INTERNATIONAL FISCAL ASSOCIATION
SECTION 987 and DCL REGULATIONS

May 18, 2007

For Presentation
by

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I. SECTION 987 PROPOSED REGULATIONS.

A. Treasury and the IRS re-proposed § 987 regulations that are markedly differently from the regulations that were proposed in 1991. In 1991, branch treatment was far less common than today, making the § 987 regulations much more important today due to the check-the-box entity characterization regime. The proposed regulations constitute a significant improvement over the 1991 proposed regulations, although the proposed new rules are quite complex and may present some compliance difficulties.

B. While the statutory language refers to remittances of *earnings*, and the 1986 Conference Report refers to the triggering of exchange gain or loss inherent in accumulated *earnings or branch capital*, the regulations propose an interestingly new and different approach.

C. The centerpiece of the proposed regulations is the “Foreign Exchange Exposure Pool Method.” First, the income of a § 987 QBU is determined by reference to the items of income, gain, deduction and loss booked to the QBU in its functional currency, adjusted to reflect U.S. tax principles. Items of income, gain, deduction and loss of a § 987 QBU generally are translated into the functional currency of the QBU’s owner at the average exchange rate for the year. However, the basis of historic assets and deductions for depreciation, depletion, and amortization of those assets are translated at the historic exchange rate.

D. Then the foreign exchange exposure pool method uses a balance sheet approach to determine exchange gain or loss, which is recognized when a remittance is made. Items whose value fluctuates with respect to changes in the functional currency of the owner will enter into this determination and those that do not, will not. Exchange gain or loss with respect to “marked items” is identified annually and is pooled and deferred until a remittance is made. A marked item is generally defined as an asset or liability that would generate § 988 gain or loss if the asset or liability were held or entered into directly by the owner of the § 987 QBU.

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E. When a § 987 QBU makes a remittance, a portion of the pooled and deferred exchange gain or loss is recognized. In general, the amount taken into account is an amount equal to the product of the owner's portion of the § 987 QBU's net unrecognized exchange gain or loss, multiplied by the owner's remittance proportion.

F. The source and character of exchange gain or loss recognized under § 987 for all purposes of the Code, including §§ 904(d), 907 and 954, is determined by reference to the source and character of the income derived from the § 987 QBU's assets.

G. Section 1.987-1: Scope, Definitions and Special Rules.

1. The proposed regulations provide rules for determining the § 987 taxable income of a taxpayer with respect to a § 987 QBU as well as the timing, amount, character, and source of § 987 gain or loss recognized with respect to the QBU. The proposed regulations do not apply to banks, insurance companies, and similar financial institutions (including leasing companies, finance coordination centers, regulated investment companies, and real estate investment trusts). The proposed regulations also do not apply to trusts, estates and S corporations.

2. An eligible QBU is defined in Prop. Treas. Reg. § 1.987-1(b)(3). Generally, an eligible QBU is an activity of an individual, corporation, partnership or disregarded entity ("DE"): (1) that constitutes a trade or business as defined in Treas. Reg. § 1.989(a)-1(c); (2) that maintains separate books and records and whose assets and liabilities used in conducting its activities are reflected on those books and records; and (3) the activities of which are not subject to DASTM. Corporations, individuals, partnerships, and DEs are not eligible QBUs.

3. In the case of ownership other than through a partnership (that is, direct ownership), the individual or corporation is treated as the owner of an eligible QBU if the individual or corporation is a tax owner of the assets and liabilities of the eligible QBU. While a DE is not recognized as a separate entity and thus is not an eligible QBU, the activities of the DE, which are treated as carried on directly by its owner, can qualify as an eligible QBU of the DE's owner.

4. With respect to partnerships, the proposed regulations apply an aggregate approach and apply the foreign exchange exposure pool method directly at the partner level.

5. Prop. Treas. Reg. § 1.987-1(b)(2)(ii) allows an owner to elect to treat certain § 987 QBU's with the same functional currency as a single § 987 QBU.

6. Under Prop. Treas. Reg. § 1.987-1(b)(5), a tiered ownership structure of eligible QBUs will not be respected as distinct tiers of QBUs for purposes of § 987. Rather, tiers of eligible and/or § 987 QBUs will be treated as a "flat" structure, with each QBU in the tier considered as owned directly by the ultimate non-QBU owner. For example, if a domestic corporation is the holder of interests in a § 987 DE and that DE owns the interest in another § 987 DE, the structure will not be treated as a tier of QBUs for purposes of § 987. Rather, the domestic corporation will be considered the direct owner of the § 987 branches.

7. A de minimis rule excepts relatively small interests in partnerships. A de minimis election applies to certain indirectly owned § 987 QBUs. An individual or corporation that owns a § 987 QBU indirectly through a partnership may elect not to take into account the § 987 gain or loss of the § 987 QBU provided the individual or corporation owns, directly or indirectly, less than 5% of the § 987 partnership. Constructive ownership rules apply for this purpose.

8. Prop. Treas. Reg. § 1.987-1(c)(1) defines the spot rate as the rate determined under the principles of the § 988 regulations on the relevant day. The proposed regulations allow taxpayers to elect to use spot rate conventions that reasonably approximate the spot rate on a particular day. Flexibility is provided in this regard. The proposed regulations allow taxpayers to conform the spot rate convention for § 987 to the spot rate conventions used under FAS 52 for financial accounting purposes.

9. Prop. Treas. Reg. § 1.987-1(c)(2) defines the yearly average exchange rate as an average exchange rate for the taxable year computed under any reasonable method that is consistently applied.

10. The historic exchange rate is defined by reference to the spot rate on the date that assets are transferred to (or acquired by) the § 987 QBU, or on the day that liabilities are assumed (or entered into) by the § 987 QBU. Spot rate conventions may be elected for these purposes.

H. Marked Items. The definitions of § 987 marked items and § 987 historic items are central to the foreign exchange exposure pool method. A marked item is defined in Prop. Treas. Reg. § 1.987-1(d) as an asset or liability reflected on the books and records of the § 987 QBU that both (1) would generate § 988 gain or loss if held or entered into directly by the owner of the § 987 QBU and (2) is not a § 988 transaction with respect to the § 987 QBU. Marked items give rise to exchange gain or loss under § 987. Historic items are items other than marked items. Historic items do not give rise to exchange gain or loss under § 987.

I. Elections Under § 987.

1. Prop. Treas. Reg. § 1.987-1(f) provides rules for making elections under § 987. Elections made under § 987 are made by the owner of the § 987 QBU. Elections are made with respect to a § 987 QBU for the first taxable year for which the election is relevant, and are made by attaching a statement to a timely filed tax return for that taxable year. Elections under § 987 are treated as methods of accounting and are governed by the general rules regarding changes in methods of accounting.

2. A reasonable cause standard will apply to determine whether taxpayers that failed to make a timely election will be eligible for an extension of time to file that election. Rulings under Treas. Reg. § 301.9100-1 will not be issued.

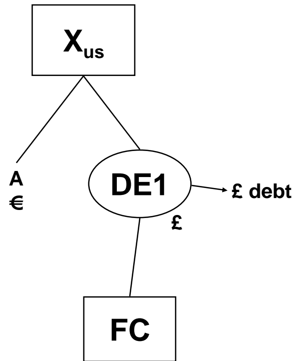
3. Under the reasonable cause standard, the owner of the QBU must demonstrate to the satisfaction of the Area Director, Field Examination, LSMB (for LSMB taxpayers) having jurisdiction over the taxpayer's return for the taxable year that the failure is due to reasonable cause and not willful neglect. A written statement must explain the reasons for the failure to comply.

4. The Director will notify the person in writing within 120 days of the filing if it is determined that the failure to comply was not due to reasonable cause or if additional time is needed to make the determination. If the Director does not notify the owner within 120 days of the filing, the owner will be considered to have demonstrated to the Director that the failure was due to reasonable cause and not willful neglect.

5. Section 987 elections cannot be revoked without the consent of the Service. The Service will consider allowing the revocation of an election if the taxpayer demonstrates significantly changed circumstances, or other circumstances that demonstrate a substantial non-tax business reason for the revocation.

J. Prop. Treas. Reg. § 1.987-1(b)(7) Examples.

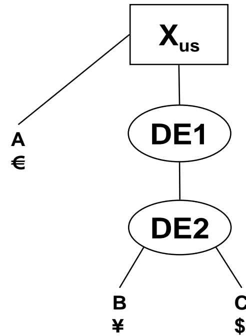
Ex. 1



X owns business A and DE1 which has £ debt and owns FC.

A is a 987 QBU; DE1 is not. The £ debt will be subject to 988.

Ex. 2

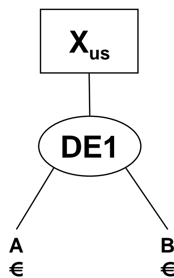


X owns business A and DE1, which owns DE2. DE2 owns businesses B and C.

A is a 987 QBU. DE1 and DE2 are not. B is a 987 QBU. C is not.

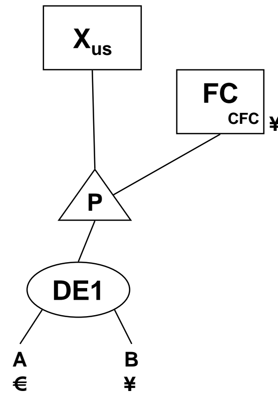
X is the direct owner of A, B and C. [The "flat" approach.]

Ex. 3



X owns DE1, which owns businesses A and B. A and B and 987 QBUs; DE1 is not. X is treated as the owner of A & B and may electively treat them as one QBU.

Ex. 4

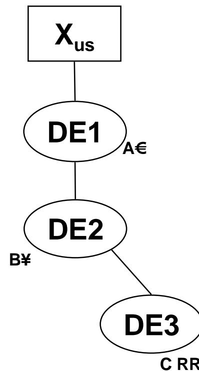


X and FC are partners in P, a partnership. P owns DE1 which owns businesses A and B.

A and B are 987 QBUs of X to the extent portions thereof are allocated to X. A is a 987 QBU of FC to the extent allocated to FC.

P and DE1 are not 987 QBUs.

Ex. 5



X owns DE1, which owns DE2. DE2 owns DE3. The DEs each conduct a business.

A, B and C are 987 QBUs owned by X. The DEs are not 987 QBUs.

K. <u>Prop. Treas. Reg. § 1.987-2: Attribution of Items to an Eligible QBU; the Definition of Transfer and Related Rules</u>.

1. The proposed regulations adopt a books and records method for allocating items to an eligible QBU. The proposed regulations provide that, subject to certain exceptions, items are attributable to an eligible QBU to the extent they are reflected on the separate set of books and records of the eligible QBU. These rules apply solely for purposes of § 987.

2. Certain assets and liabilities are not attributable to an eligible QBU, even if those assets and liabilities are reflected on the books and records of the QBU. Non-portfolio stock and interests in partnerships (and liabilities to acquire those assets), even if reflected on the books and records of the eligible QBU, are not attributed to the QBU for purposes of § 987. This is consistent with the principle, states the preamble, that a § 987 QBU cannot be the owner of another § 987 QBU.

3. If a principal purpose of recording (or failing to record) an item on the books and records of an eligible QBU is the avoidance of U.S. tax under

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§ 987, the Service may allocate any items between or among the eligible QBU, the owner of the eligible QBU, and any other persons, entities (including disregarded entities), or other QBUs. A transaction may have such a principal purpose even though the tax avoidance purpose is outweighed by other purposes when taken together. Relevant factors for determining whether U.S. tax avoidance is the principal purpose are described in the proposed regulation, but those are not the only factors that may be considered. Factors supporting an absence of tax avoidance include bona fide business purpose, consistency with the economics of the underlying transaction, treatment in accord with GAAP, and consistency with the treatment of similar items from year to year. Factors indicating tax avoidance include circular flows of cash or other property, transactions that do not have economic substance, and the presence of offsetting positions.

L. Transfers.

1. Prop. Treas. Reg. § 1.987-2(c) defines the term "transfer" for purposes of determining whether there has been a transfer to or from a § 987 QBU. The term transfer includes transactions that are regarded for both legal and tax purposes, and transactions that are regarded for legal purposes but disregarded as transactions for tax purposes ("disregarded transactions").

2. For purposes of § 987, disregarded transactions will not give rise to items of income, gain, deduction, or loss that are taken into account in determining § 987 taxable income or loss. If the owner of a § 987 DE loans cash to the § 987 QBU held by the § 987 DE, the loan is disregarded for federal tax purposes. However, as a result of the disregarded transaction, the loaned cash is reflected on the books and records of the § 987 QBU and, therefore, is treated as transferred to the § 987 QBU.

3. In the context of partnerships, an asset will be treated as transferred to an indirectly owned § 987 QBU if, and to the extent that, the asset is contributed to the § 987 partnership that carries on the § 987 QBU activities provided that immediately following the contribution, the asset is reflected on the books and records of the § 987 QBU. Deemed contributions under § 752 will be disregarded.

4. An asset will be treated as transferred from an indirectly owned § 987 QBU if, and to the extent that, the § 987 partnership that carries on the § 987 QBU activities distributes the asset to a partner provided that, immediately prior to the distribution, the asset was recorded on the books and records of the § 987 QBU. Deemed distributions under § 752 will be disregarded.

5. Mere changes in the form of ownership of an eligible QBU will not result in a transfer to or from the § 987 QBU. For example, a direct owner of a

§ 987 QBU that is owned through a § 987 DE can change to being an indirect owner of all or a portion of the § 987 QBU if the interest in the § 987 DE is transferred to a partnership.

6. Changes in form of ownership of a § 987 QBU can occur through actual or deemed transactions involving the § 987 QBU itself, or actual or deemed transactions involving interests in a § 987 DE or § 987 partnership that owns the QBU. For example, certain conversions of DEs to partnerships or partnerships to DEs result in deemed transactions pursuant to Rev. Ruls. 99-5 and 99-6. Deemed transactions with respect to partnerships also occur pursuant to § 708(b).

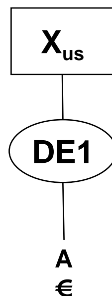
7. In determining whether an asset or liability has been transferred, circular cash flow, step-transaction, and substance-over-form doctrines apply.

8. Prop. Treas. Reg. § 1.987-2(c)(8) cross references Treas. Reg. § 1.988-1(a)(10) with respect to rules regarding the treatment of an intra-taxpayer transfer of a § 988 item. Such a transfer can give rise to gain or loss under those rules.

9. If an asset or liability is transferred to a § 987 QBU, the items are transferred into the QBU's functional currency at the spot rate on the day of transfer. No translation is required for assets or liabilities denominated in the functional currency of the § 987 QBU.

M. <u>Prop. Treas. Reg. § 1.987-2(c)(9) Examples</u>.

<u>Example 1</u>

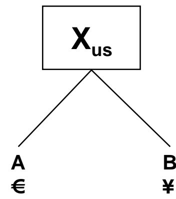


X owns DE1, which owns business A. X loans €100 to DE1 for business A.

The loan is a disregarded transaction and not taken into account.

There has been a €100 transfer from X to business A. *See also* Treas. Reg. § 1.988-1(a)(10)(ii) re § 988.

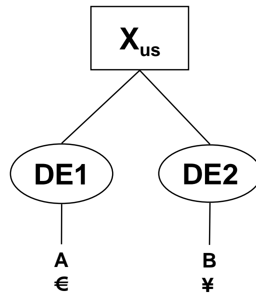
Example 2



X owns business A and B. A transfers equipment used in its business to B.

There is a triangular distribution to X and contribution by X to B.

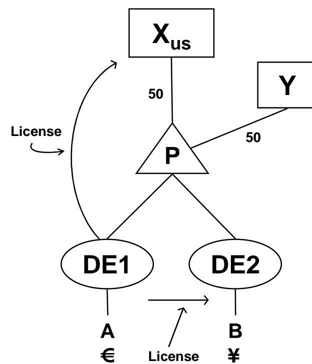
Example 3



X owns DE1 and DE2, which in turn own businesses A and B. A *sells* equipment to B.

There are 2 triangular distributions: The equipment to X and a related contribution to B from X, and the cash from B to X with a related contribution to A.

Example 4

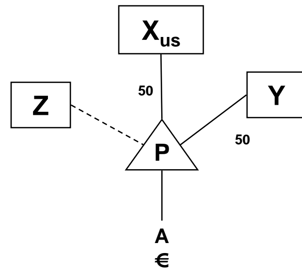


A and Y each have a 50% interest in P, a partnership. P owns DE1 and DE2 which own businesses A and B.

DE1 licenses IP to DE2 and X. The royalty received from DE2 is disregarded. The royalty does not result in income or deduction. The royalty amount is a triangular distribution to X and Y and a contribution by them to DE1.

The royalty received from X is regarded. It gives rise to an item of income and deduction, and the royalty payment does not give rise to a transfer to a 987 QBU.

Example 5

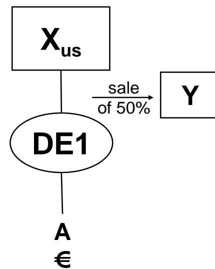


X and Y each have a 50% interest in P, a partnership, which owns business A.

