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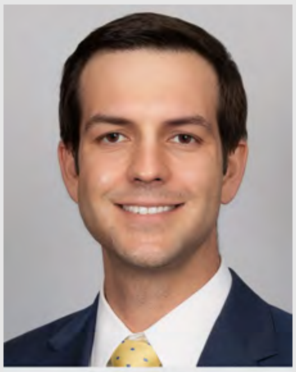

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In this article, Barlow and Blanchard explain how the dual consolidated loss rules of section 1503(d) apply to a debt obligation between a member of a U.S. consolidated group and a disregarded entity with foreign activities that is owned by another member of the group.

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The new pillar 2 rules have brought a renewed focus to the dual consolidated loss (DCL) rules under section 1503(d). Thus, an issue has once again reared its head: How do the DCL rules apply in the context of an intercompany obligation[1] between members of a U.S. consolidated group? Do the single-entity, matching principles in the intercompany transaction regulations trump the DCL rules, or vice versa?[2]

Taxpayers and their advisers have taken many positions, and the IRS has added this issue to its priority guidance plan.[3] Yet, it also appears that there is no consensus within the IRS on this issue. Given the recent focus that pillar 2 has put on the DCL rules, readers should be aware of this issue. Nevertheless, this article does not attempt to advocate for one position or the other. Instead, it merely attempts to lay out the different considerations that have been advanced by both sides.

I. Overview of the Issue via an Example

The best way to explain the different technical and policy positions on this issue is to use an example.

Example 1. Application of DCL rules to an intercompany obligation issued by a disregarded entity (DRE). U.S. Parent owns all the stock of U.S. Sub, and U.S. Sub owns all the equity interests in a disregarded entity[4] that is taxable on its worldwide income by Country X. U.S. Parent lends funds to DRE in exchange for a DRE negotiable instrument without U.S. Sub's guarantee or incurrence of any other obligation to repay the DRE debt. For year 1:

- U.S. Parent earns $100 of intercompany interest income and DRE incurs $100 of

[1] While much of the following discussion centers around the intercompany and corresponding items attributable to an "intercompany obligation" as defined in reg. section 1.1502-13(g)(2)(ii), the same discussion applies to items attributable to other "intercompany transactions" (defined in reg. section 1.1502-13(b)(1) as any transaction between S and B if they are members of the same consolidated group immediately after the transaction), such as a "true" lease or license of property by S to B in exchange for rent or royalty payments by B to S.

[2] This issue has been phrased as "strong form single-entity" versus "weak form single-entity."

[3] *See* IRS, "2023-2024 Priority Guidance Plan" (Sept. 29, 2023) ("Regulations under section 1503(d), including regulations addressing intercompany transactions.").

[4] For simplicity, this article assumes that DRE is a hybrid entity separate unit that does not have a foreign branch separate unit.

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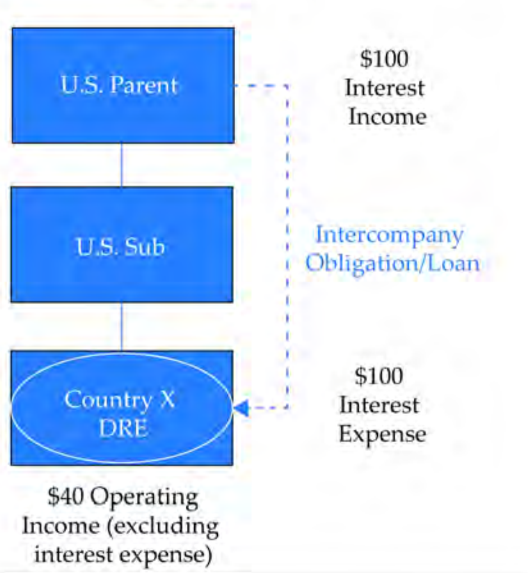
corresponding interest expense under their separate accounting methods.
- DRE earns $40 of foreign operating income, consisting of $190 of gross income from consulting services performed outside the United States, reduced by $150 of total expenses deductible under sections 162, 168, 174, and 197 ("other deductions").
- If DRE's $100 of corresponding interest expense is taken into account under the DCL rules, DRE has a DCL of $60.[5] Under reg. section 1.1503(d)-4(c)(2), the $60 DCL would comprise $36 of other deductions and $24 of the interest expense deduction.[6]
- Finally, there is "foreign use" of DRE's economic loss in Country X.[7]

Example 1



II. Technical Consolidated Return Analysis

This part of the article lays out some of the positions that have been taken under current regulations for Example 1. Most taxpayers would agree that: (1) U.S. Parent's extension of credit to DRE is an "intercompany transaction," as defined in reg. section 1.1502-13(b)(1), between U.S. Parent as "S" and U.S. Sub as "B"; and (2) the indebtedness owed by DRE to U.S. Parent constitutes an "intercompany obligation," as defined in reg. section 1.1502-13(g)(2)(ii).[8] Thus, U.S. Parent's interest income in Example 1 is an "intercompany item"[9] and U.S. Sub's interest expense is a "corresponding item."[10]

After these initial determinations, things get complicated, and the tax world has different views regarding the following three issues:
- whether DRE's $100 interest expense from the intercompany obligation can be treated as properly recorded on the books and records of DRE for purposes of the DCL rules;
- how U.S. Parent should determine its "intercompany item" (that is, its interest income); and
- whether U.S. Parent can exclude any of its "intercompany item" from U.S. Parent's income.

The analysis below summarizes the affirmative cases that have been made for some of these issues, and their effect on consolidated taxable income (CTI). Obviously, there are many nuances to each of these issues that cannot be comprehensively covered in a single article.

[5] *See* reg. sections 1.1503(d)-1(b)(5)(ii) and -5(c)(3)(i).

[6] Reg. section 1.1503(d)-4(c)(2) states that "the dual consolidated loss shall be treated as composed of a pro rata portion of each item of deduction and loss of the separate unit taken into account in calculating the dual consolidated loss." *See also* reg. section 1.1503(d)-7(c)(29), Example 29. Thus, because DRE's $100 corresponding interest expense is 40 percent of DRE's $250 in total year 1 deductions and the $150 of other deductions is 60 percent, 40 percent ($24) of the $60 DCL is treated as attributable to the interest expense deduction, and 60 percent ($36) of the DCL is attributable to the other deductions. Conversely, $76 of DRE's $100 of interest expense is treated as absorbed against the U.S. Parent group's consolidated taxable income in year 1.

