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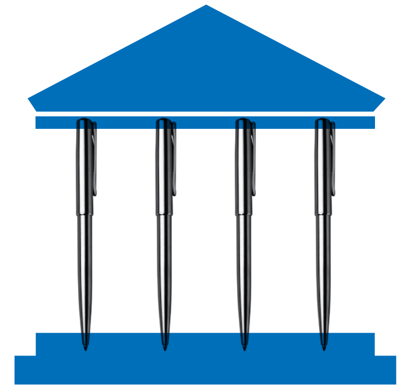

Doubling up:

Proposed regulations address interaction of dual consolidated loss rules and GloBE Model Rules, disregarded payment losses

Proposed regulations addressing the application of the section 1503(d) "dual consolidated loss" or "DCL" rules were published by the Internal Revenue Service and Treasury on August 7, 2024 (Proposed Regulations).[1] The Proposed Regulations address certain considerations with respect to the operation of the DCL rules, as well as the interaction of the DCL Rules with foreign-country laws that are based on the global minimum tax model rules published by the Organisation for Economic Cooperation and Development (OECD) (GloBE Model Rules). The Proposed Regulations also include new rules to require income inclusions in connection with "disregarded payment losses", which generally are certain payments that are disregarded for US federal income tax purposes but that give rise to losses or deductions for foreign tax purposes.

The Proposed Regulations are, in large part, intended to curb transactions that are perceived to be inconsistent with the policy objectives of the DCL rules. With respect to the interaction with the GloBE Model Rules, the Proposed Regulations generally provide that the application of such rules may result in a "foreign use," of a DCL, largely rejecting comments that were made in response to Notice 2023-80 that argued for limiting the circumstances under which the application of the GloBE Model Rules could result in a foreign use of a DCL. The disregarded payment loss rules are a significant expansion of existing rules that impact the use of foreign disregarded entities by US taxpayers, and could materially increase compliance burdens. Comments on the Proposed Regulations are requested to be provided by October 7, 2024.

A. The Section 1503(d) DCL Rules – In General

Section 1503(d) of the Code, and the regulations thereunder, limit the use of a DCL to offset US taxable income. The purpose of the DCL rules is to prevent double dipping, which may occur when a loss is used to offset both income subject to US tax (but not a foreign jurisdiction tax) and income subject to foreign tax (but not US tax).[2]

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1 *See* Notice of Proposed Rulemaking, Rules Regarding Dual Consolidated Losses and the Treatment of Certain Disregarded Payments, 89 Fed. Reg. 152, 64,750 (Aug. 7, 2024) (Proposed Regulations). References to "section" herein are to sections of the Internal Revenue Code of 1986, as amended (Code), and references to "Treas. Reg. §," "Temp. Treas. Reg. §" and "Prop. Treas. Reg. §" are to final, temporary and proposed regulations issued under the Code.

2 *See* Preamble to the Proposed Regulations, 89 Fed. Reg. 152 at 64,750, citing S. Rep. No. 99-313, 99th Cong. 2d Sess. at 419-20 (1986).

1. Definition of a DCL

   A "DCL" is defined as (i) a net operating loss of a domestic corporation that is incurred in a year in which the corporation is a "dual resident corporation," and (ii) a net operating loss attributable to a "separate unit" of a domestic corporation.[3] A dual resident corporation is a domestic corporation that is subject to the income tax of a foreign country on its worldwide income or on a residence basis.[4]

   A separate unit includes (1) a foreign branch (i.e., a business operation carried on by a domestic corporation outside the US) (FBSU);[5] and (2) an interest in an entity that is not taxable as a corporation for US tax purposes, but is subject to non-US tax at the entity level on its worldwide income or on a residence basis (i.e., hybrid entity) (HESU).[6]

   Under the "separate unit combination rule," if a domestic owner, or two or more domestic owners that are members of the same US consolidated group, have two or more separate units, then all such separate units that are located (in the case of an FBSU) or subject to tax on a worldwide or residence basis (in the case of an HESU) in the same foreign country are treated as one combined separate unit.[7] Any individual separate unit composing a combined separate unit loses its character as an individual separate unit, except as specifically provided in the regulations.[8]