Z acquires a 20% interest in P via a contribution to P. This reduces X and Y to 40% each.

Ten percent of the assets of A are treated as transferred to each of X and Y. Z has a 987 QBU.

Example 6

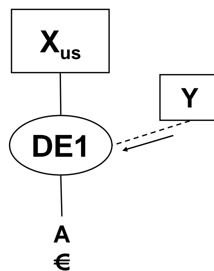


X owns DE1, which owns business A. X sells a 50% interest in DE1 to Y. DE1 becomes a partnership.

DE1 is treated as transferring 50% of its assets and liabilities to X.

Y has a 987 QBU.

Example 7

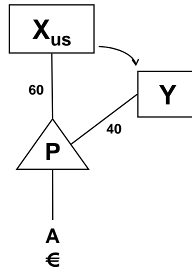


X owns DE1 which owns business A. Y contributes property to DE1 for a 50% interest in DE1. DE1 becomes a partnership.

A is treated as transferring 50% of its assets and liabilities to X. Further, 50% of the assets contributed by Y to DE1 are treated as though they were transferred by X to X's 987 QBU.

Y has a 987 QBU, to which it is treated as transferring 50% of the QBU's assets.

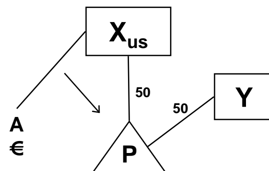
Example 8



X and Y own 60% and 40%, interests in P, a partnership. P owns business A. X sells a 50% interest in P to Y, resulting in a § 708 termination.

As a result, 50% of the A assets are treated as through they were transferred to X. Further, 50% of the A assets are treated as though they were transferred by Y to its 987 QBU.

Example 9



X and Y form P, a partnership, and each owns a 50% interest in P, in exchange for contributions. X contributes business A. Y contributes property to P which is recorded on the P books and which is not used in business A.

As a result, 50% of the A assets are treated as transferred from A to X. Further, 50% of the A assets are treated as if they were transferred from Y to Y's 987 QBU.

Examples 12-15

> **These examples involve circular cash flows, transfers without economic substance, and QBUs with offsetting positions (debt and borrowed cash) to trigger 987 losses.**
>
> **The IRS will scrutinize each to see if a principal purpose was tax avoidance.**

N. <u>Prop. Treas. Reg. § 1.987-3: Determination of § 987 Taxable Income or Loss of an Owner of a § 987 QBU</u>.

1. The term "§ 987 taxable income" refers to the items of income, gain, deduction or loss attributed to a § 987 QBU, translated into the function currency of the owner. The allocation of expenses such as interest under other provisions is not taken into account for this purpose. Section 987 taxable income is calculated by determining each item of income, gain, deduction, or loss in the § 987 QBU's functional currency, and then translating those items into the owner's functional currency.

2. Prop. Treas. Reg. § 1.987-3(b) states that the exchange rate to be used by an owner in translating an item of income, gain, deduction, or loss of a

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§ 987 QBU into the owner's functional currency is the *yearly average* exchange rate for the taxable year. Alternatively, the owner may elect to use a spot rate for the day each item is properly taken into account.

3. The exchange rate to be used by the owner in translating deductions allowable with respect to § 987 historic assets for depreciation, depletion and amortization is the historic exchange rate for the property to which the deductions are attributable.

4. When a § 987 QBU sells an historic asset, the amount realized will be translated into the owner's functional currency using the yearly average exchange rate (or, if properly elected, the spot rate), but the adjusted basis will be translated using the historic exchange rate associated with that asset.

5. In the case of a § 987 asset (other than cash) that was held on the first day of the taxable year, the exchange rate to be used in translating the amount realized is the rate used for that asset in determining the owner functional currency net value ("OFCNV") of the § 987 QBU for the proceeding taxable year. In the case of a § 987 marked asset (other than cash) transferred to the § 987 QBU or acquired by the § 987 QBU during the taxable year, the exchange rate to be used in translating the amount realized is the spot rate on the day transferred or acquired. Basis is determined similarly.

6. Prop. Treas. Reg. § 1.987-7 (discussed below) addresses the adjusted basis of a partner's interest in a § 987 partnership in computing gain or loss recognized on the sale, exchange or other disposition of that interest.

7. An item of income, gain, deduction or loss attributable to a § 987 QBU that is denominated in (or determined by reference to) the owner's functional currency is not translated and is taken into account by the § 987 QBU under U.S. tax principles in the owner's functional currency.

8. An item of income, gain, deduction or loss attributable to a § 987 QBU that is denominated in (or determined by reference to) a nonfunctional currency (other than the owner's functional currency) will be translated into the § 987 QBU's functional currency at the spot rate on the day the item is properly taken into account.

9. Section 988 applies to § 988 transactions attributable to a § 987 QBU, and the timing of any gain or loss will be determined under the applicable provisions of the Code. These transactions are § 987 historic items.

10. Transactions described in § 988(c) that are denominated in (or determined by reference to) the owner's functional currency and that are attributable to a § 987 QBU are not treated as § 988 transactions with respect to the

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QBU. Thus, no currency gain or loss will be recognized by the § 987 QBU under § 988 with respect to those items.

O. Prop. Treas. Reg. § 1.987-3(f) Examples.

1. A number of examples are set forth in Prop. Treas. Reg. § 1.987-3(f). They are all variations of Example 1. In Example 1, a U.S. corporation ("P") owns French DE, a § 987 DE that has a § 987 branch with the euro as its functional currency. P uses the yearly average exchange rate to translate items of income, gain, deduction or loss when that rate is appropriate. P elects to use a spot rate convention when the spot rate is otherwise required. Under this convention, items booked during a particular month are translated at the average of the spot rates on the first and last day of the preceding month. Accordingly, gross sales income is translated at the yearly average exchange rate and the basis of assets acquired during a month is translated into dollars at the convention rate.

2. The example assumes that the yearly average exchange rate for 2009 is €1 equals $1.05. For the taxable year 2009, French DE sells 1,200 units of inventory for a sales price of €3 per unit. The example further assumes that the purchase price for each inventory unit is €1.50.

3. The example then calculates sales using the yearly average exchange rate. Opening inventory is a stated amount and then purchases using the convention rate are added in determining total purchases and opening inventory. The French DE uses a FIFO inventory method, and thus the ending inventory, in dollars, is subtracted to determine cost of goods sold.

4. The result is gross income. The example does not go beyond determining gross income.

5. Example 2 is the same as in Example 1 except that P elects to use a spot rate convention to translate items of income, gain, deduction or loss when that rate is appropriate. In this example, gross sales are determined using the convention exchange rate.

6. Example 3 involves the same facts except that the French DE also sold raw land on November 1, 2009 for €10,000. The amount realized is translated into U.S. dollars at the yearly average exchange rate for 2009, and basis at the convention rate for 2007, as the property was purchased during 2007.

7. Example 4 involves the same facts as in Example 3 except that P elects to use the spot rate to translate items of income, gain, deduction or loss. Accordingly, the amount realized is translated at the convention rate on the day of sale.

8. Example 5 involves the same facts as in Example 1 except that the French DE provides services to an unrelated customer on September 15, 2009 and receives a cash payment of €2,000 on that day. The €2,000 item of income is translated at the yearly average exchange rate.

9. Example 6 sets forth the same facts as Example 5 except that P elects to use the spot rate to translate items of income, gain, deduction or loss. Under these facts, P translates the €2,000 item of income into dollars at the convention rate.

10. Example 7 contains the same facts as Example 1 except that French DE also incurs €500 of rental expense, €300 of salary expense and €100 of utilities expense. P translates these items of expense at the yearly average exchange rate.

11. In Example 8, the facts are the same as in Example 7 except that P elects to use the spot rate to translate items of income and expense. Under these facts, P translates the €500 of rental expense, €300 of salary expense and €100 of utilities expense at the convention rate.

12. Example 9 continues Example 1 except that the French DE incurs €100 of depreciation expense with respect to a truck. The truck was purchased on January 15, 2008, when the convention rate was €1 = $1.02. The €100 of depreciation is translated into U.S. dollars at the historic exchange rate. Since P elected to use a spot rate convention, depreciation will be translated in accordance with that convention. Thus, P translates the €100 of depreciation to equal $102.

13. In Example 10, the facts are the same as in Example 1 except that on January 12, 2009, the French DE performed services for U.K. person and received £10,000 in compensation. The exchange rate on that date was £1 = €1.25. The French DE translates the income into euros at the spot rate on that date. Accordingly, the French DE will take into account €12,500 of income from services in 2009. P translates the €12,500 item of income into dollars at the yearly average euro to dollar exchange rate. The example assumes that rate is £1 = $1.10. Accordingly, P translates the €12,500 income from services to equal $13,750.

14. French DE disposes of the £10,000 for €10,000. The disposition is a § 988 transaction. French DE will realize a loss of €2,500 (€10,000 amount realized less €12,500 basis). P translates the €2,500 loss into dollars at the yearly average euro to dollar exchange rate.

P. <u>Prop. Treas. Reg. § 1.987-4: Determination of Net Unrecognized § 987 Gain or Loss of a § 987 QBU</u>.

1. Prop. Treas. Reg. § 1.987-4 provides the mechanics for determining "unrecognized § 987 gain or loss" and, when combined with Prop. Treas.

Reg. § 1.987-5, states the preamble, forms the mathematical core of the foreign exchange exposure pool method. In summary, Prop. Treas. Reg. § 1.987-4 uses a balance sheet to distinguish the items of a § 987 QBU that give rise to § 987 gain or loss (§ 987 marked items) from those that do not (§ 987 historic items).

2. The change in the value of § 987 marked items on the opening and closing balance sheets due to changes in exchange rates give rise to unrecognized § 987 gain or loss. This unrecognized § 987 gain or loss is aggregated with similar amounts determined from prior years (to the extent not previously taken into account) and is taken into account by the owner under the rules of Prop. Treas. Reg. § 1.987-5 when a remittance is made by the § 987 QBU.

3. Unrecognized § 987 gain or loss is determined using a seven-step calculation. Under the first step, the "owner functional currency net value" ("OFCNV") of the § 987 QBU is determined under Prop. Treas. Reg. § 1.987-1(e) at the close of the taxable year in the functional currency of the owner.

4. This is a balance sheet calculation under which the basis (or amount, in the case of a liability) of each § 987 marked item is translated into the owner's functional currency at the spot rate on the last day of the taxable year. Section 987 historic items are translated into the owner's functional currency at the historic exchange rate, and therefore, do not give rise to exchange gain or loss. The amount of the liabilities determined in the owner's functional currency is subtracted from the value of the assets determined in the owner's functional currency to determine the OFCNV of the § 987 QBU at the close of the taxable year.

5. The OFCNV of the § 987 QBU at the close of the preceding taxable year is subtracted from the OFCNV of the § 987 QBU at the close of the current taxable year to determine the change in OFCNV of the § 987 QBU for the taxable year expressed in the owner's functional currency.

6. The steps are stated below:

Step	Description
1	Change in OFCNV per above
2	Increase by assets distributed by QBU
3	Decrease by assets contributed to QBU
4	Decrease by liabilities distributed by QBU
5	Increase by liabilities contributed to QBU
6	Increase by 987 taxable loss of QBU
7	Decrease by 987 taxable income of QBU

(a) The result is added to the amount of net unrealized § 987 gain or loss from prior years.

(b) Generally, states the preamble, three components are reflected in change in OFCNV for a taxable year. First, taxable income or loss of a § 987 QBU will result in increases or decreases in net assets, and therefore will affect net value. Second, transfers of assets or liabilities to or from the § 987 QBU will affect net value. Finally, any remaining change in net value (as measured in the owner's functional currency) results from changes in the value of the § 987 QBU's marked assets and liabilities. In order to isolate the change in value due to functional currency movements with respect to § 987 marked assets and liabilities, the proposed regulation reverses out the other changes. The preamble states that is the function of Steps 2-7.

Q. Prop. Treas. Reg. § 1.987-4(f) Examples.

Example 1

U.S. Corp ("P") establishes Japan Branch ("JB"), a 987 QBU, on July 1, 2009. On July 1, 2009 $1 = ¥100. P transfers $1,000 and land with a basis of $500 to JB. JB borrows ¥10,000. JB earns ¥2,000 a month for each of the next six months by providing services and incurs ¥2,000 in expenses over those six months. All income is collected and expenses paid.

P elects a spot rate convention that records transactions during a month at the spot rate on the first day of the month. The ¥12,000 of income equals $109.08, and JB's expenses equal $18.18. Its net income is $90.90.

The year end exchange rate is $1 = ¥120. P must determine the change in the owner functional currency net value ("OFCNV") of JB for 2009 in dollars. It's the year end OFCNV at year end, less the OFCNV at the prior year end.

Step 1: JB's OFCNV at year end:

Assets	¥	$	Rate
Cash	120,000[1]	999.60	Spot
Land	50,000	500.00	Historic
		1,499.60	
Liabilities			
Bank loan	10,000	83.30	Spot
OFCNV		1,416.30	

[1] ¥100,000 opening balance + ¥10,000 borrowed + ¥12,000 income - ¥2,000 expenses.

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Since the prior year end's OFCNV was zero, the change is $1,416.30.

Step	Description	Amount	Balance
2	Increase by assets distributed to P	zero	1,416.30
3	Decrease by assets contributed to JB	$1,500	– 83.70
4 & 5	No liabilities were transferred either direction	zero	– 83.70
6	Increase by JB's 987 Taxable Loss: Not applicable since JB had income		– 83.70
7	Decrease by JB's net income	$90.90	–174.60

P's unrecognized 987 loss = $174.60
(Negative $83.70 [1,416.30 minus $1,500] minus $90.90)

Example 2

U.S. Corp ("P") operates a U.K. branch ("UKB"). This example is somewhat more complex than Example 1 and I will not cover it in detail here. UKB has cash in sterling and dollars, a plant, a machine, inventory, portfolio stock, and sterling liabilities.

The sterling cash and debt are 987 marked items. The other assets are 987 historic assets. The same seven-step analysis is utilized.

At the end, the example sets forth a helpful summary chart:

Step	Description	Amount	Balance
1	Change in OFCNV	+$93.30	93.30
2	Increase by assets distributed by UKB	+ 53.00	146.30
3	Decrease by assets contributed to UKB	– 10.00	136.30
4	Decrease by liabilities distributed by UKB	0	136.30
5	Increase by liabilities contributed to UKB	0	136.30
6	Increase by 987 taxable loss of UKB	0	136.30
7	Decrease by 987 taxable income of UKB	–117.80	18.50

P’s net unrealized 987 gain is $48.50
($30 accumulated from prior years, plus $18.50 in 2009).

R. Prop. Treas. Reg. § 1.987-5: Recognized § 987 Gain or Loss.

1. Prop. Treas. Reg. § 1.987-5 provides the method for determining the amount of § 987 gain or loss a taxpayer must recognize in a taxable year. The amount of recognized § 987 gain or loss equals the net unrecognized § 987 gain or loss of the § 987 QBU determined under Prop. Treas. Reg. § 1.987-4 on the last day of the taxable year multiplied by the owner’s remittance portion.

2. The pool of net unrecognized § 987 gain or loss includes both unrecognized § 987 gain or loss on marked items for the current year and unrecognized § 987 gain or loss on marked items for prior years that has not yet been taken into account. A portion of the pool of unrecognized § 987 gain or loss is triggered by a net transfer or remittance to the owner by a § 987 QBU during the owner’s taxable year.

3. The owner’s remittance portion is determined by dividing the aggregate adjusted basis of the § 987 QBU’s gross assets (as reflected on its year-end balance sheet), without reduction for the remittance, by the amount of the remittance.

4. The 1991 proposed regulations defined a remittance as the amount of any transfer from a QBU branch based on a daily netting rule. The daily netting rule was eliminated. Prop. Treas. Reg. § 1.987-5(c) defines a remittance as the excess of total transfer from the § 987 QBU to the owner determined in the owner’s functional currency on an *annual basis* over total transfers from the owner to the § 987 QBU determined on an annual basis.

5. Solely for purposes of determining the amount of a remittance, the amount of liabilities transferred from the owner to the § 987 QBU is treated as a transfer of assets from the § 987 QBU to the owner. Similarly, the amount of liabilities transferred from the § 987 QBU to the owner is treated as a transfer of assets from the owner to the § 987 QBU.

6. The preamble states that the adjusted basis of gross § 987 QBU assets was selected as the measure because it avoids the administrative concerns raised by alternative methods and limits the potential volatility associated with the recognition of § 987 gain or loss. In particular, states the preamble, the adjusted basis of gross § 987 QBU assets measure avoids the significant administrative burdens associated with a § 987 QBU accumulated earnings approach that would require taxpayers to maintain post-1986 accumulated earnings pools for each § 987 QBU.