[7] Foreign use could arise because DRE is part of a foreign consolidation with another related entity that is a regarded corporation for federal income tax purposes. *See* reg. section 1.1503(d)-3(a)(1)(i).

[8] It is assumed that the indebtedness of DRE to U.S. Parent resulting from the loan to DRE constitutes debt under general federal income tax principles, albeit a nonrecourse debt of U.S. Sub insofar as the obligation burdens only the assets of DRE and is repayable solely out of DRE net cash flow in light of the fact that U.S. Sub has no personal responsibility for the repayment of the debt (*e.g.*, as a guarantor). There is no authority supporting a position that a nonrecourse obligation of a member owed to another member and constituting "debt" for federal income tax purposes cannot be an intercompany obligation, and allowing such a position would result in undesirable "transactional electivity" in which a group could avoid the rules of reg. section 1.1502-13(g) by simply structuring B's obligation to be nonrecourse, secured by less than all the B assets.

[9] *See* reg. section 1.1502-13(b)(2).

[10] *See* reg. section 1.1502-13(b)(3).

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A. DRE's Intercompany Interest Expense

The first issue is whether DRE's $100 of corresponding interest expense accrued for year 1 is properly recorded on DRE's books and records. Specifically, reg. section 1.1503(d)-5(c)(1)(ii) provides "items of income, gain, deduction, and loss that are otherwise disregarded for U.S. tax purposes shall not be regarded or taken into account for purposes of this section." Also, reg. section 1.1503(d)-5(c)(3)(i) generally restricts DRE's items to U.S. Sub's items of income, gain, deduction, and loss "reflected on the books and records of [DRE] . . . as adjusted to conform to U.S. tax principles." Some taxpayers have argued that reg. section 1.1502-13 does not allow DRE's corresponding interest expense attributable to an intercompany obligation to be taken into account as properly recorded on its books and records for purposes of determining whether DRE has a DCL.

In support of this position, these taxpayers argue that the single-entity principles underlying the attribute redetermination rules in reg. section 1.1502-13(c) — under which U.S. Parent and U.S. Sub are treated as divisions of a single corporation and the intercompany loan is treated as between those divisions — result in the disregard of DRE's $100 year 1 interest expense accrual. Therefore, reg. section 1.1503(d)-5(c)(1)(ii) prevents the "disregarded" interest expense from being on DRE's books and records for purposes of the DCL rules, even though the intercompany obligation in Example 1 is regarded for other U.S. tax purposes.

Further, proponents might argue that reg. section 1.1502-13(c)(3) clarifies that the $100 year 1 accrual of interest on the loan by U.S. Parent to DRE, while deemed to occur for U.S. tax purposes, is treated as between divisions of a single corporation for purposes of the general attribute redetermination rule in reg. section 1.1502-13(c)(1)(i).[11] Based on that rule, DRE's intercompany obligation cannot give rise to interest income or expense that is on DRE's books and records because a loan between divisions of a single corporation cannot result in indebtedness between the divisions. Therefore, under reg. section 1.1503(d)-5(c)(1)(ii) and (c)(3)(i), DRE's books and records (as adjusted for DCL purposes) do not include a $100 corresponding interest expense for year 1.

Thus, it can be argued that the "disregarded" $100 of accrued year 1 interest expense is not part of DRE's books and records for purposes of the DCL calculations, resulting in $40 of taxable income in year 1 rather than a $60 DCL. This is sometimes referred to below as the "ring-fence" approach because it effectively constructs a fence around the intercompany obligation that prevents any intercompany items or corresponding items taken into account by U.S. Sub from being recorded on DRE's books and records for purposes of either determining the existence or amount of a DCL or adjustments to the separate return limitation year (SRLY) register (discussed below) with respect to a DCL.[12]

Others, however, may point out that, while the "intercompany item" timing rule of reg. section 1.1502-13(c)(2)(ii) requires single-entity treatment of U.S. Parent and U.S. Sub in determining U.S. Sub's "recomputed corresponding item" within the meaning of reg. section 1.1502-13(b)(4), the "corresponding item" timing rule in reg. section 1.1502-13(c)(2)(i)

[11] Reg. section 1.1502-13(b)(6) defines attributes of an intercompany item or corresponding item as "all of the item's characteristics, except *amount*, *location*, and *timing*, necessary to determine the item's effect on taxable income (and tax liability)" (emphasis in original). According to the *Merriam Webster Dictionary*, a "characteristic" of an item is a "distinguishing trait, quality, or property" of the item. Reflecting an item on a hybrid entity separate unit's "books and records" (defined in reg. sections 1.1503(d)-5(c)(3)(i) and 1.989(a)-1(d) as "books of original entry and ledger accounts, both general and subsidiary, or similar records") is a mechanical act that does not result in a "distinguishing trait, quality, or property" of the item. Accordingly, a counter-argument to the ring-fence approach is that the attribute redetermination rules, being limited to redeterminations of "distinguishing traits" of items, do not apply for purposes of determining whether the $100 year 1 interest accrual is reflected on DRE's books and records.

[12] As explained in Example 2 in Section III of this article, the ring-fence position could have adverse collateral effects if the taxpayer seeks to take into account interest income from an intercompany obligation owned by, rather than issued by, DRE in order to reduce DRE's DCL.

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requires U.S. Sub to take its corresponding item "into account under its accounting method, but the redetermination of the attributes of a corresponding item might affect its timing." Here, the relevant U.S. Sub accounting method is that of DRE, and DRE is required under its accounting method to deduct the full amount of the $100 interest expense accrual for both U.S. and Country X tax purposes,[13] subject to potential deferral of a portion of the deduction under the DCL rules. If the treatment of U.S. Parent and U.S. Sub as divisions of a single corporation applied in determining U.S. Sub's corresponding item as well as U.S. Sub's recomputed corresponding item for year 1, then U.S. Parent's year 1 intercompany interest income would never be taken into account under reg. section 1.1502-13(c)(2)(ii) because U.S. Sub's corresponding item (that is, the interest expense accruing on the intercompany obligation) would always equal its recomputed corresponding item (the $0 interest expense that would accrue on a loan between divisions of a single corporation). Thus, the counterargument goes, reg. section 1.1502-13(c)(2)(i) prevents removal of the $100 year 1 interest expense accrual from DRE's books.

