent asserts that because Trust EstateC, Trust EstateD, and Trust EstateE are not permanent establishments under Country B’s tax laws and are not required to file Country B tax returns, DRC7, DRC8, DRC9, and DRC10 are not DRCs. In addition, Parent asserts that Pship1 and Pship2 are not able to file consolidated returns in Country A. However, there is neither a requirement that a separate unit be a permanent establishment under a foreign country’s tax laws to constitute a DRC, nor a requirement that a separate unit file tax returns in a foreign country to be a DRC. See T.D. 8434, 1992-2 C.B. 240, 243. Sections 1.1503-2(c)(2) and 1.1503-2(c)(3) merely require that a domestic corporation have a foreign branch or have an interest in a partnership or in a trust to constitute a DRC. Accordingly, Trust EstateC, Trust EstateD, and Trust EstateE are not required to be permanent establishments under Country B’s tax laws for DSub7's, DSub8's, DSub9's, and DSub10's interests in the trusts to constitute DRCs.

Presumably, Parent’s permanent establishment position is based on the reference in § 1.1503-2(c)(3) to § 1.367(a)-6T. That reference in § 1.1503-2(c)(3) applies only to foreign branches. Section 1.367(a)-6T(g)(1) requires that all the facts and circumstances be considered in determining whether activities of a U.S. person outside the United States constitute a foreign branch operation. Section 1.367(a)-6T(g)(1) further provides that activities outside the United States are deemed to constitute a foreign branch when the activities constitute a permanent establishment under the terms of a treaty between the United States and the country in which the activities are conducted. Section 1.367(a)-6T(g)(1) does not provide that activities outside the United States will constitute a foreign branch only if the activities constitute a permanent establishment under foreign laws.

Considering the definition of a DRC, the DRCs in the Leasing Arrangements are as follows:

1. Leasing Arrangement A and Leasing Arrangement B

DSub3 and DSub4's interests in Pship1 are DRCs as they are interests in a partnership held by domestic corporations (“DRC3" and “DRC4,” respectively). A domestic corporation’s interest in a partnership is a DRC. Treas. Reg. §§ 1.1503-2(c)(2) - (3). Similarly, DSub5 and DSub6's interests in Pship2 are interests in a partnership held by domestic corporations and, thus, are DRCs (“DRC5" and “DRC6,” respectively). Even if Pship1 and Pship2 were treated as corporations under Country A’s tax laws and as partnerships under U.S. tax laws, DSub3 and DSub4's interests in Pship1 and DSub5 and DSub6's interests in Pship2 would be hybrid entity separate units and, as such, would be DRCs. Treas. Reg. §§ 1.1503-2(c)(2) - (4).

2. Leasing Arrangement C

Because DSub7's interest in Trust EstateC is an interest in a trust, it is a DRC (“DRC7"). A domestic corporation’s interest in a trust is a DRC. Treas. Reg. §§ 1.1503-2(c)(2) - (3). Even if Trust EstateC were taxable at the entity level under Country B’s tax laws and as a grantor trust for U.S. Federal income tax purposes, DSub7's interest in Trust EstateC would be a hybrid entity separate unit and, as such, would be a DRC. Treas. Reg. §§ 1.1503-2(c)(2) - (4).

3. Leasing Arrangement D

DSub8 is a domestic corporation that owns an interest in Trust EstateD. Because DSub8's interest in Trust EstateD is an interest in a trust, DSub8's interest in Trust EstateD is a DRC (“DRC8"). Treas. Reg. §§ 1.1503-2(c)(2) - (3). Even if Trust EstateD were taxable at the entity level under Country B’s tax laws and as a grantor trust for U.S. Federal income tax purposes, DSub8's interest in Trust EstateD would be a hybrid entity separate unit, and as such would be a DRC. Treas. Reg. §§ 1.1503-2(c)(2) - (4).

4. Leasing Arrangement E

Because DSub9 and DSub10's interests in Trust EstateE are interests in a trust, DSub9 and DSub10's interests in Trust EstateE are DRCs ("DRC9" and "DRC10," respectively). Treas. Reg. §§ 1.1503-2(c)(2) - (3). Even if Trust EstateE were taxable at the entity level under Country B's tax laws and as a grantor trust for U.S. Federal income tax purposes, DSub9 and DSub10's interests in Trust EstateE would be hybrid entity separate units and, as such, would be DRCs. Treas. Reg. §§ 1.1503-2(c)(2) - (4).