7. The owner's remittance portion and net unrecognized § 987 gain or loss is determined on the last day of the owner's taxable year (or, if earlier, on the day the § 987 QBU is terminated under Prop. Treas. Reg. § 1.987-8). Termination is treated as a remittance of all the gross assets of the § 987 QBU to the owner on the date of termination.

8. In Prop. Treas. Reg. § 1.987-5(g) Ex. 1, a U.S. parent company ("P") owns a U.K. DE which owns a § 987 branch with the pound as its functional currency. During the year P transferred to the U.K. branch cash $300 and a truck with an adjusted basis of $2,000. The branch transferred to P a machine with a basis of $500 and cash in U.K. pounds equal to $2,300. The total remittance for the year is $500.

9. In the example, the branch has gross assets at year end equal to $5,350. The net remittance of $500 is added to that for a total of gross assets plus remittance of $5,850. The remittance proportion is the fraction $500 over $5,850. This quotient is multiplied times the net unrealized § 987 gain of $80. P's § 987 gain is $6.80.

S. <u>Prop. Treas. Reg. § 1.987-6: Character and Source</u>.

1. Prop. Treas. Reg. § 1.987-6(b)(2) provides that the owner must use the asset method set forth in Temp. Treas. Reg. § 1.861-9T(g) to characterize and source § 987 gain or loss. This determination applies for all purposes of the Code, including §§ 904(d), 907 and 954.

2. In an example, a CFC, which uses the Swiss franc as its functional currency, has a § 987 branch with significant operations in Germany. The German branch has the euro as its functional currency. The CFC recognizes § 987 gain of CHF10,000. The German branch has total average assets of CHF1,000,000, CHF750,000 of which generate foreign source general limitation income and CHF250,000 of which generate foreign source passive income all of which is Subpart F income. As a result, CHF7,500 of the CFC's § 987 gain will be treated as foreign source general limitation income which is not Subpart F income and CHF2,500 will be treated as foreign source passive income which is Subpart F income.

T. <u>Prop. Treas. Reg. § 1.987-7: Partnership Rules</u>.

1. Prop. Treas. Reg. § 1.987-7 provides rules for determining a partner's share of assets and liabilities of an eligible QBU held indirectly through a § 987 partnership. It also provides rules for coordinating the application of § 987 with Subchapter K.

2. Since the foreign exchange exposure pool method applies at the partner level, each partner must determine its share of the assets and liabilities of a § 987 QBU owned indirectly through the § 987 partnership. The proposed

regulation provides that a partner's share of the assets and liabilities of the partnership's § 987 QBUs is determined in manner that is consistent with the manner in which the partners have agreed to share the economic benefits and burdens corresponding to those assets and liabilities, taking into account the rules and principles of §§ 701-761 and the regulations thereunder.

3. A partner's adjusted basis in a § 987 partnership interest is maintained in the functional currency of the partner and is not adjusted as a result of any fluctuations in the value of the partner's functional currency and the functional currency of any § 987 QBUs owned indirectly through the § 987 partnership.

4. A partner's share of the items of income, gain, deduction or loss taken into account in calculating § 987 taxable income or loss of a § 987 QBU held indirectly through a § 987 partnership is treated as income or loss of the § 987 partnership through which the partner indirectly owns the interest. As a result, the partner's allocable share of the items of income, gain, deduction or loss taken into account in calculating § 987 taxable income or loss of the § 987 QBU is taken into account, following conversion into the partner's functional currency, in determining the appropriate adjustments to the partner's adjusted basis in its partnership interest.

5. Solely for purposes of determining the appropriate adjustments to a partner's adjusted basis in its interest in a § 987 partnership, an individual or corporation that owns a § 987 QBU indirectly through a § 987 partnership will treat any § 987 gain or loss of the § 987 QBU as gain or loss of the § 987 partnership. Any adjustments to the adjusted basis of a partner's interest in such a § 987 partnership will occur prior to determining the effect under the Code of any sale, exchange, distribution or other event.

6. For purposes of making adjustments to the partner's adjusted basis in its interest in a § 987 partnership, as a result of any contributions or distributions (including deemed contributions and distributions under § 752) between the § 987 partnership and the owner of a § 987 QBU owned indirectly through the partnership, these amounts will be taken into account in the owner's functional currency.

7. In determining the amount of any increase in a partner's share of liabilities of the partnership, or any increase in a partner's individual liabilities by reason of the assumption by the partner of a liability of the partnership, which are reflected on the books and records of a § 987 QBU owned indirectly through the partnership and which are denominated in a functional currency different from the partner's, the amount of the liabilities will be translated into the functional currency of the partner using the spot rate on the date of the increase.

8. For purposes of determining the amount of any decrease in a partner's share of liabilities of the partnership which were reflected on the books of a § 987 QBU owned indirectly through the partnership and which are denominated in a functional currency different from the partner's functional currency, the amount of the liabilities will be translated into the functional currency of the partner using the historic rate for the date on which the liabilities increased the partner's adjusted basis in its partnership interest under § 752.

9. The rules in the proposed regulations with respect to partnerships raise some important issues that need refinement. They could present issues in the context of a joint venture where, for example, a new partner is admitted and the new partner makes a contribution of assets or cash to the joint venture partnership. The existing partners should not have deemed distributions as in Prop. Treas. Reg. § 1.987-2(c)(9) Examples 7 and 9, and § 1.987-8 Example 5. The examples give the existing partners deemed distributions. This doesn't seem right. Nothing was distributed.

10. Also, Prop. Treas. Reg. § 1.987-7 determines the partners' net unrecognized § 987 gain or loss at the partner level. This is ok. The partners' § 987 gain or loss is treated for basis purposes as § 987 gain or loss of the partnership. This, too, is ok. However, some additional refinement is necessary to ensure that the correct partner gets its correct share of that partnership § 987 income. There perhaps also should be a deemed satisfaction of Subchapter K's substantial economic effect rules in this regard, without having to involve capital accounts.

U. <u>Prop. Treas. Reg. § 1.987-7(d) Examples</u>.

1. Example 1 states a base case. The other examples are variations on Example 1. PRS is a partnership that owns QBU X, a QBU in the U.K. with the pound as its functional currency. Domestic corporations A and B each has a 50% interest in PRS. The portions of X allocated to A and B are § 987 QBUs of A and B. On January 1, 2007, A and B each contribute $50 to PRS, which PRS converts into £100. The £100 is reflected on the books of X.

2. On December 31, 2007, the spot rate is $1.50 = £1. A and B use the yearly average exchange rate, which is $1.25 = £1, to translate items of income, gain, deduction or loss to dollars. A and B are each allocated £50 from X. The net unrecognized § 987 gain of A's and B's § 987 QBUs is $25 each.

3. Example 2 has the same facts, except that PRS also incurred a £50 recourse liability on January 1, 2007. The liability and the borrowed £50 are reflected on X's books. A and B are each allocated £75 from X for

calculating net unrecognized § 987 gain or loss. Each also is allocated to £25 of the liability. Each has a net unrecognized § 987 gain of $25.

4. In determining their partnership interest bases, A and B each determines a dollar basis, and each reflects PRS's liability using the spot rate for the deemed § 752 contribution on the date the liability was incurred. Therefore, A and B each increases its basis in PRS by $25.

5. In Example 3, the facts are the same as in Example 2, except the liability is nonrecourse, and the proceeds were used to purchase non-depreciation real property in the U.K. which was used as security for the nonrecourse debt. A guaranteed the debt and will be allocated any gain on its sale. If PRS liquidates prior to satisfying the liability, the real property will be distributed to A.

6. In calculating net unrecognized § 987 gain or loss, A and B each are allocated £50 from X, as in Example 1. A bears the economic burden of the nonrecourse debt and the economic benefits of the real property. Thus, both items are allocated to A. A has net unrecognized § 987 gain of $0, and B has net unrecognized § 987 gain of $25.

7. In determining A's and B's adjusted bases in their partnership interests, they do so in dollars. A's adjusted basis is increased under § 752 by the deemed contribution of $50.

8. Example 4 repeats the facts in Example 1, except that during 2007 PRS earns £50 which is reflected on X's books. The £50 is allocated equally between A and B. Each is allocated £25 of taxable income. They convert this amount to dollars using the yearly average exchange rate for the year.

9. Each takes into account $31.25 of taxable income. This amount increases A's basis in PRS and B's basis in PRS, and will be taken into account in calculating A's and B's net unrecognized § 987 gain or loss for their respective § 987 QBUs.

10. In Example 5, the facts are the same as those in Example 4, except that A and B agree to allocate, with substantial economic effect, the £50 of income to A.

11. In calculating A's and B's § 987 taxable income or loss, and adjusted to conform to U.S. tax principles, A has £50 of taxable income and B has £0. A and B have $62.50 and $0 of taxable income, respectively.

12. These amounts are taken into account in determining A's and B's bases in their partnership interests in PRS, and in calculating their net unrecognized § 987 gain or loss.

13. Example 6 restates the facts of Example 1, except that A owns less than a 5% interest in PRS. A can, and does, elect not to apply the provisions of the § 987 regulations for purposes of taking into account the § 987 gain or loss of its § 987 QBU. On January 1, 2008 A sells its partnership interest to C for $75.

14. A's basis in PRS is $50, the amount of its contribution to PRS. The amount S realizes on sale is $75. A's gain on sale is $25.

V. Prop. Treas. Reg. § 1.987-8: Termination of a § 987 QBU.

1. The termination of a § 987 QBU is treated as a remittance of all the gross assets of the § 987 QBU to its owner. A termination occurs when (1) the activities of the § 987 QBU cease, (2) substantially all the assets of the § 987 QBU are transferred to its owner, or (3) the owner of the § 987 QBU ceases to exist. A termination also occurs when a foreign corporation that is a CFC that is the owner of a § 987 QBU ceases to be a CFC.

2. A number of exceptions apply. A termination generally does not occur when other tax attributes under § 382 are carried over in a liquidation under § 332 or an asset reorganization under § 368. However, inbound and outbound liquidations and reorganizations terminate a § 987 QBU. These transactions materially change the circumstances in which § 987 gain or loss is taken into account.

3. An additional exception applies when the distributor and a distributee are both foreign corporations and the functional currency of the distributee is the same as the functional currency of the distributor's § 987 QBU.

4. Five examples illustrate these rules. Examples 1, 3 and 4 are fairly straightforward. Examples 2 and 5 are discussed below.

5. In Example 2, DC, a domestic corporation, has a branch in country X that is a § 987 QBU. DC transfers all the assets and liabilities of the Country X branch to DS, a domestic corporation, under § 351. This causes a termination of the Country X branch because it ceases to exist as an eligible QBU of DC.

6. In Example 5, DC1, a domestic corporation, owns Entity A, a DE. Entity A conducts business in Country X. The Country X business is an eligible QBU and a § 987 QBU of DC1. DC2, a domestic corporation, contributes property to Entity A in exchange for a 95% interest in Entity A. The property is used in the business conducted by the Country X QBU and is reflected on its books and records. Entity A is converted to a partnership as a result of the contribution. Also, as a result of the contribution, 95% of the assets and liabilities on the books and records of DC1's § 987 QBU are

deemed to be transferred from the QBU to DC1, and DC1 is deemed to transfer to the QBU 5% of the property contributed by DC2 to Entity A.

7. As a result of the contribution of property from DC2 to Entity A, assets were transferred from DC1's § 987 QBU to DC1. Similarly, assets were transferred from DC1 to its § 987 QBU as a result of the contribution. For purposes of determining whether substantially all the assets of the Country X QBU were transferred from DC1's § 987 QBU, the assets transferred from DC1's § 987 QBU to DC1 are reduced by the amount of assets transferred from DC1 to the § 987 QBU pursuant to the contribution.

W. Prop. Treas. Reg. § 1.987-9: Recordkeeping Rules. A taxpayer must keep records that are sufficient to establish the § 987 QBU's § 987 taxable income or loss, its § 987 gain or loss, and the transition method used for its § 987 QBUs. Prop. Treas. Reg. § 1.987-9 also lists supplemental records that must be maintained.

X. Prop. Treas. Reg. § 1.987-10: Transition Rules.

1. Two transition rules apply to a taxpayer that is the owner of a § 987 QBU on the transition date. The taxpayer must transition to the foreign exchange exposure pool method whether or not the taxpayer made determinations required under § 987 in prior years. A taxpayer that failed to make required determinations under § 987 in prior years or that used an unreasonable method in prior years can only use the fresh start transition method of Prop. Treas. Reg. § 1.987-10(c)(4). Generally, use of the 1991 proposed § 987 regulation's method or an "earnings only" § 987 method will be considered a reasonable method for this purpose.

2. Prop. Treas. Reg. § 1.987-10(c) allows taxpayers to transition to the foreign exchange exposure pool method using the "deferral transition method" or the "fresh start transition method." The election must be applied with respect to all members that file a consolidated return with the taxpayer and any CFCs in which the taxpayer owns more than 50% of the voting power or stock.

3. Under the deferral transition method of Prop. Treas. Reg. § 1.987-10(c)(3), § 987 gain or loss is determined *under the taxpayer's prior § 987 method* on the transition date as if all QBUs of the taxpayer terminated on the last day of the taxable year preceding the transition date. The deemed termination is solely for purposes of measuring § 987 gain or loss in order to transition to the foreign exchange exposure pool method and does not apply for any other purpose. Section 987 gain or loss on the deemed termination is not immediately recognized. It is deferred by treating it as net unrecognized § 987 gain or loss of the relevant § 987 QBU.

4. The exchange rules used to determine the amount of assets and liabilities transferred from the owner to the § 987 QBU on the transition date under the deferral election method is determined with reference to the historic exchange rates on the day the assets were acquired or liabilities entered into by the QBU that was deemed terminated. If the taxpayer is not able to trace an historic exchange rate to a particular asset or liability, the exchange rate must be determined under a reasonable allocation method, consistently applied, that takes into account an allocation of the aggregate basis and an allocation of the deferred § 987 gain or loss.

5. Prop. Treas. Reg. § 1.987-10(c)(3)(ii) provides rules to avoid double counting. The exchange rates used to determine the amount of an asset or liability transferred from the owner to the new § 987 QBU on the transition date is determined with reference to the historic exchange rates. That exchange rate is then adjusted to take into account an allocation of § 987 gain or loss determined under the deferral method.

6. Taxpayers whose previous method produced losses likely will prefer this transition method. In effect, they are "rewarded" for following the previous rules, and are not deprived of their loss. Taxpayers whose previous method produced unrecognized gains likely will prefer not to use this method, as it will lock in their gain determined under the previous method used.

7. Under the fresh start transition method of Prop. Treas. Reg. § 1.987-10(c)(4), on the transition date all QBUs of the taxpayer subject to § 987 are deemed terminated on the last day of the taxable year preceding the transition date. This deemed termination is solely for purposes of transitioning to the foreign exchange exposure pool method under § 987. *No § 987 gain or loss is determined or recognized on the deemed termination.*

8. Under the fresh start transition method, the exchange rates used to determine the total amount of assets and liabilities deemed transferred from the owner to the § 987 QBU are determined with reference to the historic exchange rates on the day the assets were acquired or liabilities entered into by the QBU that was deemed terminated. Like the deferral transition method, if the taxpayer is not able to trace an exchange rate to a particular asset or liability, the exchange rate must be determined under a reasonable allocation method, consistently applied, that takes into account the aggregate basis of the QBU's assets (and amount of liabilities).

9. Under the fresh start transition method, the taxpayer starts with a "clean slate." However, there will be a "catch up" to the extent the assets deemed contributed under this method are marked assets, since they are contributed using their historic exchange rates.

10. Three somewhat lengthy examples illustrate these rules. Two illustrate the deferral method, and one uses the fresh start method.

Y. Prop. Treas. Reg. § 1.987-11: Effective Date.

1. The regulations are proposed generally to be effective with respect to taxable years beginning one year after the first day of the first taxable year following the date of publication of a Treasury decision adopting the regulations as final regulations. A taxpayer may elect to apply the regulations to taxable years beginning after the date of publication of a Treasury decision adopting them as final regulations.

2. Pending finalization, the IRS and Treasury will consider positions consistent with these proposed regulations to be reasonable constructions of the statute.

Z. Section 985 Proposed Regulations.

1. Treasury and IRS issued proposed regulations under § 985 as a part of their proposed § 987 regulations project.

2. Prop. Treas. Reg. § 1.985-1(d)(2) states that the amount of income or loss or earnings and profits (or deficit in earnings and profits) of each QBU and its functional currency shall be translated into a foreign corporation's functional currency under the principles of § 987.

3. Prop. Treas. Reg. § 1.985-5 deals with adjustments required when there is a change in functional currency. The changes incorporate the new terms and concepts used in the proposed § 987 regulations, for example, "§ 987 QBU."

4. The changes add some new rules in Prop. Treas. Reg. § 1.985-5(d)(1) with respect to adjustments that are necessary when a § 987 QBU changes its functional currency to reflect the different treatment of marked items and historic items. The rules apply for purposes of determining the "owner functional currency net value" of the § 987 QBU. Prop. Treas. Reg. § 1.985-5(d)(2) provides that when a § 987 QBU changes its functional currency to its owner's functional currency, the § 987 QBU is treated as if it terminated on the last day of the taxable year ending before the year of change.