B. USP's Income Taken Into Account

If a taxpayer takes the position that items attributable to an intercompany transaction can be taken into account for purposes of the DCL rules (that is, the taxpayer does not take the ring-fence position described in the discussion of the first issue), the next issue that arises is the amount of U.S. Parent's intercompany interest income inclusion for year 1 under the intercompany timing rule.

Under the intercompany item timing rule for "intercompany items" found in reg. section 1.1502-13(c)(2)(ii), U.S. Parent takes into account interest income in year 1 that is equal to the difference between (1) the amount of U.S. Sub's "corresponding item" that is "taken into account" in year 1 and (2) U.S. Sub's "recomputed corresponding item" taken into account in year 1.[14]

It is relatively easy to determine U.S. Sub's recomputed corresponding item for year 1 in Example 1. Under reg. section 1.1502-13(b)(4), U.S. Sub's recomputed corresponding item (that is, the interest deduction U.S. Sub would be allowed if U.S. Parent and U.S. Sub had been divisions of a single corporation and the loan had been between those divisions) is $0 because there can be no debt between divisions of a single corporation. The more difficult issue is determining the amount of U.S. Sub's corresponding item that is "taken into account" in year 1.

To determine the timing of U.S. Parent's interest income, the taxpayer must ascertain (1) the amount of U.S. Sub's corresponding item from the intercompany obligation[15] and (2) the proper tax year in which U.S. Sub takes this item into account.[16] Specifically, does U.S. Sub take into account a corresponding item equal to the entire $100 interest expense accrued by DRE for year 1? Or, does U.S. Sub take into account a corresponding item equal to only $76 (that is, the portion of the interest expense accrual actually used to reduce CTI in year 1)?[17] If the former, then all of U.S. Parent's $100 of interest income is taken into account in year 1 even though U.S. Sub is able to deduct only $76 of interest expense in year 1. If the latter, then $76 of U.S. Parent's $100 of interest income is taken into account in year 1, and the remaining $24 is deferred and taken into account in later tax years as the $60 DCL of DRE is taken

[13]Under reg. section 1.1503(d)-5(c)(3)(i), DRE's accrual of the interest expense (or other expense from an intercompany transaction) for Country X purposes is irrelevant for purposes of determining the items properly recorded on DRE's books and records for U.S. tax purposes but is relevant in determining "indirect foreign use" under reg. section 1.1503(d)-3.

[14]The timing rule for U.S. Parent's interest income in reg. section 1.1502-13(c)(2)(ii) provides that U.S. Parent takes its interest income into account "to reflect the difference for the year between [U.S. Sub's] corresponding item *taken into account* and the recomputed corresponding item" (emphasis added). *See also* reg. section 1.1502-13(b)(3) and (4).

[15]As discussed in the following text, reg. section 1.1502-13(b)(3)(i) defines "corresponding item" to include any deduction attributable to the intercompany transaction.

[16]*See* reg. section 1.1502-13(c)(2)(ii). It is not clear whether the "taken into account" language refers to whether an item is taken into account under an accounting method or whether the item is taken into account on the consolidated federal income tax return filed for the tax year at issue (that is, the item is actually reflected in CTI for the year).

[17]In the event that the interest expense is properly reflected on DRE's books and, hence, can comprise a portion of a DCL, the deduction can be deferred to future tax years under the separate return limitation year rules of reg. section 1.1503(d)-4(c).

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into account under the SRLY rules of reg. section 1.1503(d)-4(c) in determining the group's CTI.

Reg. section 1.1502-13(b)(3)(i) generally defines U.S. Sub's corresponding item as "[U.S. Sub's] income, gain, deduction, and loss from an intercompany transaction, or from property acquired in an intercompany transaction." Reg. section 1.1502-13(b)(3)(ii) provides the following additional guidance:

> [U.S. Sub's] corresponding items include amounts that are *permanently disallowed or permanently eliminated*, whether directly or indirectly. Thus, corresponding items include amounts disallowed under section 265 (expenses relating to tax-exempt income) and amounts not recognized under section 311(a) (nonrecognition of loss on distributions), section 332 (nonrecognition on liquidating distributions), or section 355(c) (certain distributions of stock of a subsidiary). *On the other hand, an amount is not permanently disallowed or permanently eliminated (and therefore is not a corresponding item) to the extent it is not recognized in a transaction in which [U.S. Sub] receives a successor asset within the meaning of paragraph (j)(1) of this section*.[18] For example, [U.S. Sub's] corresponding items do not include amounts not recognized from a transaction with a nonmember to which section 1031 applies or from another transaction in which [U.S. Sub] receives exchanged basis property. [Emphasis added.]

The $24 portion of U.S. Sub's $100 corresponding interest expense accrued for year 1 that is a DCL component is deferred under the SRLY rules of reg. section 1.1503(d)-4(c),[19] not "permanently disallowed" or "permanently eliminated." Hence, the $24 portion is not a corresponding item under the first sentence of reg. section 1.1502-13(b)(3)(ii). It also is not excepted from corresponding item status under the second sentence of reg. section 1.1502-13(b)(3)(ii) because the deferral of $24 of U.S. Sub's $100 corresponding interest expense deduction as a component of a DCL is not achieved by virtue of the acquisition of a "successor asset." Rather, the $60 DCL deferral results from the facts that (1) DRE's $190 of year 1 gross income is less than its $250 in total year 1 deductions ($150 of other deductions + $100 of interest expense deductible under section 163), and (2) there is foreign use of DRE's $60 net loss in year 1. Thus, reg. section 1.1502-13(b)(3)(ii) does not require that $24 of U.S. Sub's year 1 interest expense (the amount deferred under the DCL rules) be included in U.S. Sub's corresponding item. Instead, U.S. Sub's corresponding item is determined solely under reg. section 1.1502-13(b)(3)(i).