5. Leasing Arrangement F

Other members of the Parent Consolidated Group are involved in leasing arrangements in Country A and Country B through partnerships and grantor trusts. The § 1503(d) provisions would apply to Leasing Arrangement F because a domestic corporation's foreign branch and a domestic corporation's interests in a partnership or in a trust are DRCs. Treas. Reg. §§ 1.1503-2(c)(2) - (3).

D. General Rule Limiting Losses

Section 1.1503-2(b) of the final regulations provides the general rule that a corporation may not use a DCL of a DRC to offset its income or the income of any other member of the corporation's consolidated group. In addition, a DCL of a DRC cannot offset the income of another corporation by means of a transaction in which the other corporation succeeds to the tax attributes of the DRC under Code § 381, nor can a DCL of a separate unit of a domestic corporation be used to offset income of the corporation following the termination, liquidation, sale or other disposition of the separate unit. Treas. Reg. § 1.1503-2(b)(2).

Section 1.1503-2(g)(2)(i) provides an exception to the general § 1503(d) loss disallowance rule and permits a taxpayer to elect to use a DCL of a DRC by entering into an agreement under which the taxpayer certifies that the DCL has not been, and will not be, used to offset the income of another person under the laws of the foreign country and agrees to recapture the DCL if a "triggering event" occurs within fifteen years of the loss. If foreign law allows a DRC to combine its income and losses with other persons by making an election, a DRC's losses are considered to offset income of another person only when the election is made.

Treas. Reg. § 1.1503-2(c)(15)(ii). For the § 1.1503-2(g)(2)(i) exception to apply, no other person can use any part of the DCL in another country to offset income. Treas. Reg. § 1.1503-2(c)(15). If another person uses any portion of the DCL in a foreign country, the entire amount of the DCL is treated as having been used in the foreign country. Treas. Reg. § 1.1503-2(c)(15)(ii).

Parent has refused to enter into § 1.1503-2(g)(2)(i) agreements in Year 3 and Year 4 for the Year 3 and Year 4 net operating losses of DRC3, DRC4, DRC5, DRC6, DRC7, DRC8, DRC9, and DRC10 (the "Parent DCLs").

Even if Parent files § 1.1503-2(g)(2)(i) agreements, Parent must prove that the Parent DCLs do not actually offset the income of any other person for foreign tax purposes in Year 3 or Year 4. In general, losses taken into account in computing a DCL are treated as offsetting income of another person under foreign tax law in the year the DCL is made available for offset. Treas. Reg. § 1.1503-2(c)(15)(ii). It is irrelevant that the other person does not have enough income in the year to benefit from the offset. Treas. Reg. § 1.1503-2(c)(15)(ii).

For Leasing Arrangement A and Leasing Arrangement B, Parent must prove that no other person in a foreign country used the Year 3 or Year 4 DCLs of DRC3, DRC4, DRC5, or DRC6.[2] Also, Parent must prove that to the extent that the tax allocations of Pship1 or Pship2 are different under Country A's tax laws than under U.S. tax laws, the DCLs of DRC3, DRC4, DRC5, and DRC6 are not partially used to offset the income of another person for foreign tax purposes. If the losses are partially used, the DCL(s) would be treated as used by another person for foreign tax purposes, and Parent would be prohibited from using any amount of the DCL(s) to offset the income of any other member of the Parent Consolidated Group. See Treas. Reg. § 1.1503-2(c)(15)(i) and T.D. 8434, 1992-2 C.B. 240. Similarly, for Leasing Arrangement C, Leasing Arrangement D, and Leasing Arrangement E, Parent must prove that no other person in a foreign country used the Year 3 or Year 4 DCLs of DRC7, DRC8, DRC9, or DRC10.

Except as provided in § 1.1503-2(g)(2)(vi)(C), a taxpayer has to file annual certifications that the losses, expenses, and deductions that make up the DCLs have not been used to offset the income of another person for foreign tax purposes. Treas. Reg. § 1.1503-2(g)(2)(vi). Failure to file the annual certifications is a triggering event that requires the taxpayer to recapture the loss and pay an interest charge. Treas. Reg. § 1.1503-2(g)(2)(iii)(A)(8). If a taxpayer fails to comply with the § 1503(d) recapture provisions upon the occurrence of a triggering event, then the DRC that incurred the DCL (or a successor-in-interest) will not be eligible for relief to use any DCLs incurred in the five taxable years beginning with the year in which recapture is required. Treas. Reg. § 1.1503-2(g)(2)(vii)(F)(1).