5. Prop. Treas. Reg. § 1.985-5(e)(4), which addresses adjustments when an owner changes its functional currency, would incorporate the new § 987 rules with respect to historic items and marked items. The rules apply for purposes of determining the "owner functional currency net value" of the § 987 QBU. In addition, if an owner changes to the same functional currency as its § 987 QBU, the § 987 QBU is treated as if it terminated on the last day of the taxable year ending before the year of change.

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AA. Section 988 Proposed Regulations.

1. Treasury and the IRS also proposed changes in the § 988 regulations as a part of their § 987 proposed regulations project. Prop. Treas. Reg. § 1.988-1(a)(3) provides that transactions described in Prop. Treas. Reg. § 1.987-3(e)(2) (regarding certain transactions that are denominated in the functional currency of the owner of a § 987 QBU) are not treated as § 988 transactions with respect to the § 987 QBU. Thus, no currency gain or loss is recognized by a § 987 QBU under § 988 with respect to those items.

2. Prop. Treas. Reg. § 1.988-1(a)(4) addresses assets and liabilities of a partnership or disregarded entity that are not attributable to an eligible QBU (within the meaning of Prop. Treas. Reg. § 1.987-1(b)(3)). For purposes of applying § 988 to transactions involving the assets and liabilities of a partnership that are not attributable to an eligible QBU, the owners of the partnership are treated as owning their share of those assets and liabilities. Prop. Treas. Reg. § 1.987-7(b) will apply for purposes of determining the owner's share of those assets and liabilities. For purposes of applying the § 988 rules to assets and liabilities that are held by a disregarded entity that are not attributable to an eligible QBU, the owner of the disregarded entity is treated as owning those assets and liabilities.

3. In an example, P, a foreign partnership, has two equal partners, X and Y. X is a domestic corporation. Y is a foreign corporation that has the yen as its functional currency. On January 1, year 1, P borrowed yen and issued a note to the lender that obligated P to pay interest and repay principal to the lender in yen. P used the yen to acquire 100% of the stock of F, a foreign corporation, from an unrelated person. P also has an eligible § 987 QBU that has the yen as its functional currency. The assets and liabilities of the eligible QBU are reflected on the P books and records. The F stock held by P, and the yen liability incurred to acquire the F stock, are also recorded on the books and records of P. For purposes of the § 987 rules, the yen liability and the F stock are treated as not reflected on those books and records.

4. X's portion of the assets and liabilities of the eligible QBU owned by P constitutes a § 987 QBU. Y's portion of the assets and liabilities of the eligible QBU owned by P does not constitute a § 987 QBU because Y and the eligible QBU have the same functional currency. Since the F stock and the yen-denominated liability incurred to acquire that stock are treated as not reflected on the books and records of the eligible QBU, they are not subject to § 987. X and Y are treated as owning their shares of that stock and liability for purposes of applying § 988. As a result, P's becoming the obligor under the portion of the yen-denominated note that is treated as being an obligation of X is a § 988 transaction. Similarly, payments of

interest and principal on the liability, to the extent treated as owned by X, are § 988 transactions.

5. Prop. Treas. Reg. § 1.988-1(a)(10) deals with exchange gain or loss with respect to nonfunctional currency and certain other items transferred from an owner to a § 987 QBU or from a § 987 QBU to the owner when, as a result of the transfer, the currency or other item loses its character as nonfunctional currency or a nonfunctional currency item or when the source of the exchange gain or loss could be altered. The gain or loss is treated as realized on the transfer. It is computed as if the nonfunctional currency or item had been sold or otherwise transferred at fair market value between unrelated taxpayers. The taxpayer must use a translation rate that is consistent with the translation conventions of the § 987 QBU to which or from which, as the case may be, the item is being transferred. If the transaction does not have a significant business purpose, the Service may defer the gain or loss.

BB. Section 861 Proposed Regulation. Treasury and the IRS also proposed a relatively minor change to the § 1.861-9T regulations in connection with their proposed § 987 regulations project. Prop. Treas. Reg. § 1.861-9T(g)(2)(ii)(A)(1) provides that in the case of a § 987 QBU, tax book value is determined by applying the rules of Temp. Treas. Reg. § 1.861-9T(g)(2)(i) and (3) to the beginning of the year and end of the year functional currency amounts of assets. The beginning of the year functional currency amount of assets is determined by reference to the functional currency amount of assets under Prop. Treas. Reg. § 1.987-4(d)(1)(i)(B) and (e) on the last day of the preceding taxable year. The end of the year functional currency amount of assets is determined by reference to the functional currency amount of assets computed under Prop. Treas. Reg. § 1.987-4(d)(1)(i)(A) and (e) on the last day of the current taxable year. The beginning of year and end of year functional currency amounts of assets, as determined within each grouping, must then be averaged as provided in Temp. Treas. Reg. § 1.861-9T(g)(2)(i).

II. DUAL CONSOLIDATED LOSS RULES.

A. Treasury and the IRS finalized the dual consolidated loss ("DCL") regulations. The regulations apply to DCLs incurred in taxable years beginning on or after April 18, 2007. However, taxpayers may apply the regulations, in their entirety, to DCLs incurred in taxable years beginning on or after January 1, 2007. Special effective dates apply to certain other portions of the regulations, such as the reasonable cause exception (no § 9100 rulings) and the reduced certification period (five years for all certifications).

1. Partnerships. Foreign partnerships are an important focus of the new regulations. More than a quarter of the 40 examples involve foreign partnerships.

2. Separate Unit Combination Rules.

(a) The final regulations expand the separate unit combination rules to apply to same-country separate units of multiple domestic corporations that are members of the same consolidated group. The current regulations provide that foreign branches located in the same foreign country must be owned by a single domestic corporation to utilize the separate unit combination rule.

(b) The current regulations also require that losses of each separate unit must be available to offset the income of the other separate units under the tax laws of a single foreign country in order for them to combine. This requirement is not in the new final regulations. The individual separate units simply must be located, or subject to tax on a worldwide or resident basis, in the same foreign country.

(c) Some commentators recommended that the combination rule be expanded to combine DRCs that are members of the same consolidated group. This comment was rejected. Nevertheless, states the preamble, a DRC will often carry on its activities through a foreign branch and, as a result, will be a domestic owner of a foreign branch separate unit. In these cases, the foreign branch separate unit through which it carries on its activities in the foreign country will be eligible for combination. As a result, Treasury and the IRS believe that not extending the combination rule to DRCs should, as a practical matter, have limited effect.

(d) Commentators also recommended making the combination rule *elective* in certain situations. This comment was not adopted. Thus, when separate units can be combined, they must be combined. Any individual separate unit that is part of a combined separate unit loses its character as an individual separate unit. This not only will enter into the determination of whether a DCL exists, but in determining whether a recapture event has occurred later. For example, in determining whether there is a triggering event as a result of the transfer of the assets of the combined separate unit, all of the assets of the combined separate unit are taken into account (rather than only the assets of an individual separate unit within the combined separate unit).

3. Definition of Foreign Branch.

(a) The final regulations clarify that a foreign branch is defined, in part, by reference to Temp. Treas. Reg. § 1.367(a)-6T(g)(1), rather than by reference to Temp. Treas. Reg. § 1.367(a)-6T(g). Thus, the term "foreign branch" means an integral business operation

carried on by a U.S. person outside the U.S. This is determined under all the facts and circumstances. Evidence of the existence of a foreign 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 U.S. This appears to be more of a "housekeeping" change rather than a substantive change.

(b) The final regulations exclude from the definition of a foreign branch separate unit certain business operations that, under an applicable income tax treaty, would not be considered a permanent establishment. Commentators suggested that the definition of foreign branch separate unit should not include a branch that would not be subject to income tax in a foreign jurisdiction either as a result of an income tax convention or because of the passive nature of the activities. In such a case, there would be no potential use of a branch loss for foreign tax purposes. Although the final regulations include the permanent establishment exception to the definition of foreign branch separate unit, the IRS and Treasury do not believe an exception is appropriate when the business operations are not subject to tax in the foreign jurisdiction because of the passive nature of the activities. Such an exception would require an analysis of foreign law that, to the extent possible, should not be required under these rules.

(c) The home-country activities of a DRC or hybrid entity separate unit can qualify as a foreign branch separate unit.

4. Consistency Rule. The controversial consistency rule is not in the final regulations. Under the consistency rule, if any losses, expenses, or deductions taken into account in computing the DCL of a DRC or separate unit are used to offset the income of another person under the laws of a single foreign country while the DRC or separate unit is owned by the domestic owner or member of the consolidated group, the losses, expenses, or deductions taken into account in computing the DCL of other DRCs or separate units owned by the same consolidated group in the year are deemed to offset income of another person in the same country. The rule only applied when, under foreign law, the other DRC or separate unit can use its losses, expenses, or deductions to offset income of another person in that taxable year. The IRS and Treasury believe that the consistency rule would have had only limited application as a result of the expansion of the separate unit combination rule.

5. Domestic Reverse Hybrid Entities.

(a) One commentator stated that the application of the current and proposed regulations to certain structures involving domestic reverse hybrid entities is inconsistent with the policies underlying § 1503(d). In a typical structure, a foreign corporation owns the majority of the interest in a partnership or LLC that elects to be treated as a corporation for U.S. tax purposes and, therefore, is subject to tax on its worldwide income in the U.S., but is treated as a pass-through entity under foreign law.

(b) The structure allows the interest expense of the domestic reverse hybrid to offset income of the foreign corporation, which is not subject to U.S. tax, and to offset income of the other members of the U.S. consolidated group, which is not subject to foreign tax.

(c) The preamble states that IRS and Treasury recognize that this type of structure results in a double dip similar to that which Congress intended to prevent through the adoption of § 1503(d). However, the preamble states that such a domestic reverse hybrid is neither a DRC nor a separate unit and, therefore, is not subject to § 1503(d). As a result, no change was made to the final regulations. However, the preamble states that the IRS and Treasury continue to study these and similar structures.

6. Transparent Entities.

(a) The current regulations define a separate unit of a domestic corporation as a foreign branch, and an interest in a partnership, trust, or hybrid entity. The proposed regulations modified the definition to exclude interests in non-hybrid entity partnerships and non-hybrid entity grantor trusts. These interests were excluded because the IRS and Treasury believe that it is unlikely that losses and deductions attributable to these interests could be put to a foreign use (as that term is defined in the proposed regulations). However, the proposed regulations retained the rule that a domestic corporation can own a separate unit through a non-hybrid entity partnership or non-hybrid entity grantor trust.

(b) Commentators stated that, as a result of the change, the proposed regulations may not sufficiently and consistently address the treatment of certain entities. Such an entity is a pass-through entity for U.S. tax purposes (for example, a disregarded entity, a partnership or grantor trust), but is not a hybrid entity because it is not subject to tax on its worldwide income or on a residence basis in a foreign country. The entity also would not be treated as a pass-through entity under the laws of the applicable foreign

country. One example of such an entity (transparent entity) is a LLC organized in the U.S. that for U.S. tax purposes is a partnership or disregarded entity, but, for foreign purposes, is not viewed as a pass-through entity. Another example is a foreign entity that is a pass-through entity for U.S. tax purposes, is not subject to income tax in a foreign country as a corporation either on its worldwide income or on a residence basis (because, for example, is it organized in a foreign country that does not impose an income tax), and is not treated as a pass-through entity under the laws of the applicable foreign country.

(c) The commentators stated that under the proposed regulations, items of income, gain, deduction and loss of a transparent entity that is a partnership for U.S. tax purposes would be taken into account in computing the DCL of a DRC or hybrid entity separate unit that owns an interest in the entity, even though it is unlikely that the items are taken into account by the jurisdiction in which the DRC or hybrid entity is subject to tax. As a result, items of deduction or loss that are unlikely to be available for a double dip (because they are not likely to be taken into account by the foreign country in which the DRC or hybrid entity is subject to tax) could inappropriately result in a DCL. The commentators also stated that items of income or gain which are unlikely to be taken into account by the foreign country could inappropriately reduce (or eliminate) a DCL of the DRC or hybrid entity separate unit that owns an interest in the entity.

(d) The preamble states that the IRS and Treasury believe that losses attributable to interests in transparent entities should not be subject to § 1503(d), but also believe that items attributable to these interests should not influence the calculation or use of a DCL of a DRC or separate unit in a manner that is inconsistent with the purposes of § 1503(d). Accordingly, the final regulations provide four new rules that address transparent entities (and interests therein).

(e) First, the final regulations provide a definition of a transparent entity that is consistent with the description and examples in the preceding discussion. A transparent entity: (1) is not taxable as an association for U.S. tax purposes; (2) is not subject to an income tax in a foreign country as a corporation (or otherwise at the entity level) either on its worldwide income or on a residence basis; and (3) is not a pass-through entity under the laws of the applicable foreign country. The applicable foreign country is the foreign country in which the relevant foreign branch separate unit is located, or the foreign country that subjects the relevant hybrid

entity (an interest in which is a separate unit) or DRC to an income tax either on its worldwide income or on a residence basis.

(f) Second, rules are provided for attributing items of income, gain, deduction, and loss to interests in transparent entities. The rules applicable for attributing items to these interests are consistent with the rules for attributing items to hybrid entity separate units.

(g) Third, the final regulations provide that items of income, gain, deduction, and loss attributable to interests in transparent entities are not considered when calculating whether a DRC that holds an interest in such an entity has income or a DCL. This modification is to ensure that in cases in which the foreign country in which the DRC is subject to tax is unlikely to take into account items of the transparent entity, the items do no inappropriately affect the computation of income or a DCL of the DRC. Similar rules apply with respect to the DCL of a separate unit through which an interest in a transparent entity is owned (directly or indirectly).

(h) Finally, an interest in a transparent entity will be treated as a domestic affiliate for purposes of determining whether there is a domestic use of a DCL. This change prevents a DCL from being used to offset the income of a transparent entity such that there is no inappropriate domestic use of the loss.

7. Reasonable Cause Exception.

(a) Under the current regulations, many § 9100 ruling requests have been filed to remedy tardy filings. The proposed regulations eliminated the need to seek a § 9100 ruling and instead adopted a reasonable cause standard.

(b) In January 2006, the IRS and Treasury published Notice 2006-13 announcing that taxpayers that must file agreements, statements, and other information under § 1503(d) may cure any late filings by applying a reasonable cause exception similar to the standard contained in the proposed regulations, until such time as the proposed regulations become final.

(c) The final regulations adopt the reasonable cause standard set forth in the proposed regulations and Notice 2006-13, with certain modifications.

(d) The final regulations also provide that the reasonable cause procedures supplant the current procedures for all untimely filings with respect to DCLs incurred under the current regulations as well, except with respect to closing agreements. Taxpayers requiring relief to cure a late request for a closing agreement must

continue to seek extensions of time under the § 9100 regulations. Taxpayers seeking relief for other late filings required in connection with these closing agreements must, however, use the reasonable cause procedure of the final regulations. Therefore, untimely filings under § 1503(d) will no longer be eligible for relief under the § 9100 regulations, regardless of whether those filings were required under the current regulations (except for certain closing agreements) or the new final regulations.

(e) Taxpayers that have pending letter ruling requests under § 9100 are not required to use the reasonable cause procedures of the new regulation. However, if these taxpayers have not yet received a determination of their request, they may withdraw their request and use the reasonable cause procedures. In that event, the IRS will refund the taxpayer's user fee.

8. Domestic Use Limitation.

(a) Treas. Reg. § 1.1503(d)-6 contains exceptions to the domestic use limitation rule that generally were set forth in the proposed regulations. It states that the absence of a foreign affiliate or a foreign consolidation regime alone does not constitute an exception to the domestic use limitation rule. This is because it still may be possible that all or a portion of the DCL may be put to a foreign use, for example, through an acquisition. These exceptions also do not apply to losses of a foreign insurance company that is a DRC, or losses of any separate unit of a foreign insurance company.

(b) Exceptions, as under the proposed regulations, apply if: (1) if there is an elective agreement in place between the U.S. and a foreign country (such as the recent U.S.-U.K. agreement); or (2) there is no possibility of foreign use. The second exception requires that the taxpayer demonstrate to the satisfaction of the IRS that no foreign use of the DCL occurred in the year in which it was incurred, that *no foreign use can occur in other year by any means*, and the taxpayer attaches a statement to its timely-filed tax return which supports the "no possibility of foreign use of DCL."

(c) The final exception, of course, is the domestic use election. This requires a certification that there has not been, and will not be, a foreign use of any portion of the DCL. If there later is a foreign use, as defined and discussed below, the prior deduction must be taken into income, with an interest charge.