In applying reg. section 1.1502-13(b)(3)(i) and the intercompany timing rule of reg. section 1.1502-13(c)(2)(ii), some may argue that Example 5 in reg. section 1.1502-13(c)(7)(ii) requires U.S. Sub's corresponding item to be limited to the $76 of interest expense treated as absorbed in the calculation of the group's year 1 CTI under reg. section 1.1503(d)-4(c)(2). In that example, S sells an asset with a value of $100 and basis of $70 to B for $100, recognizing $30 of deferred intercompany gain and providing B with a $100 cost basis in the asset. In a later tax year, B sells the asset to a non-member in exchange for an installment obligation in the stated principal amount of $110. B recognizes $10 of corresponding gain that B elects to report under the installment sale method of section 453, thereby deferring the $10 corresponding gain to the following tax year when the installment obligation is paid in full. The example concludes S's $30 of intercompany gain is taken into account in the tax year in which B reports its $10 of corresponding gain under the installment sale

[18] Reg. section 1.1502-13(j)(1) defines successor asset as an asset, the basis of which is determined in whole or in part by reference to the basis of the predecessor asset.

[19] Under reg. section 1.1503(d)-4(c)(3), DRE's $60 DCL can be absorbed against the consolidated group's CTI in future tax years to the extent DRE generates future taxable income subject to taxation in the United States. Nonetheless, because this might occur in one or more post-year 1 tax years, the DCL rules in effect defer the deduction of the $60 DCL — they do not "permanently disallow" the deduction.

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method of section 453, not in the earlier tax year in which B sells the asset to a non-member.[20]

Thus, goes the argument, if a deferral provision in the IRC (such as section 453) or in the regulations (such as reg. section 1.1503(d)-4(c)), prevents the item from being taken into account in the determination of CTI for a tax year, then only the portion of the corresponding item actually used in the determination of CTI for that tax year is treated as taken into account by B for purposes of the timing rules of reg. section 1.1502-13(c)(2). Thus, it can be argued that U.S. Parent is required to take into account only $76 of interest income under the timing rule in reg. section 1.1502-13(c)(2)(ii) because U.S. Sub's corresponding item that has been deducted in determining the group's year 1 CTI is only $76.

Others, however, may argue that the amount of a deductible corresponding item "taken into account" during a tax year under reg. section 1.1502-13(c)(2)(ii) is determined under B's separate accounting method without regard to a deferral rule (such as the DCL SRLY limitation, the at-risk rules of section 465, or the passive activity loss rules of section 469) that defers the deduction to the extent gross income earned in the conduct of the targeted activity generating the deductible corresponding item is less than the sum of the deductions (including the corresponding item at issue) attributable to the activity. In any such case, the corresponding expense is fully deductible if the taxpayer has sufficient gross income from the targeted activity, and, hence, failure to treat the entire corresponding expense as a corresponding item within the meaning of reg. section 1.1502-13(b)(3)(i) could prevent the deferral rules from working properly by reducing CTI by excluding from S's gross income an amount of intercompany income equal to the portion of the deferred net loss consisting of the corresponding expense. Therefore, under the general definition in reg. section 1.1502-13(b)(3)(i), DRE's entire $100 corresponding interest expense arguably constitutes the corresponding item, and, hence, all of U.S. Parent's $100 of interest income accrued in year 1 would be taken into account by U.S. Parent in year 1 under the timing rule of reg. section 1.1502-13(c)(2)(ii).

Taxpayers who take the position that the entire $100 of interest expense accrued for year 1 must be taken into account as a corresponding item in year 1 then must decide whether any portion of U.S. Parent's $100 of interest income can be excluded from its income. This is discussed in Section II.C of this article.

C. Redetermining USP's Income to Be Excluded

The third technical question, which arises only if both the ring-fence approach is rejected and U.S. Parent takes into account all of its $100 of intercompany interest income in year 1 under reg. section 1.1502-13(c)(2)(ii), is whether $24 of U.S. Parent's intercompany interest income is excluded from income under the relevant attribute redetermination rules.[21] Specifically: Given that $24 of U.S. Sub's $100 interest expense that accrued in year 1 is not deductible in year 1, must $24 of U.S. Parent's $100 of year 1 intercompany interest income be redetermined to be permanently excluded from U.S. Parent's gross income under the attribute redetermination rules of reg. section 1.1502-13(c)?

It can be argued under those attribute redetermination rules that, if U.S. Parent were to include in gross income the entire $100 of intercompany interest income in year 1, the group's CTI would be overstated by $24 (the portion of U.S. Parent's intercompany interest

[20]This is permitted by the example even though B's sale to the non-member in the earlier year is an acceleration event under reg. section 1.1502-13(d)(1) (single-entity matching is no longer available), which normally would require S to take into account its $30 of intercompany gain in the earlier year. The acceleration rule of reg. section 1.1502-13(d)(1) has no application under the facts of text Example 1.

[21]The relevant rules are found in reg. section 1.1502-13(c)(1)(i) ("The separate entity attributes of S's intercompany items and B's corresponding items are 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."); reg. section 1.1502-13(c)(4) (attribute redetermination rules where the intercompany item and corresponding item offset each other in amount); and reg. section 1.1502-13(c)(6)(ii) ("Notwithstanding the general rule of [reg. section 1.1502-13(c)(1)(i)], S's intercompany income or gain is redetermined to be excluded from gross income only to the extent . . . B's corresponding item is a deduction or loss and, in the taxable year the item is taken into account under this section, it is *permanently and explicitly disallowed* under another provision of the Internal Revenue Code or regulations.") (emphasis added), as modified by reg. section 1.1502-13(g)(4)(i)(B) ("[Reg. section 1.1502-13(c)(6)(ii)] (limitation on treatment of intercompany income or gain as excluded from gross income) does not apply to prevent any intercompany income or gain from the intercompany obligation from being excluded from gross income.").