[2] This means that the Year 3 and Year 4 DCLs of DRC3, DRC4, DRC5, and DRC6 cannot, generally, be used to offset the income of DSub3, DSub4, DSub5, DSub6 or any other corporation. Under § 1.1503-2(d)(1)(ii), DRC3, DRC4, DRC5, and DRC6 are treated as separate corporations from DSub3, DSub4, DSub5, and DSub6.

For the Parent Consolidated Group to be able to use the Parent DCLs, no portion of the net operating losses related to the Leasing Arrangements can be used to offset the income of any other person for foreign tax purposes. In addition, Parent must file agreements under § 1.1503-2(g)(2)(i) for the Parent Consolidated Group to be able to use the Parent DCLs. Parent, however, might not be able to file agreements under § 1.1503-2(g)(2)(i) for the Year 3 and Year 4 DCLs of DRC3, DRC4, DRC5 and DRC6. A DRC is treated as if it actually uses its DCLs to offset the income of another person in a foreign country when the foreign country has income tax laws that deny the use of the losses, expenses, or deductions of the DRC to offset the income of another person because the DRC is also subject to income taxation by another country on its worldwide income or on a residence basis. This type of foreign country tax law is often referred to as § 1503(d) "mirror legislation." Treas. Reg. § 1.1503-2(c)(15)(iv); T.D. 8434, 1992-2 C.B. 240.[3] The only way that the § 1503(d) provisions will not apply to the net operating losses related to the Leasing Arrangements is if Parent can prove that the net operating losses are not DCLs under § 1.1503-2(c)(5)(ii).

When a country's section 1503(d) mirror legislation applies to losses of a DRC, a taxpayer cannot file an agreement under § 1.1503-2(g)(2)(i) to use the DCLs to offset the income of other U.S. consolidated group members. See British Car Auctions, Inc. v. U.S., 35 Fed. Cl. 123 (1996), aff'd without op., 116 F.3d 1497 (Fed. Cir. 1997); see also Treas. Reg. § 1.1503-2(c)(15)(iv) and Staff of Joint Committee on Taxation, 99th Cong., 2nd Sess., General Explanation of the Tax Reform Act of 1986, at 1065 - 1066 (1987). Country A has a form of section 1503(d) mirror legislation, and Parent must prove that Country A's mirror legislation does not apply to the Year 3 and Year 4 DCLs of DRC3, DRC4, DRC5 and DRC6.

Finally, Parent contends that because Pship1 and Pship2 are not members of a Country A tax group and currently are unable to file group relief elections, any

DCLs related to Pship1 and Pship2 cannot offset the income of any other person in Country A. Partnerships generally are not permitted to file consolidated returns. The issue for purposes of § 1503(d) is whether the Year 3 and Year 4 DCLs of DRC3, DRC4, DRC5, and DRC6 may be used to offset the income of any other person for foreign tax purposes. Also, the issue is not whether Pship1 and Pship2 can carry the losses forward or back for tax purposes, but whether any taxpayer can carryforward or back or otherwise use the Year 3 or Year 4 losses of DRC3, DRC4, DRC5, or DRC6. See Treas. Reg. § 1.1503-2(b)(1).

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[3] If the United States and a foreign country have entered into a § 1.1503-2(g)(1) agreement, the mirror legislation deemed use provision will not apply. Treas. Reg. § 1.1503-2(c)(15)(iv). There are no § 1.1503-2(g)(1) agreements between the United States and a foreign country.

## E. Determining Whether Losses are Dual Consolidated Losses

The term "dual consolidated loss" is defined as the net operating loss of a domestic corporation, computed under U.S. tax principles, incurred in a year in which the corporation is a DRC. Treas. Reg. § 1.1503-2(c)(5).

Parent takes the position that the Year 3 and Year 4 net operating losses from the Leasing Arrangements are not DCLs. Parent is correct that both the final and temporary regulations contain an exception to the § 1503(d) general loss limitation rule by excluding certain net operating losses from the definition of a DCL. See Treas. Reg. § 1.1503-2(c)(5)(ii) and Treas. Reg. § 1.1503-2A(c)(1). The exception does not apply to the Parent DCLs.