9. Foreign Use. The final regulations adopt the proposed regulations' rules and provide that a foreign use is deemed to occur if two conditions are

satisfied. The first condition is satisfied if *any portion* of a deduction or loss taken into account in computing the DCL 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 the laws of that country regardless of whether income or gain is actually offset, and regardless of whether these items are recognized under U.S. tax principles. The second condition is satisfied if items that are (or could be) offset pursuant to the first condition are considered (under U.S. tax principles) to be items of: (1) a foreign corporation; or (2) a direct or indirect (for example, through a partnership) owner of an interest in a hybrid entity, provided the interest is not a separate unit.

(a) Indirect foreign use.

i. The proposed regulations did not provide comprehensive examples illustrating when an indirect use of a DCL occurs. The provision was included in the proposed regulation, states the preamble to the final regulations, to address transactions that are structured to avoid the application of § 1503(d) through, for example, the use of a back-to-back lending or conduit financing-type arrangements, or through the use of one or more hybrid instruments.

ii. The final regulations clarify when an indirect foreign use is deemed to occur, include an exception to the general indirect foreign use rule for certain ordinary course transactions, and provide related examples. The indirect foreign use rules are designed to limit an indirect use to situations in which taxpayers have engaged in transactions that have the effect of transferring an item of deduction or loss composing a DCL to another entity for foreign tax purposes, so that it is made available to offset the income of a foreign corporation or the owner of an interest in an entity that is not a separate unit. The preamble states that these rules are intended to target structured transactions that are designed to achieve a double-dip that is contrary to the policies of § 1503(d), and are not intended to apply to ordinary business transactions.

iii. However, there must not be "a principal purpose" of avoiding § 1503(d) to use the "ordinary cause" exception. In some transactions, those involving interest expense that is disregarded for U.S. tax purposes and hybrid instruments, there is a deemed principal purpose.

(b) Exceptions to foreign use.

i. The proposed regulations contained three exceptions to the definition of a foreign use, including an exception where there is no dilution of an interest in a separate unit. The preamble to the proposed regulations stated that a revenue procedure would be issued that would provide additional exceptions (safe harbors) under which a triggering event would be deemed rebutted if various conditions were satisfied, including, in certain cases, a demonstration that there can be no foreign use of a significant portion of the DCL.

ii. The IRS and Treasury believe it is appropriate to include in the regulations certain safe harbors in which a foreign use will be deemed not to occur. As a result, the final regulations (rather than a revenue procedure) set forth additional exceptions to the definition of a foreign use. These exceptions generally apply in cases in which the potential for foreign use is de minimis, or in which the transaction giving rise to a foreign use occurs as a result of events largely outside of the taxpayer's control.

iii. These new exceptions to foreign use include a de minimis rule and rules that apply to certain transactions involving the carry over of asset basis and the assumption of liabilities. However, these new exceptions are limited, and will not be available in many situations.

iv. Another new exception applies to a transaction that qualifies for the multiple-party event exception to a triggering event (referred to as successor elector events under the proposed regulations) in which the acquiring unaffiliated domestic owner or consolidated group owns, immediately after the transaction, more than 90% but less than 100% of the acquired assets or interests. There will not be a trigger solely as a result of the 10%-or-less acquisition.

v. Finally, the final regulations modify the "no dilution" exception contained in the proposed regulations to incorporate a de minimis exception. Unfortunately, this de minimis exception will be unavailable in many cases. Bringing a new foreign partner into a foreign partnership will trigger DCLs in most cases.

(c) Ordering rules for determining foreign use. The current and proposed regulations provide rules for determining the order in which DCLs are used in cases in which the laws of a foreign country provide for the foreign use of the loss, but do not provide applicable rules for determining the order in which the losses are used in a taxable year. The final regulations adopt a rule that the losses will be deemed to be used in a manner that would not result in the recapture of a DCL. One commentator was concerned that in certain cases involving DCLs incurred in different taxable years, the ordering rules could result in losses being deemed to be made available for a foreign use resulting in a recapture, even though there are other losses that, if deemed to be used, would not result in a recapture. The commentator also stated that losses that do not give rise to a foreign use should be deemed used on a "last-in/first-out" basis. These comments were adopted.

(d) Mirror legislation.

i. The current regulations contain a mirror legislation rule that denies the taxpayer the ability to make an election to use a DCL to offset the income of a domestic affiliate when the foreign country has enacted legislation that operates in a manner similar to § 1503(d). Thus, the taxpayer is prohibited from claiming the loss in either country. The final regulations retain the mirror legislation rule, although they modified it somewhat.

ii. Commentators suggested that a "stand-alone" exception to the mirror legislation rule be adopted. This exception would apply when filing a domestic use election with respect to a DCL otherwise subject to the mirror legislation rule would not violate the policies of § 1503(d). This would be the case, stated the commentators, because the mirror legislation in the foreign country would not have the effect of forcing taxpayers to use the losses in the U.S. These commentators suggested that the mirror legislation rule should apply only when there is a foreign affiliate to which the separate unit or DRC could put the DCL to a foreign use. The IRS and Treasury agree: as a result, the final regulations contain a stand-alone exception to the mirror legislation rule.

10. Elimination of a DCL After Certain Transactions.

(a) Both the current and proposed regulations contain rules that eliminate a DCL that is subject to the general restrictions of § 1503(d)(1) following certain transactions. In the case of a DRC,

the DCL is generally eliminated in a transaction described in § 381(a) because the DRC ceases to exist. In the case of a separate unit, the DCL is generally eliminated in a transaction in which the separate unit ceases to be a separate unit of its domestic owner. Both the current and final regulations provide exceptions to the general elimination rule. These exceptions generally apply in cases in which it is possible that income that is generated by the transferee corporation after the transaction is subject to tax in both the U.S. and the foreign country such that it is appropriate for the income to be offset by the DCL that carries over to the transferee.

(b) The final regulations also made certain modifications to the elimination rules. The rules were modified to reflect the expansion of the separate unit combination rule. Thus, the final regulations take into account transactions involving combined separate units that have more than one domestic owner. For example, a DCL of a domestic owner that is attributable to a separate unit will not be eliminated under the final regulations if the separate unit continues to be a separate unit of any member of its domestic owner's consolidated group.

11. Application of SRLY Limitation to a Former DRC.

(a) The proposed regulations provided that a DCL would be treated as a loss incurred by a DRC or separate unit in a separate return limitation year (SRLY) and generally subject to the limitations of the consolidated return SRLY rules. The proposed regulations provided that when determining the general SRLY limitation with respect to a DRC, the calculation of aggregate consolidated taxable income only includes income, gain, deduction, and loss generated in years in which the DRC is a resident (or is taxed on its worldwide income) in the same foreign country in which it was resident (or was taxed on its worldwide income) during the year in which the DCL was generated.

(b) As one commentator noted, this rule prevents the DCL of a DRC from being taken into account by its consolidated group after the DRC ceases to be subject to tax on a residence basis (or on its worldwide income), regardless of whether the former DRC contributes taxable income to the consolidated taxable income of the group. This seems inappropriate, stated that commentator, because it not only limits the use of a DCL from offsetting the income of a domestic affiliate, but it also has the effect of limiting the use of a DCL from offsetting the domestic corporation's own taxable income.

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(c) The IRS and Treasury agreed with this comment. The limitations of § 1503(d)(1) do not prevent the use of a DCL to offset the income of the DRC that incurred the loss, even when the DRC ceases to be subject to tax in the foreign country. As a result, this limitation rule is not contained in the final regulations.

12. Effect of § 1503(d) on Foreign Tax Credits. Some commentators asked whether a creditable foreign tax expenditure incurred by a DRC or separate unit, for which an election is made to claim a credit pursuant to § 901, may be subject to the limitations of § 1503(d)(1). The IRS and Treasury, states the preamble, do not believe that Congress intended the limitations of § 1503(d) to apply to foreign taxes, so long as the foreign taxes do not enter into the computation of a net operating loss (that is, so long as an election is made to claim a credit for those taxes in lieu of deducting them).

13. Tainted Income Rule.

(a) Section 1503(d)(4) authorizes regulations as may be necessary or appropriate to prevent the avoidance of the purposes of § 1503(d) by contributing assets to the corporation with the DCL after the loss is incurred. The current regulations prevent the DCL of a DRC that ceases being a DRC from offsetting the income from assets that are acquired by the DRC in a nonrecognition transaction, or as a contribution to capital, at any time during the three taxable years immediately preceding the taxable year in which the corporation ceases to be a DRC, or at any time thereafter.

(b) The proposed regulations retained the tainted income rule, with certain modifications. Despite certain comments with respect to the source of the tainted assets (distinguishing assets received from an unrelated party from those received from a related party), the tainted asset rule was adopted unchanged in the final regulations. The IRS and Treasury were concerned that commentator's suggestion would require the IRS to trace the source of tainted assets received (for example, to ensure that the rule cannot be avoided through the imposition of an intermediary entity).

14. Items Taken Into Account in Computing Income or a DCL.

(a) The current regulations provides a limited rule for attributing items of a domestic owner to a separate unit. The proposed regulations provided more detailed rules for determining the amount of income or DCL of a separate unit. The determination depends on various factors, including the type of separate unit, the ownership structure, and the nature of the item. The determination generally turns on

whether it is likely that the relevant foreign country would take into account the item (assuming the item is recognized) for tax purposes.

(b) The final regulations adopt the attribution rules contained in the proposed regulations, with some modifications. The preamble to the final regulations also states that this determination is solely for purposes of the DCL rules and does not apply for any other purpose such as attributing items under an applicable income tax treaty or under other Code sections such as §§ 884 or 987.

(c) Books and records.

i. The proposed regulations provided that the items of income, gain, deduction, and loss that are attributable to a hybrid entity are those that are properly reflected on its books and records, as adjusted to conform to U.S. tax principles.

ii. One commentator asked whether this is a strict booking rule, or whether it would permit taxpayers to take positions contrary to how items are reflected on the books and records if, under the facts and circumstances, the items were not appropriately reflected on the books and records. The final regulations clarify that only the IRS, and not the taxpayer, may make adjustments to the books and records when the booking practices are employed with a principle purpose of avoiding the principles of § 1503(d), including inconsistently treating the same or similar items of income, gain, deduction, and loss. In addition, the final regulations clarify that a domestic owner's items of income, gain, deduction, and loss are attributable to the domestic owner's hybrid entity separate unit, or interest in a transparent entity, to the extent these items are reflected on the hybrid entity or transparent entity's books and records, as adjusted to conform to U.S. tax principles.

iii. The preamble states that the books and records standard is intended to be consistent with the more detailed approach for attributing items that was adopted in Prop. Treas. Reg. § 1.987-2(b). The preamble further states that when those regulations are published as final regulations, that approach will, as appropriate, be incorporated in the DCL regulations. The IRS and Treasury believe that applying consistent standards under these two provisions, where appropriate, would make the rules more administrable. Comments are requested in this regard.

(d) Attributing interest expense.

i. The proposed regulations provided that the principles of Treas. Reg. § 1.882-5, as modified, apply for purposes of determining the interest expense that is attributable to a foreign branch separate unit. The IRS and Treasury continue to believe that the principles of Treas. Reg. § 1.882-5, as modified, serve as a reasonable proxy for determining the items of interest expense recognized for U.S. tax purposes that, if recognized by the foreign country, would be taken into account by the foreign country. Therefore, the principles of Treas. Reg. § 1.882-5, as modified, were retained as the general rule for purposes of determining the interest expense that is attributable to a foreign branch separate unit.

ii. However, the final regulations contain an exception to the general rule which provides that interest expense will be treated as attributable to a foreign branch separate unit to the extent it is reflected on its books and records. This exception only applies if the foreign country in which the foreign branch is located determines, for purposes of computing the taxable income or loss under the laws of that foreign country, the interest expense of the foreign branch separate unit by taking into account only the items of interest expense reflected on the foreign branch separate unit's books and records.

(e) Treaty-based methods. The proposed regulations provided that for purposes of determining the items of income, gain, deduction (other than interest), and loss that are taken into account in determining the taxable income or loss of a foreign branch separate unit, the principles of §§ 864(c)(2) and (c)(4) will apply. Despite a comment suggesting a treaty-based approach when applicable, the proposed regulations approach was adopted. The treaty-based suggestion was not adopted.

(f) Gain or loss recognized under § 987. The proposed regulations did not provide whether gain or loss of a domestic owner recognized under § 987 as a result of a remittance or transfer is attributable to a separate unit for purposes of calculating income or a DCL, but instead requested comments. Commentators suggested that gain or loss recognized under § 987 should not be attributable to a separate unit because in most cases the foreign country will not recognize those items since the income of the separate unit is computed in local currency. The IRS and Treasury agree with these comments: as a result, the final regulations provide that any gain or loss

recognized under § 987 as a result of a remittance or transfer will not be taken into account for purposes of computing the income or DCL of a separate unit.

(g) Attributable to or taken into account. The proposed regulations generally provide that items are *attributable to* a hybrid entity separate unit, but are *taken into account by* a foreign branch separate unit. The final regulations provide that items are attributable to a separate unit, regardless of whether the separate unit is a foreign branch separate unit or a hybrid entity separate unit.

15. Basis Adjustments.

(a) The current regulations contain special basis adjustment rules that override the normal investment adjustment rules under Treas. Reg. § 1.502-32 for stock of affiliated DRCs and affiliated domestic owners owned by other members of the consolidated group. These special basis adjustment rules were included to prevent the indirect deduction of a DCL. The proposed regulations retained these rules.

(b) Commentators recommended that the special basis adjustment rules be removed. For example, the commentators noted that an indirect use, which the special basis rules were intended to prevent, may not occur for many years after the DCL was incurred. In response to these comments, the special basis rules are not contained in the final regulations. In fact, they were eliminated retroactively, as discussed further below.

(c) Thus, the basis adjustment rules under Treas. Reg. § 1.1502-32 will apply without modification for purposes of determining the adjusted basis in the stock of a DRC or the stock of an affiliated domestic owner owned by other members of the consolidated group.

(d) The final regulations also contain rules to ensure consistent treatment for a partner's basis in a partnership interest that is a separate unit, or through which a separate unit is owned indirectly.

16. Foreign Insurance Company Treated as Domestic Corporation.

(a) Section 953(d) generally provides that a foreign corporation that would qualify to be taxed as an insurance company if it were a domestic corporation may, under certain circumstances, elect to be treated as a domestic corporation. Section 953(d)(3) provides that if a § 953(d) company is treated as a member of an affiliated group, any loss of the corporation will be treated as a DCL for

purposes of § 1503(d). Although the current regulations do not address the application of § 953(d)(3), the proposed regulations defined a DRC to include a § 953(d) company that is a member of an affiliated group. The proposed regulations also clarified that a § 953(d) company may not make a domestic use election. The final regulations contain these rules, with certain modifications.

(b) The preamble to the final regulations states that taxpayers may be implementing structures that result in the same overall tax consequences as structures that Congress intended be subject to the loss limitation rules provided under §§ 953(d)(3) and 1503(d). For example, a foreign insurance company may, in lieu of making an election under § 953(d), file a certificate of domestication in a state as an LLC. Taxpayers may take the position that this entity is entitled to the same benefits as a company that makes an election under § 953(d), without being subject to limitations on the use of its losses that are imposed under §§ 953(d)(3) and 1503(d).

(c) The IRS and Treasury disagree with any such characterization of these structures under current law. The IRS and Treasury therefore are considering issuing regulations, which may be retroactive, that would clarify the application of § 953(d)(3) to these structures.

17. All or Nothing Rule.

(a) Under the current regulations a triggering event (other than a foreign use) generally can be rebutted only if *no portion* of the DCL can be used by (or carries over to) another person under foreign law. Thus, even a de minimis foreign use will cause the entire amount of the DCL to be recaptured and reported as income. Although the all or nothing principle was retained in the proposed regulations, the IRS and Treasury requested comments.

(b) Several comments were received. A number of commentators suggested that the final regulations should remove the all or nothing principle and allow for a pro rata recapture. Another commentator suggested that the final regulations include a general de minimis rule.

(c) The IRS and Treasury continue to believe that, even under the approaches suggested by these commentators, departing from the all or nothing principle would lead to substantial administrative complexity. As a result, the comments were not adopted.

(d) Although these comments were not adopted in the final regulations, the IRS and Treasury believe that the application of the all or nothing rule will be significantly reduced as a result of

the new exceptions to foreign use and the further reduction of the term of the certification period.

18. Triggering Events and Related Rules.

(a) Modification of exceptions to triggering events.

i. The proposed regulations contained exceptions to triggering events that generally applied when assets or interests sold or disposed of are acquired, directly or through certain wholly-owned pass-through entities, by members of the consolidated group that includes the DRC or separate unit, or by the unaffiliated domestic owner.

ii. The final regulations generally retain these exceptions, but modify them to take into account the new exceptions to foreign use. For example, the exceptions are modified to include certain acquisition by pass-through entities that are more than 90% owned (rather than wholly-owned) by the consolidated group or unaffiliated domestic owner. The final regulations also address certain deemed transactions (for example, pursuant to Rev. Rul. 99-5) to minimize the likelihood that they result in triggering events, when appropriate.

iii. Finally, in response to comments, the regulations contain a new exception to triggering events that occur as a result of certain compulsory transfers.