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income not offset in year 1 by U.S. Sub's corresponding interest expense deduction) — given that had the loan been between divisions of a single corporation, there would be no interest income or offsetting interest expense. Thus, continues the argument, under the general attribute redetermination rule of reg. section 1.1502-13(c)(1)(i), $24 of U.S. Parent's $100 intercompany interest income must be redetermined to be excluded income so that CTI for year 1 is neither increased nor decreased from what would have been the case if the loan had been between divisions of a single corporation. Also, the "governor" in reg. section 1.1502-13(c)(6)(ii) — which normally would prevent intercompany income from being excluded from U.S. Parent's gross income unless the income is taken into account by reason of a corresponding item constituting a noncapital expense, the deduction of which is "permanently and explicitly disallowed" — is turned off by reg. section 1.1502-13(g)(4)(i)(B). Thus, goes the argument, it is irrelevant that the deduction of $24 of U.S. Sub's $100 year 1 corresponding interest expense is deferred rather than "permanently and explicitly disallowed," and, hence, $24 of U.S. Parent's $100 of intercompany interest income taken into account in year 1 must be redetermined to be excluded income.

Under this position, the consolidated group could realize a significant benefit because U.S. Parent includes only $76 of interest income in year 1, yet the consolidated group might ultimately be able to deduct the entire $100 of year 1 interest expense incurred by DRE as the DCL is absorbed in future tax years under the DCL SRLY limitation. Thus, permanently excluding $24 of U.S. Parent's $100 year 1 interest income from U.S. Parent's gross income in Example 1 could provide the consolidated group with a materially larger U.S. tax benefit than would have resulted if the loan had been between divisions of a single corporation.

In light of the unintended tax benefit that could result from the permanent exclusion of $24 of the intercompany interest income from U.S. Parent's gross income, some taxpayers would conclude that U.S. Parent must include in gross income the entire $100 of interest income in year 1 and that $24 of U.S. Sub's interest expense is subject to deferral under the DCL rules. In reaching this conclusion, such a taxpayer must conclude that: (1) DRE's $100 interest expense is recorded on its books and is subject to the DCL rules (that is, the taxpayer does not take the ring-fence position), (2) the amount of U.S. Parent's intercompany item taken into account in year 1 under the timing rule of reg. section 1.1502-13(c)(2)(ii) is $100, and (3) U.S. Parent cannot exclude $24 of its $100 year 1 intercompany interest income from its gross income under the attribute redetermination rules in reg. section 1.1502-13(c), as modified by reg. section 1.1502-13(g)(4).

D. Summary of Outcomes

In sum, there are at least four positions on the interaction of reg. section 1.1502-13 with the DCL rules under current law in the context of Example 1:

1. Under the first position, the taxpayer applies the ring-fence approach and removes the $100 year 1 interest expense accrual from DRE's books and records solely for purposes of the DCL rules. In year 1, U.S. Sub would deduct $100 of interest expense, U.S. Parent would take into account $100 of interest income, and DRE would report $40 of taxable income in lieu of a $60 DCL.
2. Under the second position, the taxpayer does not apply the ring-fence approach, thereby taking into account the interest expense accruing in year 1 when applying the DCL rules. However, the taxpayer takes the position that the amount of U.S. Sub's corresponding item taken into account for a tax year is limited to the $76 of interest expense absorbed in the computation of year 1 CTI for purposes of the intercompany timing rule of reg. section 1.1502-13(c)(2)(ii). Thus, U.S. Parent takes into account only $76 of intercompany interest income in year 1 to match the $76 of interest expense deducted by U.S. Sub. In future years, U.S. Sub would deduct the remaining $24 of interest expense as provided under the DCL rules, and U.S. Parent would include an equivalent amount of year 1 interest income in U.S. Parent's gross income.
3. Under the third position, the taxpayer does not apply the ring-fence approach and relies

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on the attribute redetermination rules to permanently exclude $24 of U.S. Parent's $100 of interest income from U.S. Parent's CTI in year 1. U.S. Sub would then deduct the remaining $24 of year 1 interest expense in future years as provided under the DCL SRLY rules without any income inclusion to U.S. parent attributable to the $24 of intercompany interest income permanently excluded from U.S. Parent's gross income for year 1.

4. The fourth position does not apply the ring-fence approach, requires U.S. Parent to take into account its entire $100 of intercompany interest income accrued for year 1, and does not redetermine any of U.S. Parent's $100 interest income to be permanently excluded. Thus, U.S. Parent takes into account the entire $100 of interest income accrued in year 1, and U.S. Sub deducts $76 of interest expense in year 1 and the remaining $24 in future years as provided under the DCL rules without any additional income inclusions to U.S. Parent attributable to its year 1 interest income if, as, and when the group is able to use DRE's $60 DCL in future tax years under the DCL SRLY limitation.

After considering the preceding discussion, it should be abundantly clear that the interaction of the DCL and intercompany transaction rules is a complex area that is full of uncertainty. Moreover, this article discusses only some of the potential positions and forgoes a detailed discussion of their nuances. This article also does not attempt to address the strength of any position. Presumably, the IRS has added this issue to the priority guidance plan to provide a uniform position for all taxpayers.

III. Policy: Should Example 1 Give Rise to a DCL?

A. Should Single-Entity Principles Prevail?

The key issue facing taxpayers with facts similar to those described in Example 1 above is whether interest expense accruals under the nonrecourse intercompany obligation issued by U.S. Sub via DRE are taken into account under the DCL rules.[22] From a policy perspective, the principal question is whether the DCL rules should take into account intercompany or corresponding items receiving single-entity treatment provided in the matching rules of reg. section 1.1502-13(c).

If the separate-entity DCL rules apply without regard to the single-entity treatment mandated by reg. section 1.1502-13, then DRE has a $60 DCL that is not allowed to reduce year 1 CTI because DRE calculates its DCL taking into account its $100 of corresponding interest expense. Thus, U.S. Sub would not be able to currently deduct $24 of its corresponding interest expense in year 1 because that portion of the expense would constitute part of the $60 DCL subject to foreign use.[23] Yet, as discussed, U.S. Parent might still be required to include the entire $100 of intercompany interest income in CTI for year 1. This resulting $24 overstatement of year 1 CTI is justifiable only if mandated under the DCL statute and regulations.