Under the final regulations, a DCL does not include a net operating loss incurred by a DRC in a foreign country with income tax laws that: (1) do not permit the DRC to use its losses, expenses or deductions to offset the income of any other person that is recognized in the same taxable year in which the DRC incurs the losses, expenses or deductions, and (2) do not permit the losses, expenses or deductions of the DRC to be carried over or back to be used, by any means, to offset the income of any other person in other taxable years. Treas. Reg. § 1.1503-2(c)(5)(ii)(A).

The temporary regulations also include an exception to the general § 1503(d) loss limitation provisions through what is often referred to as the "stand alone" exception. To qualify for the "stand alone" exception: (1) the income tax laws of the foreign country must have at no time since December 31, 1986, permitted any other person, corporation, or entity by any means to use the losses, expenses, or deductions of the DRC to offset income, and (2) in taxable years beginning after December 31, 1986, the losses, expenses, or deductions of the DRC cannot, under the income tax laws of the foreign country, be carried forward or back to offset the income of another person, corporation, or entity in other years. Treas. Reg. § 1.1503-2A(c)(1)(i).

Because most foreign countries permit some use of net operating losses by other entities as a result of corporate reorganizations, the exception from the definition of DCLs under the final regulations rarely applies. See generally Treas. Reg. § 1.1503-2(c)(5)(ii). Both Country A and Country B allow some form of use of net operating losses as a result of corporate reorganizations. Also, both Country A and Country B allow some form of combination or consolidation of income and losses for income tax purposes. Unless Parent proves that the Year 3 and Year 4 Parent DCLs can never be used to offset income of another person for foreign tax purposes, including that the losses can never be carried over or carried back as a result of a corporate reorganization, the § 1.1503-2(c)(5)(ii) exception does not apply to the Parent DCLs. See generally Treas. Reg. § 1.1503-2(c)(5)(ii).

Parent contends that the stand alone exception under § 1.1503-2A(c)(1) applies to Leasing Arrangement A and Leasing Arrangement B because Pship1 and Pship2 file "stand alone" Country A tax returns. First, the stand alone exception, is an exception under the temporary § 1503(d) regulations, but not under the final regulations. See T.D. 8434, 1992-2 C.B. 240, and Treas. Reg. § 1.1503-2A(c)(1)(i). The final regulations apply to the Year 3 and Year 4 Parent DCLs. Second, even if the temporary regulations applied to the Year 3 and Year 4 losses, Parent would have to prove that the stand alone exception applies to the Year 3 and Year 4 net operating losses of DRC3, DRC4, DRC5, and DRC6.

For the "stand alone" exception to apply to Leasing Arrangement A and Leasing Arrangement B, Parent would have to prove that: (1) the relevant net operating losses were incurred in taxable years beginning before October 1, 1992; (2) the Country A income tax laws did not at any time since December 31, 1986, permit any other person, corporation, or entity by any means to use the losses, expenses, and deductions of DRC3, DRC4, DRC5, or DRC6 to offset income; and (3) in taxable years beginning after December 31, 1986, the losses, expenses, and deductions of DRC3, DRC4, DRC5, and DRC6 cannot be carried forward or back to offset the income of any other person, corporation, or entity in other years under the income tax laws of a foreign country. Treas. Reg. § 1.1503-2A(c)(1)(i).

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

Revenue agents can apply the § 1503(d) DCL provisions to LILO transactions. To disallow DCLs, a revenue agent merely has to identify the relevant DRCs and determine that it is possible for some other person in the other country to use the DCLs for tax purposes or that § 1503(d) mirror legislation could apply to the DCLs. The taxpayer, such as Parent, then must prove that no other person used the losses to offset income for foreign tax purposes and that the foreign country does not have § 1503(d) mirror legislation that applies to the DCLs at issue. Also, even when a revenue agent can disallow losses related to LILO transactions by applying the § 1503(d) DCL provisions, a taxpayer, such as Parent, can use the losses on a separate return limitation year basis to offset, generally, only the income generated by that DRC. The net present value of the use of the losses on a separate return limitation year basis is likely to be nominal, however, as LILO transactions typically do not result in net taxable income for many years.

Disallowing losses arising from LILO transactions by using the § 1503(d) provisions may be effective in the short-run, but with knowledge of the Service's application of the § 1503(d) provisions and with careful planning, taxpayers may be able to avoid having the § 1503(d) provisions apply to disallow the use of net operating losses by a domestic consolidated group. Therefore, when appropriate, losses arising from LILO transactions should also be disallowed because of statutory or regulatory tax avoidance provisions or because of economic substance judicial doctrines.

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

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cc: Regional Counsel, [redacted]