(b) Rebuttal.

i. Under the current regulations, taxpayers may rebut all but two of the triggering events such that there is no recapture of a certified DCL (or related interest charge) as a result of a triggering event. In general, a triggering event is rebutted if the taxpayer demonstrates to the satisfaction of the IRS that, depending on the triggering event, either: (1) the losses, expenses, or deductions of the DRC (or separate unit) cannot be used to offset income of another person under the laws of a foreign country; or (2) the transfer of assets did not result in a carryover under foreign law of the losses, expenses, or deductions of the DRC (or separate unit).

ii. The proposed regulations generally retained the strict rebuttal standard contained in the current regulations, with some modifications.

iii. One commentator stated that the rebuttal standard of the proposed regulations is unnecessarily broad with respect to certain asset transfers. For example, a triggering event cannot be rebutted under this standard when a separate unit transfers over 50% of its assets in a transaction that does not result in a loss carryover to the transferee under foreign law. This is the case because the separate unit would not be able to establish that the DCL, which did not carry over to the transferee, could never be put to a foreign use. The IRS and Treasury agreed with this comment and the final regulations were modified accordingly. Thus, the rebuttal must show that the transfer of assets did not result in a carryover under foreign law of the losses, expenses, or deductions of the DRC (or separate unit).

iv. Another commentator stated that neither the proposed nor the current regulations specify how taxpayers must demonstrate that there can be no foreign use during the remaining certification period by any means. This lack of specificity creates uncertainty and, as a result, this commentator requested additional guidance as to how the determination can be made. The preamble to the final regulations states that this determination can be made in a number of ways, including based on the taxpayer's interpretation of foreign law, on an opinion from local advisors, or on assurance from local country tax authorities. In all cases, however, the determination must be made to the satisfaction of the IRS.

v. Under the current DCL rules, the IRS has raised many objections to opinions from local advisors and to the taxpayer's interpretation of foreign law. *See, for example,* FSA 200221018. The FSA states that the burden is on the taxpayer to prove that these tests are met. The FSA states that it is a difficult burden to carry. The difficulty arises, states the FSA, because the taxpayer must provide a negative. That is, the taxpayer must show that it cannot use the losses, expenses, or deductions *by any means* to offset the income of another person under the laws of a foreign country. Thus, the final regulations have not improved the situation in this regard.

(c) Reduction of recapture amount. The proposed regulations permitted the elector to reduce the amount of the DCL that must be recaptured on a triggering event. The recapture amount can be reduced to the extent the elector demonstrates that the DCL would have offset other income of the DRC or separate unit reported on a

timely-filed U.S. income tax return for any taxable year up to and including the taxable year of the triggering event if the loss had been subject to the limitation under Treas. Reg. § 1.1503(d)-2(b). The IRS and Treasury continue to believe that the SRLY rules are a reasonable and appropriate mechanism for implementing the restrictions of § 1503(d)(1) in the vast majority of cases. As a result, certain comments were not adopted.

(d) Interest on recapture. Under both the current regulations and the final regulations, taxpayers must pay an interest charge in connection with recapture that is computed under the rules of § 6601. In response to comments, the final regulations clarify that the interest charge is deductible to the same extent as interest under § 6601.

(e) Treatment of recapture income under § 384.

i. One commentator requested clarification regarding a subsequent elector's agreement to treat potential recapture amounts as unrealized built-in gain for purposes of § 384(a). The commentator stated that is may be unclear as to whether § 384 must otherwise apply to the transaction, whether the thresholds of § 384 apply, and whether potential recapture income treated as unrealized built-in gain is subject to reduction for income earned by a separate unit or DRC.

ii. The IRS and Treasury believe that the potential recapture amounts should be treated as unrealized built-in gains for purposes of determining whether § 384 applies, but that the requirements and exceptions of § 384 otherwise apply. The final regulations were modified accordingly.

(f) Reconstituted DCL.

i. Both the current and proposed regulations contain a reconstituted loss provision. This rule generally provides that if a DCL is recaptured as a result of a triggering event, the DRC or separate unit that incurred the loss is treated as having a net operating loss in an amount equal to the amount recaptured. The loss is reconstituted in the taxable year immediately following the year of recapture and is subject to the general restrictions of § 1503(d). This rule is intended to put the taxpayer in the same approximate position it would have been in had it never made an election to use the DCL.

ii. The final regulations modify the proposed regulations' reconstituted loss rule to reflect the expansion of the separate unit combination rule and the rules that eliminate DCLs following certain transactions. In addition, the rule was modified to better take into account the interaction of the DCL rules with the general loss carryover rules. For example, the final regulations provide that, other than with respect to the multi-party event exception, a transfer of an interest in a separate unit by its domestic owner to another corporation cannot cause all or a portion of the DCL of the separate unit to carryover to the acquiring corporation, absent the application of § 381.

19. Certification Period.

(a) The current regulations provide that if a (g)(2) election is made with respect to a DCL of a DRC or hybrid entity separate unit, the consolidated group, unaffiliated DRC, or unaffiliated domestic owner, as the case may be, must file with its tax return an annual certification during a 15-year certification period. The proposed regulations reduced the certification period from 15 years to 7 years and expanded the annual certification requirement to include DCLs of foreign branch separate units.

(b) The final regulations reduce the certification period to five years.

(c) A number of commentators requested that the reduced certification period apply with respect to DCLs that are subject to the current regulations. Commentators also recommended that the reduced certification period contained in the final regulations apply to closing agreements entered into between taxpayers and the IRS, as well.

(d) The IRS and Treasury agree with these comments. Accordingly, under the final regulations, the 5-year certification period will apply to all current DCL (g)(2) agreements, as well as closing agreements thereunder.

20. Other Comments: No Possibility of Foreign Use.

(a) One commentator stated that taxpayers may be eligible to demonstrate no possibility of foreign use, but still choose to enter into a domestic use agreement. The commentator explained that taxpayers may do so to avoid the cost and effort required to satisfy the no possibility of foreign use standard, recognizing that this demonstration would only be beneficial if there is a triggering event during the certification period. The commentator further

stated that the taxpayer should nonetheless retain the ability to argue at a later time, when a foreign use may occur after a change in foreign law, that no DCL existed in the year in which the loss was actually incurred. Thus, if there was a change in foreign law, the taxpayer would not be penalized for being unable to rebut the triggering event in the current year (due to the change in foreign law) but could instead rely on the foreign law in effect for the year in which the loss was incurred.

(b) The preamble states that the IRS and Treasury recognize that taxpayers may simply choose to file a domestic use election, rather than engage in additional efforts to demonstrate no possibility of foreign use. The IRS and Treasury believe that the final regulations provide ample opportunities for taxpayers willing to demonstrate no possibility of foreign use. Taxpayers have three opportunities to demonstrate no possibility of foreign use under the final regulations: first, under Treas. Reg. § 1.1503(d)-6(c) to be excepted from the domestic use limitation; second, under Treas. Reg. § 1.1503(d)-6(e)(2) to rebut a triggering event; and third, under Treas. Reg. § 1.1503(d)-6(j)(2) to terminate a domestic use agreement. Because of these opportunities and the administrative burdens that would ensue from taking into account changes in foreign law, changes were not made to the final regulations as a result of the commentator's suggestions.

21. Effective Dates.

(a) The General Rule. Except as provided in the preamble, the final regulations apply to DCLs incurred in taxable years beginning on or after April 18, 2007. However, a taxpayer may apply the regulations, in their entirety, to DCLs incurred in taxable years beginning on or after January 1, 2007.

(b) Certification Period. As discussed above, the certification period was reduced to five years and is applicable to existing DCL and closing agreements.

(c) Reasonable Cause Exception. As discussed above, the final regulations' reasonable cause procedures apply today to the exclusion of rulings under § 9100 (except for certain closing agreements).

(d) Multi-Party Event Exception to Triggering Events. The final regulations provide an exception to certain triggering events involving multiparties. In general, the exceptions provided under the final regulations with respect to multi-party events are similar to those under the current regulations. One important difference is

that the final regulations do not require (or permit) taxpayers to obtain closing agreements. The final regulations also provide a special effective date with respect to events described in Treas. Reg. § 1.1503-2(g)(2)(iv)(B)(1) that occur after April 18, 2007 that are with respect to DCLs subject to the current regulations. Such events are not eligible for the exception described in Treas. Reg. § 1.1503-2(g)(2)(iv)(B)(1) and thus are not eligible for a closing agreement as described in Treas. Reg. § 1.1503-2(g)(2)(iv)(B)(3)(i). Instead, these events are eligible for the multiple-party event exception described in the final regulations. Taxpayers may, however, choose to apply the multiple-party exception to events described in Treas. Reg. § 1.1503-2(g)(2)(iv)(B)(1)(i-iii) that occur after March 19, 2007 and on or before April 18, 2007.

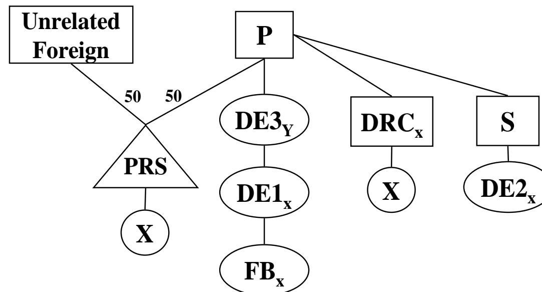
(e) Basis Adjustments. One commentator requested that the elimination of the special basis adjustments be applied retroactively. The commentator further requested that the retroactive application apply to adjustments that occurred in closed taxable years if the basis of the stock is relevant in an open taxable year. The IRS and Treasury agreed with this comment. As a result, the final regulations provide that taxpayers may apply the basis adjustment rules of the final regulations for all taxable years if the adjustments affected tax basis that is relevant in an open taxable year.

(f) Other Provisions. A number of commentators requested that the IRS and Treasury provide that taxpayers be allowed to electively apply other provisions of the regulations to DCLs that are subject to the current regulations. The IRS and Treasury do not believe that it would be appropriate to allow taxpayers to selectively apply provisions of the regulations (other than those that the IRS and Treasury view as clarifications) retroactively, because it would lead to administrative complexity for the IRS and could lead to unintended results.

Dual Consolidated Loss Examples

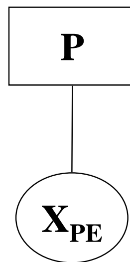
P and S are U.S.

Example 1



The X entities and branches (but not DRC) are combined and treated as a combined separate unit.

Example 2

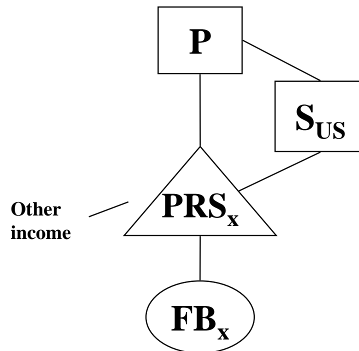


X is a PE of P in country X. It is a foreign branch separate unit. Its year 1 loss is a DCL. This is so even though there is no country X affiliate. Its loss can be carried forward as a SRLY loss, and can offset later income of the X foreign branch separate unit.

Alternative facts. P's country X business does not constitute a PE in country X under the U.S.-country X treaty. Thus, it is not a foreign branch separate unit, and its year 1 loss is not a DCL.

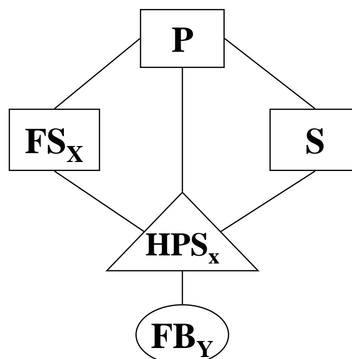
Alternative facts. If P instead carried on business in country X through $DE1_X$, then there would be a hybrid entity separate unit. Its year 1 loss would be a DCL.

Example 3



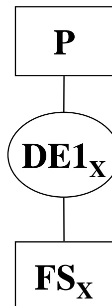
PRS_X earns U.S. source income unconnected with FB_X. The income is not taxable in country X. It also is not attributable to FB_X under Treas. Reg. § 1.1503(d)-5. P's and S's shares of FB_X are foreign branch separate units that are treated as a single combined separate unit. The loss of FB_X cannot offset P's and S's income, including their distributive share of the U.S. source income earned by PRS_X, absent a domestic use election.

Example 4



The partnership interests in HPS_X held by P and S are hybrid entity separate units. They are treated as a single combined separate unit. P's and S's shares of FB_Y are foreign branch separate units. They are treated as a single combined separate unit. DCLs attributable to P's and S's combined interests in HPS_X can only be used to offset income attributable to their combined interests in HPS_X (other than income attributable to P's and S's combined interests in FB_Y), absent a domestic use election. Neither FS_X's interest in HPS_X nor its share of FB_Y is a separate unit.

Example 5

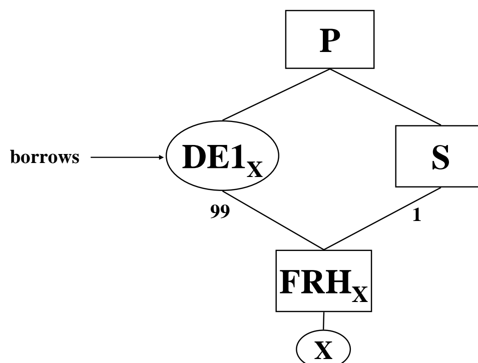


In year 1, there is a \$100 loss attributable to P's interest in $DE1_X$ that is a DCL. FS_X earns \$200. $DE1_X$ and FS_X file a country X consolidated return. The $DE1_X$ loss is available to and does offset FS_X's income. There has been a foreign use of $DE1_X$'s year 1 DCL. P cannot make a domestic use election. The result would be the same even if FS_X had no income (unless FS_X's ability to use the loss requires an election, and no election is made).

Alternative facts. FS_X cannot use the loss without an election, and the election is not made. There is no foreign use. P can make a domestic use election. At the beginning of year 3, P sells $DE1_X$ to a foreign corporation. This is a foreign use triggering event. The loss carries over and is available for use by the purchaser. It also is a foreign use because the loss is available to offset the purchaser's income.

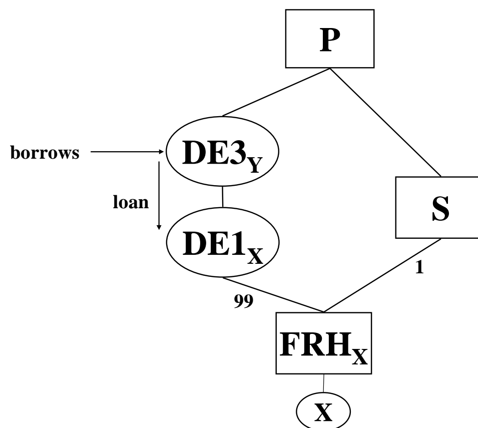
Alternative facts. P sells only a 5% interest in $DE1_X$. Per Rev. Rul. 99-5, P has sold a 5% interest in $DE1_X$'s assets to purchaser, and then a partnership is formed. The sale is a foreign use triggering event because a portion of the loss carries over and is available to offset the income of the purchaser. However, a de minimis exception applies. Thus, there is no foreign use.

Example 6



FRH_X is a partnership in country X checked into a corporation for U.S. tax purposes. $DE1_X$ incurs interest expense on a third-party loan, which is a DCL. $DE1_X$ gets flow through income from FRH and uses the interest expense to reduce its income for country X purposes. This is a foreign use. From a U.S. perspective, FRH_X has the income. $DE1_X$'s DCL offsets FRH_X's income. P cannot make a domestic use election.

Important alternative facts. P owns $DE3_Y$, which owns $DE1_X$. $DE3_Y$ borrows, then lends to $DE1_X$. The $DE3_Y$ to $DE1_X$ loan is a disregarded loan. $DE3_Y$ has a DCL. $DE3_Y$'s DCL is made available for a foreign use because $DE1_X$'s interest expense reduces FRH_X's income. There is an indirect foreign use, and because it involves disregarded interest (disregarded for U.S. tax purposes), it is deemed to have as "a principal purpose" avoiding § 1503(d). P cannot make a domestic use election.



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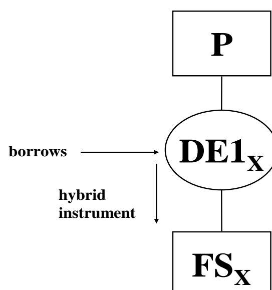
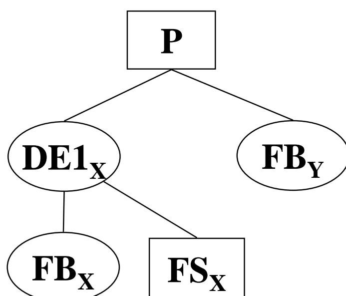
Example 7



$DE1_X$ borrows from an unrelated lender and transfers the cash to FS_X for a hybrid instrument (debt for foreign purposes; equity for U.S. purposes). FS_X pays the amounts owing on the hybrid instrument with its stock, giving rise to a deduction in country X. $DE1_X$ has a DCL, which is made available for a foreign use. Since a hybrid instrument is involved, the transaction is an indirect foreign use with the deemed principal purpose of trying to avoid § 1503(d). P cannot make a domestic use election.