Understandably, such a result seems contrary to the single-entity principles of the intercompany transaction regulations, which generally require an intercompany transaction to have the same effect on CTI as would occur if S and B were divisions of a single corporation and the transaction was between those divisions.[24] Thus, some might take the position that, regardless of whether there is foreign use of DRE's loss in year 1, single-entity treatment trumps the DCL rules and mandates that the consolidated group in effect ring-fence the $100 of interest and apply DRE's entire $100 corresponding interest expense as an offset eliminating U.S. Parent's $100 of intercompany interest income so that there is no net increase or decrease in year 1 CTI attributable to the intercompany obligation owed by DRE to U.S. Parent.

While this result may be justified by the single-entity principles underlying reg. section

[22] While this article addresses only intercompany transactions involving advances of money, the problem clearly can also arise in the context of any other intercompany transaction between one member and a separate unit owned by another member.

[23] Reg. section 1.1503(d)-4(b) and (c)(3). The domestic use limitation in reg. section 1.1503(d)-6 does not apply as there is foreign use of the DCL.

[24] *See* reg. section 1.1502-13(c)(1)(i) and (3).

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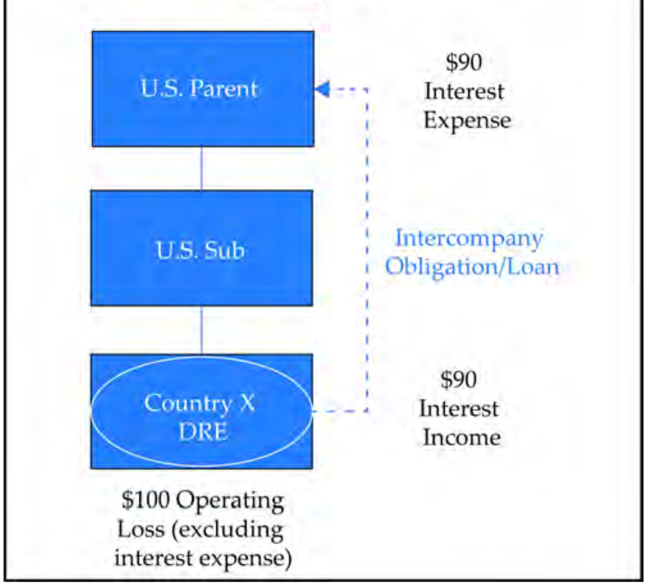
1.1502-13, it certainly appears to be contrary to the "anti-double-dipping" policy underlying section 1503(d) because the corresponding interest expense both reduces CTI and is subject to foreign use.[25] Accordingly, other taxpayers have taken the position that the DCL rules require DRE's corresponding interest expense to be taken into account in determining DRE's DCL.

Some may wonder why a taxpayer would ever want to take the position that the separate-entity principles underlying the DCL rules trump the single-entity principles underlying the intercompany transaction regulations. Other than the fact that many taxpayers believe this is the correct result, the answer lies in the fact that, in the DCL context, single-entity principles can be a double-edged sword. Consider the following Example 2.

Example 2. Application of DCL rules to an intercompany obligation issued to a DRE. The facts are the same as Example 1, except that:

- the loan is made by DRE to U.S. Parent and generates $90 of intercompany interest income to DRE and $90 of corresponding interest expense to U.S. Parent for year 1;
- absent the $90 of interest income, DRE's year 1 operating loss would be $100;
- if DRE's $90 of intercompany interest income is taken into account under the DCL rules, DRE's operating loss is only $10; and
- there is foreign use of DRE's $10 net loss in Country X.

Example 2



Unlike Example 1, the application of a "strong" single-entity (ring-fence) rule to Example 2 would result in a $100 DCL that could not be deducted in determining year 1 CTI rather than a $10 DCL.[26] That is to say, if the $90 of intercompany interest income is disregarded for purposes of section 1503(d) (because no interest income or expense would arise if U.S. Sub and U.S. Parent had been divisions of a single corporation), DRE's net loss is increased by $90 to $100.

On the other hand, if the separate-entity principles underlying the DCL rules trump single-entity treatment, then, in Example 2, DRE should take into account its $90 of intercompany interest income when calculating its DCL[27] — so that DRE has a DCL of only $10.[28] Thus, DRE would have only $10 of expenses that could not be deducted in year 1 for U.S. tax purposes. Some may argue that this result raises a concern regarding those $90 of year 1 deductions of DRE — none of which are attributable to intercompany transactions and all of which are used to offset DRE's $90 of year 1 intercompany interest income under Country X tax law. Specifically, (1) those

[25] *See, e.g.*, T.D. 9315 (Apr. 25, 2007) (noting double-dipping concerns under section 1503(d)).

[26] As noted, a "strong" single-entity or ring-fence position eliminates the DCL for year 1 in Example 1.

[27] *See* reg. section 1.1503(d)-5(c)(3)(i).

[28] *See* reg. section 1.1503(d)-1(b)(5)(ii).

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DRE deductions are used, or available for use, under Country X law to eliminate the $90 of DRE year 1 intercompany interest income; (2) those DRE deductions are also used to reduce $90 of the consolidated group's year 1 CTI; and (3) DRE's $90 of year 1 intercompany interest income does not increase the group's year 1 CTI because of U.S. Parent's offsetting $90 corresponding interest expense taken into account in year 1.

That fiscal concern, however, is not a "double-dipping" concern under section 1503(d) because there is no "foreign use" of the DRE deductions that offset DRE's $90 of intercompany interest income. Reg. section 1.1503(d)-3(a)(1) generally defines "foreign use" as:

> deemed to occur when *any portion of a deduction or loss taken into account in computing the dual consolidated loss is made available* under the income tax laws of a foreign country to offset or reduce, directly or indirectly, any item that is recognized as income or gain under such laws and that is, or would be, considered under U.S. tax principles to be an item of — (i) A foreign corporation as defined in section 7701(a)(3) and (a)(5); or (ii) A direct or indirect owner of an interest in a hybrid entity, provided such interest is not a separate unit. [Emphasis added.]