Compare Example 23.

Example 8



P's interest in $DE1_X$ and FB_X are combined into a single separate unit. $DE1_X$ elects to consolidate with FS_X. FB_Y renders services in its service business to unrelated persons and to $DE1_X$. $DE1_X$ pays FB_Y for the services. The payment is a disregarded payment. The country X separate unit and FB_Y each has a DCL. The country X separate unit's DCL is put to a foreign use (the country X consolidation).

The payment by $DE1_X$ to FB_Y has the effect of making FB_Y's DCL available for a foreign use. However, because the transaction was entered into in the ordinary course of FB_Y's business, it will not constitute a foreign use if P can demonstrate it was not entered into with a principal purpose of avoiding § 1503(d). In that case, P can make a domestic use election with respect to FB_Y's DCL.

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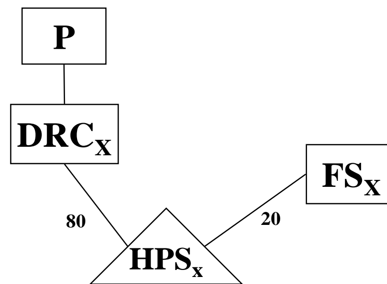
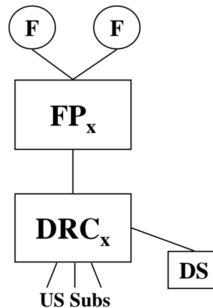
Example 9



DRC_X has a \$100 loss (without regard to DRC_X's interest in HPS_X). HPS_X has \$100 of income, \$80 of which is attributable to DRC_X's interest in HPS_X. DRC_X and HPS_X file a country X consolidated tax return. HPS_X offsets its \$100x of income with the \$100 loss from DRC_X.

DRC_X and its interest in HPS_X are not combined because DRC_X is a DRC. The \$100 loss is a DCL. DRC_X's interest in HPS_X is a hybrid entity separate unit, but one without a DCL. DRC_X's loss offsets \$100 of income for country X purposes, and \$20 of that income is, under U.S. tax rules, income of FS_X, which owns an interest in HPS_X that is not a separate unit. Thus, there is a foreign use. P cannot make a domestic use election. The result would be the same even if HPS_X had no income.

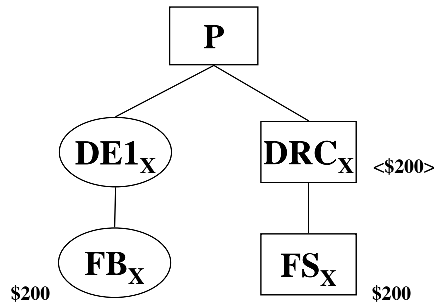
Example 10



DRC_X is the parent of a consolidated group that includes DS. DRC_X has a DCL of \$100. FP_X has \$100 income. FP_X and DRC_X consolidate, and DRC_X's loss offsets FP_X's income. This is a foreign use. This would be the case even if the U.S. did not recognize the items of income earned by FP_X. DRC_X cannot make a domestic use election.

Alternative facts. FP_X is a partnership for U.S. tax purposes. The result is the same. The income would be treated as the income of the foreign owners of FP_X for U.S. tax purposes. There is a foreign use of DRC_X's loss.

Example 11



FB_X and FS_X each earn $200. DRC_X has a DCL of $200. The three country X entities file a country X consolidated return. Country X has no rules for determining which income is offset by DRC_X's $200 DCL. The DCL is treated as having been made available to offset the $200 of P's country X separate unit ($DE1_X$ and FB_X). Thus, there is no foreign use. P can make a domestic use election.

Alternative facts. In year 1, only $150 of income is attributable to P's country X separate units. Thus, $50 of DRC_X's year 1 DCL offset's FS_X's income, or is made available to offset FS_X's income. There is a foreign use. DRC_X cannot make a domestic use election.

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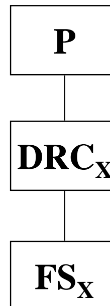
Example 12



Under the country X rules, a consolidated group may elect annually to consolidate. If an election is not made, losses carry forward, and can be used by the group in a future year. There is no ordering rule for determining which losses are used because loss carry forwards never expire.

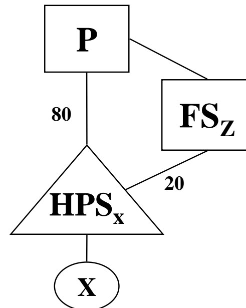
In year 1, DRC_X has a $80 capital loss, not a DCL. DRC_X also has an NOL of $80 which is a DCL. FS_X has $60 of capital gain in year 1, which can be offset with either capital losses or NOLs. DRC_X elects to use $60 of year 1 loss of $160 to offset FS_X's income. The remaining $100 carries forward. This is a foreign use of $30 (pro rata) of the DCL. P cannot make a domestic use election.

In both years 2 and 3, DRC_X has NOLs of $100. FS_X has no income or loss. DRC_X's losses are DCLs. P can make a domestic use election.

In year 4, DRC_X has a $10 NOL. The loss is a DCL. FS_X has $125 of income, and DRC_X and FS_X elect to use DRC_X's losses against FS_X's income. The $10 loss is treated as offsetting FS_X's income. This is a foreign use. P cannot make a domestic use election.

Next, $50 of capital loss carry over and $50 of NOL carry over from year 1 are deemed used. This is not a triggering event. Then, the remaining $15 of FS_X's income is deemed offset by DRC_X's year 3 NOL. The year 3 DCL is recaptured. The year 2 DCL is not.

Example 13

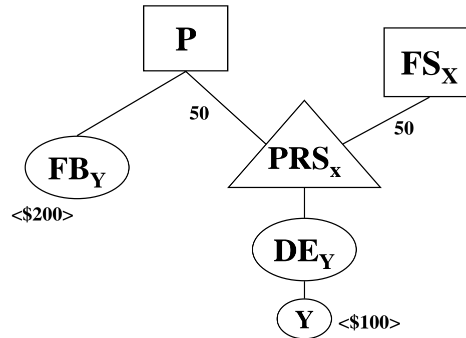


P's interest in HPS_X and the country X branch are separate units combined into a single separate unit. In year 1, HPS_X incurs a $100 loss, $80 of which is a DCL. P makes a domestic use election. In year 2, HPS_X has $50 of income, $40 of which is attributable to P's interest. The year 1 loss is carried forward and offsets the income. While P's DCL offsets income of FS_Z (not a separate unit), there is no foreign use because P's interest in HPS_X was not reduced by more than a de minimis amount.

Alternative facts. P also owns FS_X. FS_X and HPS_X file a consolidated return. This is a foreign use.

Alternative facts. Instead (no consolidated return), FS_X contributes cash to HPS_X at the end of year 2 and receives an equity interest. P is diluted from 80% to 70%. P's interest is reduced by 12.5%. Therefore, in year 2, there is a foreign use, and a triggering event. If FS_X were domestic, there would not be a foreign use or a triggering event.

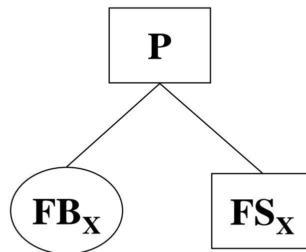
Example 14



FB_Y and P's interests in DE_Y and the Y business are a combined separate unit. In year 1, there is a $250 loss attributable to P's Y combined separate unit. The $250 is a DCL.

As a result of the carryover of Y's $100 loss (including $50 of DCL), a portion of the loss will be available to offset income of DE_Y that is attributable to FS_X's indirect interest (not a separate unit). There would be a foreign use of a portion of the $250 DCL. However, there has not been a reduction of P's interest in DE_Y. There is no foreign use as a result of the carry forward.

Example 15

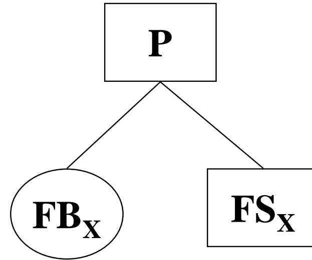


FB_X has a DCL in year 1. The DCL includes depreciation. P makes a domestic use election. At the end of year 2 [year 1?], P contributes a portion of FB_X's assets to FS_X. The adjusted basis of the transferred assets is less than 10% of the aggregate adjusted basis of all of FB_X's assets. A portion of the depreciation deductions taken into account in year 1 for U.S. tax purposes are taken into account in year 2 for country X purposes.

A portion of the year 1 DCL is available for a foreign use. However, the aggregate adjusted basis of all assets transferred in the 12-month period ending at the end of year 2 is less than 10% of FB_X's assets. Not more than 30% of FB_X's assets have been transferred to FS_X during the certification period.

As a result, there is not a foreign use.

Example 16



In year 1, FB_X has a DCL. P makes a domestic use election. The DCL includes a deduction for accrued salary expense, which salary is payable in year 2 which is when it will be deductible locally. P sells the FB_X assets to FS_X for cash and assumption of liabilities.

The DCL is available in part to FS_X due to the assumption of liabilities. However, the item of expense is made available solely as a result of the assumption of a liability of FB_X incurred in the ordinary course of FB_X's business. Thus, there is not a foreign use.

The transfer of all of FB_X's assets is a triggering event unless P can rebut. For purposes of determining whether there is a carryover under foreign law, the exception to foreign use for the assumption of the liability is taken into account. Nonetheless, P must rebut the other triggering events.

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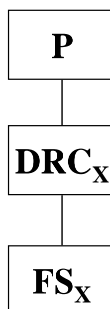
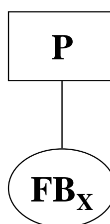
Example 17



In year 1, DRC$_X$ incurs a \$100 NOL that is a DCL. Country X has mirror legislation that prevents FS$_X$ from using the DCL. Thus, there is a deemed foreign use. The stand-alone exception does not apply because, absent the mirror legislation, DRC$_X$'s DCL would be available for a foreign use. This is the case even if country X did not recognize DRC$_X$ as having a loss.

Alternative facts. P owns DE1$_X$ (rather than DRC$_X$). DE1$_X$ has the \$100 DCL. The mirror legislation only applies to DRCs. A domestic use election can be made.

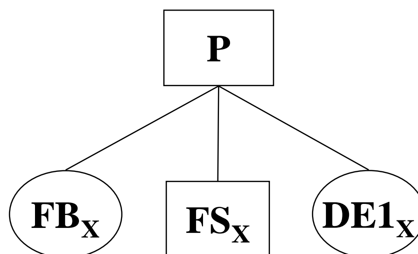
Example 18



FB$_X$ has a \$100 DCL. Country X has mirror legislation which applies to country X branches. Here, the stand-alone exception applies. There is no other country X affiliate. If another X country entity was acquired, or any item of the DCL otherwise was available for a foreign use during the certification period, the DCL would be recaptured.

Alternative fact. The mirror legislation operates in a manner similar to § 1503(d): it permits the taxpayer to chose to put the DCL to a foreign use, but does not deny the opportunity to put the DCL to a foreign use. There is not a deemed foreign use. A domestic use election can be made.

Example 19

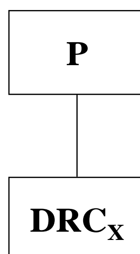


In year 1, there is a \$50 DCL attributable to FB_X and \$10 of income attributable to P's interest in $DE1_X$. FS_X has income of \$100. P's X interests are a combined separate interest, which has a DCL of \$40. Country X has mirror legislation which addresses country X branches. The U.S. and country X have a DCL agreement permitting a DCL to be used in country X.

The mirror legislation does not apply to hybrids such as $DE1_X$. The mirror legislation doesn't apply to FB_X due to the agreement. A domestic use election can be made.

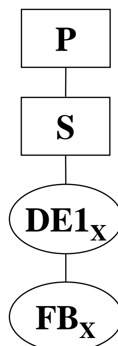
Alternative facts. The country X mirror legislation also applies to losses attributable to $DE1_X$. The mirror agreement does not cover losses attributable to $DE1_X$. The mirror legislation rule would apply with respect to P's interest in $DE1_X$. As a result, there is a deemed foreign use of the DCLs attributable to the country X separate unit and a domestic use election cannot be made. This is the case even though P's interest in $DE1_X$ does not have a DCL. The stand-alone exception does not apply.

Example 20



In year 1, DRC_X incurs a DCL. P does not make a domestic use election. At the beginning of year 2, DRC_X sells its assets for cash and distributes the cash in a § 332 liquidation. § 381 applies. P would succeed to, and be permitted to use, DRC_X's NOL carryover. However, Treas. Reg. § 1.1503(d)-4(d)(1)(i) prohibits the DCL from carrying over to P. Therefore, DRC_X's NOL is eliminated.

Example 21



S's interest in $DE1_X$ and its indirect interest in FB_X are combined and treated as a single separate unit. In year 1, there is a DCL attributable to this separate unit. P does not make a domestic use election. At the beginning of year 2, S transfers its entire interest in $DE1_X$ to FS_X in a transaction described in § 381.

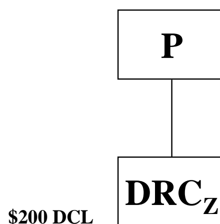
The DCL is eliminated if the separate unit ceases to be a separate unit, as is the case here.

Alternative facts. S instead transfers its assets to DC, a domestic corporation that is not a member of the P consolidated group, in a § 381 transaction. The separate unit is a separate unit of DC. Because the transferee is a domestic corporation and the separate unit is a separate unit of DC, the DCL is not eliminated. Treas. Reg. § 1.1503(d)-4(d)(2)(iii)(A). The SRLY rules continue to apply.

Alternative facts. Same facts, except that P owns $DE2_X$ and the interest in $DE2_X$ is a part of the combined separate unit. The result is the same with respect to the DCL acquired by DC. The portion of the DCL attributable to P's interest in $DE2_X$ does not carryover, but is retained by P and continues to be subject to the SRLY limitations with respect to P's interest in $DE2_X$.

Alternative facts. DC is a member of P's consolidated group. The DCL of the combined separate unit is not eliminated, and income attributable to the combined separate unit may continue to be offset by the DCL subject to the SRLY rules. The result would be the same even if the interest in $DE1_X$ ceased to be a separate unit in the hands of DC (for example, because it dissolved under foreign law in connection with the transfer), provided P or another member of the P group continues to own a portion of the country X separate unit.

Example 22



DRC_Z incurred a DCL of $200 during year 1. P did not make a domestic use election. At the end of year 1, DRC_Z moved its residence to the U.S. and ceased being a DRC. At the beginning of year 2, P transferred asset A, a nondepreciable asset, to DRC_Z. P's basis was $50 and the FMV was $100. This was not replacement property acquired in the ordinary course of business.

DRC_Z did not have income during years 2-4. On June 30 of year 5, DRC_Z sold asset A to an unrelated person for $100. DRC_Z also had operating income in year 5 of $100. The FMV of all of DRC_Z's assets at the end of year 5 was $400.

DRC_Z's DCL cannot be offset by tainted income after it ceased being a DRC. Asset A is a tainted asset. Thus, the $50 of gain in year 5 is tainted income and cannot be offset by the DCL. Absent evidence establishing the actual amount of tainted income, $25 of the $100 year 5 operating income ($100/$400 times $100) also is treated as tainted income and cannot be offset by the DCL.

Therefore, $75 of the $150 year 5 income constitutes tainted income and may not be offset by the year 1 DCL. The remaining $75 of year 5 income may be offset by the DCL.

The result would be the same if the asset was received from a separate unit or transparent entity of DRC_Z.

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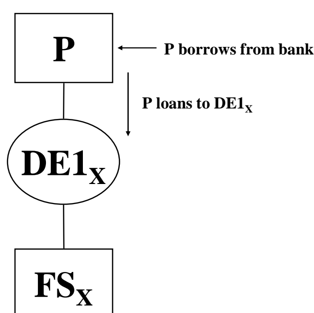
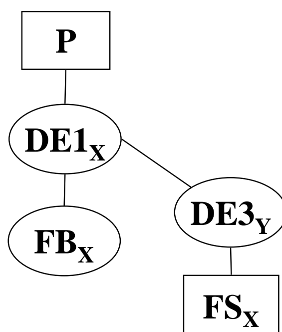
Example 23



P borrows from an unrelated person and on-lends the proceeds to $DE1_X$. $DE1_X$'s interest expense is disregarded. There is no DCL. This is so even though the interest expense is reflected on the books and records of $DE1_X$. It is not taken into account for U.S. purposes since the P loan to $DE1_X$ is disregarded for U.S. tax purposes.

Compare with Example 7.

Example 24

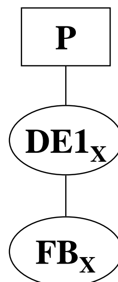


The X units are a combined Country X separate unit. P's country X separate unit has a DCL of $75. FS_X distributes a $50 dividend to $DE3_Y$. $DE3_Y$ distributes this amount to $DE1_X$. The § 78 gross up is $25.

The $50 dividend is reflected on the books of $DE3_Y$ and is attributable to P's interest in $DE3_Y$. The § 78 gross up is also attributable to $DE3_Y$.

The distribution by $DE3_Y$ to $DE1_X$ is a disregarded dividend and is disregarded for DCL purposes. P's country X separate unit still has a DCL of $75. It is not reduced by the distribution from $DE3_Y$.

Example 25



P's country X units are a combined country X separate unit. $DE1_X$'s books reflect sales, depreciation, a political contribution, royalty expense paid to P, repair expenses paid to third parties, and country X income tax.

For purposes of determining the income or DCL, items of income, gain, depreciation and loss must be attributed to separate units. For purposes of attributing items to FB_X, the principles of § 864(c) apply, and for interest expense, Treas. Reg. § 1.882-5.

These items then must be adjusted to conform to U.S. tax principles. Depreciation must be adjusted. The political contribution is not deductible. The royalty is disregarded. The repair expense must be capitalized and amortized. Since P elected to claim foreign tax credits, the foreign tax expense cannot be deducted.

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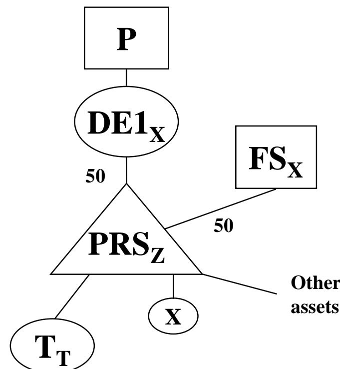
Example 26



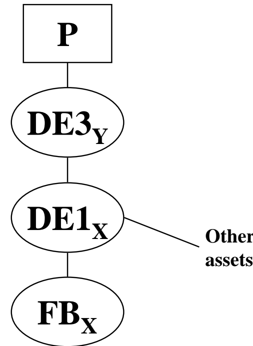
PRS_Z owns assets that are not a part of its country X branch, including all the interests in T_T, a disregarded entity. T_T is an entity incorporated in, *e.g.*, Cayman Islands. A country X interest holder of T_T does not have to take into account on a current basis its share of items of income, gain, deduction and loss of T_T.

P's interests in $DE1_X$ and the X operations are a combined separate unit. The principles of § 864(c) apply for purposes of determining P's items of income, etc. (other than interest to which Treas. Reg. § 1.882-5 applies) attributable to P's indirect interest in the country X operations carried on by P's indirect interest in the country X operations carried on by PRS_Z.

P carries on its share of the country X operations through $DE1_X$. Only the items attributable to P's interest in $DE1_X$, and only the assets, liabilities, and activities of P's interest in $DE1_X$, are taken into account, per $DE1_X$'s books and records. This includes the flow through from PRS_Z to the extent not taken into account by the X operations of PRS_Z.

T_T is a transparent entity. It is not taxable as an association, is not subject to income tax in a foreign country as a corporation (or otherwise at the entity level), and is not treated as a pass-through entity under the laws of country X. T_T is not a separate unit. A loss attributable to T_T would not be a DCL. Nonetheless, items must be attributable to T_T, for example, to separate them in calculating the X DCL. Items of T_T are not treated as reflected on the books and records of $DE1_X$.

Example 27

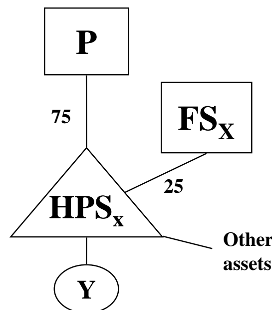


$DE1_X$ and FB_X are combined and treated as a combined separate unit. $DE3_Y$ sells its interest in $DE1_X$ at the end of year 1 and incurs a $30 ordinary loss. Items of income, etc., that give rise to the $30 loss are attributable to the country X separate unit. There are no other items of income, gain, deduction and loss.

The $30 loss is attributable to the country X separate unit, and not P's interest in $DE3_Y$. The loss is a DCL. P cannot make a domestic use election because the sale is a triggering event. The loss also is eliminated.

If there were a DCL attributable to P's interest in $DE3_Y$, the sale of the interest on $DE1_X$ would not be taken into account for purposes of determining whether there is a triggering event with respect to that DCL.

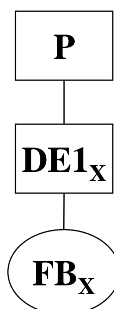
Example 28



P's indirect interest in Y and P's interest in HPS_X are each separate units. P sells its interest in HPS_X and recognizes a gain of $150. P's portion of the Y assets had a built-in gain of $200, and P's portion of HPS_X's other assets had a built-in gain of $100.

Thus, $100 of the $150 gain is attributable to P's indirect interest in its share of the Y operations. Similarly, $50 of the gain is attributable to P's interest in HPS_X.

Example 29



P's interests in $DE1_X$ and FB_X are a combined separate unit. The combined items of income/loss are:

Item	Year 1	Year 2
Sales income	$100	$160
Salary expense	<75>	<75>
R&D	<50>	<50>
Interest expense	<25>	<25>
Income/DCL	$<50>	$10

P does not make a domestic use election with respect to the year 1 DCL. The DCL, which P does not include, is line-by-line. The items not taken into account, for example, are salary expense of $25 ($75/$150 x $50). The remaining amounts are taken into account by P, such as salary expense of $50.

The DCL of $50 is carried forward as a SRLY and offsets the year 2 $10 of income. The calculation is line-by-line, pro rata. Thus, for example, $5 of salary expense from year 1 is deductible ($25/$50 x $10).

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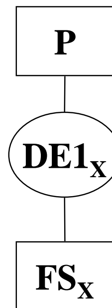
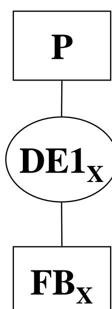
Example 30



The sole item of income, gain, deduction and loss attributable to P's interest in $DE1_X$ is $100 of interest expense paid to an unrelated lender. For country X purposes, the $100 is treated as a repayment of principal which is not deductible.

The $100 is a DCL. It cannot be deducted or capitalized (at any time) for country X tax purposes. Thus, P can demonstrate there has been no foreign use of the DCL at any time. P must attach a statement to its tax return. If it does so, the loss will not be subject to the domestic use limitation.

Example 31



P's X interests are a combined separate unit. The items taken into account are $75 of sales income and $100 of depreciation expense. For country X tax purposes, the depreciation is deductible in year 2. The $25 is a DCL.

P cannot demonstrate that there is no possibility of foreign use because of the depreciation expense. For example, if $DE1_X$ elected to be a corporation and the deferred depreciation expense were available for country X tax purposes to offset year 2 income of $DE1_X$, an entity treated as a foreign corporation in year 2 for U.S. tax purposes, there would be a foreign use.

Alternative facts. The expenses are $100 of interest expense and $25 of depreciation expense. For country X tax purposes, $DE1_X$ generates $75 of sales income, the $100 treated as a repayment of loan principal, and $25 of depreciation expense which is deductible in year 2.

The $50 is a DCL. P cannot demonstrate there is no possibility of foreign use. P cannot demonstrate this as to the depreciation expense, even though the $100 of interest expense is nondeductible, noncapital item for country X tax purposes.

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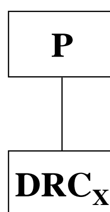
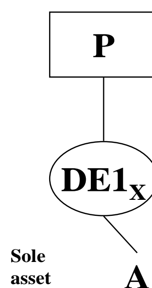
Example 32



DRC_X has a \$100 DCL. P makes a domestic use election. DRC_X has no income or loss in years 2-5. In year 5, P sells the stock of DRC_X to FS_X. The losses in year 1 had expired as an NOL; country X has a 3 year NOL carryforward. The sale normally would constitute a triggering event. However, if P can document that the NOL carryover expired, P can rebut the presumption that a triggering event occurred.

Example 33

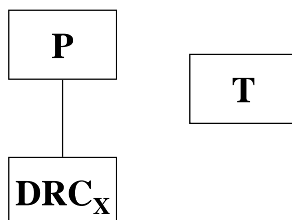


$DE1_X$'s sole asset is A, which $DE1_X$ acquired at the beginning of year 1 for \$100. $DE1_X$ has \$20 of depreciation in year 1. $DE1_X$ has a \$20 DCL. P makes a domestic use election. For country X purposes, A is not a depreciable asset. Thus, there is no loss for country X purposes.

P sells $DE1_X$ during year 2 for \$80. This constitutes a presumptive triggering event. $DE1_X$ retains its basis of \$100 in A following the sale. The deduction composing the DCL thus was retained by $DE1_X$. Thus, the DCL is made available for a foreign use. P cannot demonstrate there can be no foreign use following the triggering event, and must recapture the year 1 DCL.

<u>Alternative facts</u>. Instead of P's selling $DE1_X$, $DE1_X$ sells A to FS_X for \$80. This is a presumptive triggering event. P may demonstrate (for example, by obtaining the opinion of a country X tax advisor) that there can be no foreign use. In such case, P would not be required to recapture the year 1 DCL.

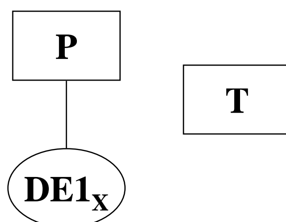
Example 34



DRC_X incurs a DCL. P makes a domestic use election. T acquires P, the parent of a consolidated group, at the end of year 2. P and DRC_X become members of the T consolidated group. This is not a triggering event provided that the T consolidated group files a new domestic use agreement. In that case, the P domestic use agreement is terminated.

T files a new domestic use agreement. A triggering event occurs at the end of year 3. The T consolidated group must recapture the DCL (and pay an interest charge). Each member of the T consolidated group, including DRC_X and former members of the P consolidated group, is severally liable for the tax.

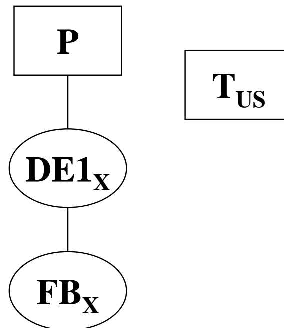
Example 35



In year 1, $DE1_X$ has a $100 DCL. P files a domestic use agreement. In year 2, P sells a 33% in $DE1_X$ to T, an unrelated domestic company. Pursuant to Rev. Rul. 99-5, P is treated as selling a 33% interest in each of $DE1_X$'s assets to T following which P and T contribute the assets to a partnership. On the sale, a foreign use does not occur. However, P's deemed transfer of a 67% interest in the assets to a partnership nominally constitutes a triggering event. The deemed asset transfer, however, is not a triggering event under Treas. Reg. § 1.1503(d)-6(f)(4).

Alternative facts. Instead, P sells a 60% interest in $DE1_X$ to T. The sale is a triggering event without regard to the occurrence of a deemed transaction.

Example 36

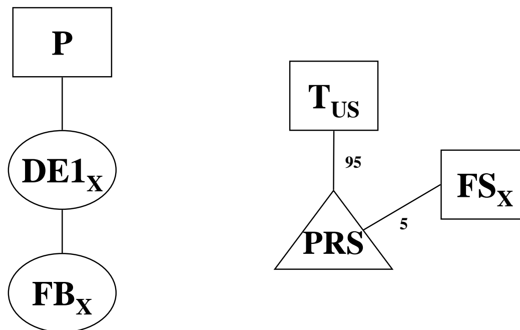


In year 1, the X combined separate unit has a \$100 DCL. P makes a domestic use election. At the end of year 2, T, the parent of the T consolidated group, acquires all of P's interest in $DE1_X$ for cash.

The acquisition by T of the interest is not a event requiring the recapture of the year 1 DCL provided (1) the T consolidated group files a new domestic use agreement, and (2) the P consolidated group files the necessary statement. If so, the domestic use agreement filed by the P consolidated group is terminated.

A triggering event occurs at the end of year 3. If the T group does not pay the recapture tax, the P group is liable. In such a case, T has a reconstituted NOL.

Example 37



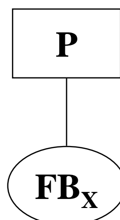
The country X combined separate unit has a year 1 $100 DCL. P makes a domestic use election. At the beginning of year 3, PRS purchases $DE1_X$. $DE1_X$'s year 1 NOL continues to carry forward.

P's sale of its interest in $DE1_X$ is a triggering event. However, if P and T comply with the requirements under Treas. Reg. § 1.1503(d)-6(f)(2)(iii), the sale will qualify for the multiple-party event exception.

In addition, because the $100 DCL carries over, there is a foreign use immediately after the sale. The DCL is made available to offset income that is considered, under U.S. tax principles, to constitute income of FS_X. FS_X's interest in PRS is not a separate unit.

However, there is no foreign use here under Treas. Reg. § 1.1503(d)-3(c)(8). The acquiring unaffiliated domestic owner or consolidated group owns, directly or indirectly, more than 90% of the transferred assets or interests immediately after the transaction. Thus, there is no foreign use with respect to the less than 10% interest.

Example 38



In year 1, FB_X's items of income, gain, deduction and loss giving rise to its $25 DCL are: sales income $100; salary expense $75; and interest expense $50. P makes a domestic use election.

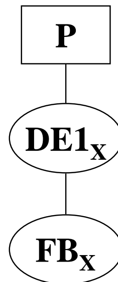
Under Treas. Reg. § 1.861-8, the $75 of salary expense is allocated to foreign source general limitation income. Pursuant to Temp. Treas. Reg. § 1.861-9T, the $50 of interest expense is allocated $25 to U.S. source income, $15 to foreign source general limitation income, and $10 to foreign source passive income.

During year 2, $5 of income is attributable to FB_X and the P consolidated group has positive income. At the end of year 2, there is a triggering event, and P continues to own FB_X. P is able to demonstrate that the $25 year 1 DCL would have offset the year 2 $5 of income if a domestic use election had not been made (under the SRLY rules).

P must recapture and report as ordinary income $20, plus applicable interest. By relation-back, the $20 of recapture income is characterized and sourced as follows: $4 domestic source income (($25/$125) x $20); $14.4 foreign source general limitation income ((($75 + $15)/$125) x $20); and $1.6 foreign source passive income (($10/$125) x $20).

Beginning in year 3, the $20 recapture amount is reconstituted and treated as an NOL incurred by FB_X in a SRLY, subject to those rules. The domestic use agreement is terminated.

Example 39

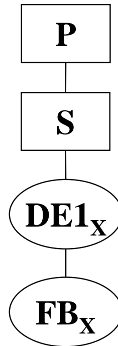


P's country X combined separate unit has a $100 DCL in year 1. P makes a domestic use election. In year 2, the X separate unit has $100 of income, and the P consolidated group has $200 of income. At the end of year 2, there is a triggering event.

P demonstrates this if a domestic use election had not been made, the year 1 DCL would have been offset by the $100 of year 2 income (under the SRLY rules).

There is no recapture of the year 1 DCL. The DCL amount is reduced to zero. However, P is still liable for an interest charge because the P group had the benefit of the DCL in year 1, and did not have to wait until year 2 to use the DCL.

Example 40



In year 1, S's country X combined separate unit has a $100 DCL. P makes a domestic use election. In year 2, $30 of income is attributable to the X separate unit. The income is offset by a $30 NOL incurred by P in that year.

In year 3, the X separate unit earns $25 of income, and P earns $15 of income. At the end of year 3, there is a foreign use that constitutes a triggering event

Under the presumptive rule of Treas. Reg. § 1.1503(d)-6(h)(1)(i), S must recapture $100. However, S may be able to demonstrate that a lesser amount is subject to recapture. The lesser amount is the amount of the DCL that would have remained subject to recapture if a domestic use election had not been made.

Although the X separate unit earned $30 of income in year 2, there was no consolidated taxable income that year. As a result, the $100 DCL would continue to be subject to the SRLY rules if a domestic use election had not been made. However, the $30 earned in year 2 can be carried forward.

In year 3, the X separate unit had $25 of taxable income. The consolidated group earned $40 of income in total, including the $25. As a result, the DCL is reduced by the $40. If a domestic use election had not been made, only $60 of DCL would have remained.

Commencing in year 4, the $60 recapture amount is reconstituted and treated as a SRLY NOL. It can only be carried forward to years after year 3. The carryover period starts with year 1. The domestic use agreement is terminated.

Alternative facts. The triggering event that occurs at the end of year 3 is a sale by S of its entire interest in $DE1_X$ to B, an unrelated domestic corporation. The sale does not qualify under § 381.

The results are the same as above, except that the $60 is not reconstituted (with respect to either S or B). The loss is not reconstituted as to S because the X

separate unit ceases to be a separate unit of S, and therefore would have been eliminated if a domestic use election had not been made.

The loss is not reconstituted with respect to B because B was not the domestic owner when the DCL was incurred, and B did not acquire the X separate unit in a § 381 transaction.