Also, reg. section 1.1503(d)-3(b) provides:

> foreign use shall be deemed to occur in the year in which any portion of a deduction or loss taken into account in computing the dual consolidated loss is made available for an offset described in paragraph (a) of this section, regardless of whether it actually offsets or reduces any items of income or gain under the income tax laws of the foreign country in such year, and regardless of whether any of the items that may be so offset or reduced are regarded as income under U.S. tax principles.[29]

Under the facts of Example 2, DRE's net loss for Country X income tax purposes is $10 for Year 1 because the $90 of intercompany interest income is taken into account by DRE for Country X income tax purposes. That in turn means that only the $10 of DRE Year 1 deductions in excess of DRE's Year 1 gross income (including the $90 of intercompany interest income) can be subject to "foreign use" under reg. section 1.1503(d)-3(a) and (b) because only that amount is available for use by a foreign corporation or direct owner of a hybrid entity that is not a "separate unit." Thus, because "foreign use" cannot exist regarding the DRE deductions offsetting DRE's $90 of intercompany interest income, the U.S. tax concern regarding the use of the intercompany loan to shift $90 of DRE deductions from U.S. Sub, where they would be DCL-limited, to U.S. Parent, where they are not DCL-limited, does not appear to violate the "anti-double-dipping" policy of section 1503(d).[30]

In any case, each of the two conflicting positions regarding single-entity principles has potential benefits and detriments to taxpayers, with the key fact being the direction of the intercompany loan.

B. Potential Arguments for Each Position

Those who desire single-entity treatment under the intercompany transaction regulations regarding items attributable to intercompany obligations (or other intercompany transactions) rely primarily on the single-entity language of reg. section 1.1502-13. Also, they may point to

[29] Reg. section 1.1503(d)-3(c) establishes exceptions to foreign use for specific transactions, none of which apply to the facts of Example 2. Reg. section 1.1503(d)-3(d) provides ordering rules for the absorption of deductions comprising a DCL for cases in which ordering rules are not provided by the foreign country's income tax law. Finally, reg. section 1.1503(d)-3(e) addresses when "mirror legislation" in a foreign country results in "foreign use" of a DCL.

[30] An argument might be advanced, however, to the effect that U.S. Parent's $90 corresponding interest deduction taken into account in Year 1 under U.S. Parent's separate accounting method and the timing rule of reg. section 1.1502-13(c)(2)(i) must be redetermined under reg. section 1.1502-13(c)(4)(i)(B) to be a noncapital, nondeductible expense, and DRE's offsetting $90 of intercompany interest income taken into account in Year 1 under the timing rule of reg. section 1.1502-13(c)(2)(ii) should be redetermined under reg. section 1.1502-13(c)(4)(i)(B) to be permanently excluded from U.S. Sub's gross income.

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other regulations that specifically allow or require mismatches between interest expense and income regarding intercompany obligations. For example, the section 263A interest rules contain a special provision that allows for timing mismatches for intercompany interest income and its corresponding interest expense that is capitalized under section 263A.[31]

Yet, setting the "special status" exception in reg. section 1.1502-13(c)(5) to one side for the moment, there are no provisions in the DCL rules or reg. section 1.1502-13 allowing such a mismatch of interest income and expense in determining whether a DCL exists or the amount of the DCL. Thus, argue the "strong" single-entity proponents, the structure of the consolidated return and other IRC provisions addressing intercompany obligations require a complete offset of corresponding interest expense and intercompany interest income attributable to an intercompany obligation absent an express provision allowing or requiring a mismatch, and that, in turn, prevents the corresponding interest deduction or intercompany interest income from being taken into account in determining the existence or amount of a DCL.

On the other hand, those who desire separate-entity treatment under the DCL rules regarding items attributable to intercompany obligations (for example, U.S. Parent in Example 2) may advance a handful of arguments. For example, they may note that DRE must determine its corresponding item under its separate accounting method, as discussed in Section II of this article.[32]

Perhaps the most intriguing argument is that the DCL statute confers "special status" under reg. section 1.1502-13(c)(5) on a consolidated group member that owns a foreign DRE treated as a separate unit for DCL purposes.[33] If a member owning or issuing an intercompany obligation has special status regarding the intercompany or corresponding items attributable to the obligation, then single-entity treatment does not apply to alter an attribute of the intercompany or corresponding item taken into account by that particular member from the attribute flowing from the member's special status, as mandated by a specific IRC or regulatory provision. In Example 2, if U.S. Sub has special status regarding the intercompany interest income attributable to the intercompany obligation owned by DRE under the DCL provisions, then U.S. Sub presumably would take the interest income into account under the DCL rules, thereby ensuring a DCL of only $10 rather than $100.

Little authority exists for when a member has special status. A commentator, however, has observed: "A special status apparently exists only if a particular provision of the Code or regulations is unique to one of the members participating in the intercompany transaction and is not solely a function of activities in which both S and B could engage."[34] Proponents of this argument may analogize the DCL rules to the SRLY rules in reg. section 1.1502-21(c) because both sets of rules are based on separate-entity principles restricting the use of a member's losses against CTI by allowing them only to the extent the member originating the losses has made a cumulative contribution to

[31] Reg. section 1.263A-9(g)(5).

[32] Also, some taxpayers point to the DCL-rules' form-driven nature and specificity of application regarding hybrid entity separate units. Those taxpayers then argue that a rule so tied to form, and specifically applicable to DRE's items addressed in examples 1 and 2, should not be overridden by the more general, and certainly more vague, single-entity rules in reg. section 1.1502-13. *See, e.g.*, *Morton v. Mancari*, 417 U.S. 535 (1974) ("Where there is no clear intention otherwise, a specific statute will not be controlled or nullified by a general one, regardless of the priority of enactment.").

[33] Reg. section 1.1502-13(c)(5) prohibits the single-entity attribute redetermination rules of reg. section 1.1502-13(c), but not the timing rules of reg. section 1.1502-13(c)(2), from requiring a federal income tax consequence (incident to an intercompany or corresponding item of S or B attributable to an intercompany transaction) that differs from the federal income tax consequence required as a result of the "special status" of S or B vis-à-vis the intercompany transaction or obligation. The question is: When does a member have "special status" regarding an intercompany transaction or intercompany obligation?

[34] Jerred G. Blanchard Jr. et al., *Federal Income Tax Consequences of Corporations Filing Consolidated Returns*, section 31.05[1][c]. For example, the general SRLY limitation in reg. section 1.1502-21(c) applicable to an S joining the P consolidated group with a SRLY net operating loss carryover or "net unrealized built-in loss" (NUBIL) applies only if S has a tax attribute (the SRLY NOL carryforward or NUBIL) that no other member can have. *See also* PLR 200736003 (May 31, 2007) (implying that a member's status as a "personal holding company" under the separate-entity rule of section 542(b)(2) is "special status" under reg. section 1.1502-13(c)(5); thus, even though a consent dividend by B to S results in intercompany income to S that is excluded from S's gross income under reg. section 1.1502-13(f)(2)(ii), B's personal holding company income is reduced by the consent dividend).

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CTI, taking into account only the member's items of income and deduction.

This argument has legs in view of the conclusion reached in Example 10(*4*) in reg. section 1.1502-13(c)(7)(ii).[35] That conclusion implies that a member has special status regarding an intercompany or corresponding item of that member if the item can create a SRLY-limited loss or enhance the SRLY register maintained for the loss. In other words, arguably "SRLY effect" is an attribute of DRE's corresponding interest expense in Example 1 and an attribute of DRE's intercompany interest income in Example 2.

Arguably, then, U.S. Sub (but not U.S. Parent) qualifies for the special status exception in reg. section 1.1502-13(c)(5) to the attribute redetermination rules in both Example 1 and Example 2 vis-à-vis the accruals of DRE's corresponding interest expense, in Example 1, and DRE's intercompany interest income, in Example 2. If the special status exception applies, then in Example 1, DRE's $100 of corresponding interest expense must be taken into account for DCL purposes, resulting in a $60 DCL. Similarly, in Example 2, DRE's $90 of intercompany interest income must be taken into account for DCL purposes, resulting in a $10 DCL (rather than a $100 DCL).[36]

IV. Potential Regulatory Responses

Taxpayers can expect regulations that address the interaction of section 1503(d) and reg. section 1.1502-13, given that this issue is included in the IRS's priority guidance plan. In line with the analysis above, there are several potential responses.

One approach, which presumably would be welcomed by the "strong single-entity" proponents, would be to write a regulation disregarding items attributable to intercompany transactions or intercompany obligations for purposes of determining the amount of a DCL and additions to the DCL SRLY register, similar to the approach taken in the section 163(j) context.[37] It appears that this response has some supporters in the government, but it also appears that there are others in the government who believe that this solution does not give due accord to Congress's intent in enacting section 1503(d). This solution would also create issues for a large number of taxpayers that are relying on income attributable to intercompany obligations (or other intercompany transactions) to reduce the amount of a DCL.

Another approach (the "weak single-entity approach") would seek to blend single-entity treatment with section 1503(d). Presumably, two regulations would be issued under this approach. The first regulation would clarify that intercompany and corresponding items resulting from an intercompany transaction would be required to be taken into account under the DCL rules when the item is taken into account under reg. section 1.1502-13(c)(2)(ii). This rule would apply both for purposes of ascertaining the existence and amount of a DCL and for purposes of determining the cumulative SRLY register for the DCL. The second regulation, perhaps in the form of language added to the intercompany timing rule in reg. section 1.1502-13(c)(2)(ii), would clarify that a corresponding item is "taken into account" during a tax year for purposes of that timing rule only to the extent the item is used in determining CTI for that tax year.

If this weak single-entity approach were applied to Example 2, the effect would be to eliminate the potential possibility of the ring-fence approach applying, thereby confirming that

[35] In reg. section 1.1502-13(c)(7)(ii), Example 10(*4*), P buys all the stock of S, and S brings a net operating loss carryover into the P consolidated group that is both section-382-limited and limited under the SRLY rules of reg. section 1.1502-21(c)(1). In year 1, S sells a gain asset to B, another member of the P group, recognizing $30 of gain that is taken into account in year 5 when B sells the property to a nonmember. The example concludes: "The application of the SRLY rules depends on S's status as a separate corporation having losses from separate return limitation years. Under paragraph (c)(5), the attribute of S's intercompany item as it relates to S's SRLY limitation is not redetermined, because the SRLY limitation depends on S's special status. Accordingly, S's $30 intercompany gain is included in determining its SRLY limitation for Year 5."

[36] There are numerous considerations, counterarguments, and rebuttals to those counterarguments for this special status analysis.

[37] *See* reg. section 1.163(j)-4(d)(2)(v)(A) ("Except as otherwise provided in paragraph (d)(2)(v)(B) of this section, for purposes of determining a member's business interest expense and business interest income, and for purposes of calculating the consolidated group's [adjusted taxable income], all intercompany obligations, as defined in section 1.1502-13(g)(2)(ii), are disregarded. Therefore, except as otherwise provided in paragraph (d)(2)(v)(B) of this section, interest expense and interest income from intercompany obligations are not treated as business interest expense and business interest income.").

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the DCL is $10 (rather than $100). Taxpayers that are relying on income from intercompany transactions to reduce a DCL would be strongly encouraged to draft comments to the IRS recommending that any future regulations confirm that intercompany items are taken into account in a taxpayer's DCL calculations. These comments should explain why the DCL rules should not create DCLs in this circumstance.

In Example 1, the first potential regulation under the weak single-entity approach would seem to carry out the anti-double-dipping policy of the DCL rules by taking all of DRE's $100 of interest expense into account in year 1 in determining DRE's $60 DCL. The second potential regulation would avoid damage to the single-entity policy of reg. section 1.1502-13 by not requiring U.S. Parent's intercompany interest income inclusion for a tax year to exceed the group's reduction in CTI (or increase in consolidated net operating loss) attributable to U.S. Sub's corresponding interest expense accrued in that or a prior tax year. While the second potential regulation under the weak single-entity approach would adhere to single-entity principles, IRS officials may be concerned that it could allow taxpayers to continue taking the benefit of interest expense deductions abroad without a corresponding income inclusion in the United States.[38]

And so continues the battle between the DCL provisions and reg. section 1.1502-13.

V. Conclusion

The battle between the DCL rules and the intercompany transaction rules will likely continue until the IRS issues regulations resolving the conflict. While this issue was recently added to the priority guidance plan and one or more regulations resolving the issue are certainly practicable, it remains to be seen whether the IRS will issue guidance soon — especially given the internal debate within the IRS. ■

[38]The deferral of U.S. Parent's interest income inclusion would also likely create issues under many foreign law anti-hybrid regimes.

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