2. Calculation of the DCL

   Specific rules apply for purposes of determining the amount of income or loss of a separate unit.[9] Under these rules, only items of income, gain or loss of the separate unit or its owner (or owners in the case of a combined separate unit) are taken into account.[10] The rules apply "separately to each separate unit or interest in a transparent entity."[11]

   In the case of an FBSU, the items of income, gain, deduction and loss of a domestic owner that are attributable to the separate unit are determined based on US tax principles, specifically section 864(c)(2), (4) and (5) and the regulations thereunder, with certain modifications.[12] In the case of an HESU, the items of income, gain, deduction and loss of the domestic owner that are attributable to the separate unit generally are those items that are "reflected on the books and records of the hybrid entity . . . as adjusted to conform to US tax principles."[13] Foreign tax treatment is not relevant for purposes of determining whether items are on the books and records or for purposes of making adjustments to such items to conform to US tax principles.[14]

   In the case of a combined separate unit, allocation is done by first determining the items attributable to each individual separate unit, then the combined separate unit takes into account all of the items attributable to the individual separate units.[15]

3. The Domestic Use Limitation

   Generally, the domestic use of a DCL is not permitted, except as provided in the regulations.[16] Unless an exception applies, the regulations only allow the DCL to be used to offset income of the specific

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3 *See* Treas. Reg. § 1.1503(d)-1(b)(5).

4 Treas. Reg. § 1.1503(d)-1(b)(2).

5 For the definition of a foreign branch, *see generally* Temp. Treas. Reg. § 1.367(a)-6T(g)(1). Evidence that a foreign branch exists includes, but is not limited to, the existence of a separate set of books and records, and the existence of an office used by employees or officers of the US taxpayer in carrying out business activities outside of the US. A permanent establishment is considered to be a foreign branch under the regulations.

6 *See* Treas. Reg. § 1.1503(d)-1(b)(4).

7 Treas. Reg. § 1.1503(d)-1(b)(4)(ii).

8 *Id.*

9 *See generally* Treas. Reg. § 1.1503(d)-5.

10 Treas. Reg. § 1.1503(d)-5(c)(1)(ii).

11 Treas. Reg. § 1.1503(d)-5(c)(1)(iii).

12 *See Treas.* Reg. § 1.1503(d)-5(c)(2)(i).

13 Treas. Reg. § 1.1503(d)-5(c)(3)(i).

14 *Id.;* Treas. Reg. § 1.1503(d)-5(d). An anti-abuse rule allows the IRS to reallocate items if it determines that the method used was used with a principal purpose of avoiding the DCL rules. *See* Treas. Reg. § 1.1503(d)-5(c)(3)(i).

15 *See* Treas. Reg. § 1.1503(d)-5(c)(4)(ii).

16 *See* section 1503(d)(1)-(3); Treas. Reg. § 1.1503(d)-4(b).

dual resident corporation or separate unit that generated the loss.[17] There are several exceptions to the domestic use limitation: (i) elective agreement with the foreign country;[18] (ii) no possibility of foreign use;[19] and (iii) the "domestic use election" or DUE.[20] In practice, the DUE is the most commonly applied exception.

4. The Domestic Use Election

In order to make a DUE, a taxpayer generally must include a statement with its tax return certifying, among other things, that there has not been and will not, during the 5-year period following the year in which the DCL is incurred, be a "foreign use" as defined in the regulations.[21] A DUE may not be made if there is a triggering event (and no exception applies) in the year that the DCL is incurred.[22]

Except as specifically provided, a foreign use is deemed to occur "when any portion of a deduction or loss taken into account in computing the dual consolidated loss is made available under the income tax laws of a foreign country to offset or reduce, directly or indirectly, any item that is recognized as income or gain under such laws and that is, or would be, considered under US tax principles to be an item of" (i) a foreign corporation; or (ii) a direct or indirect owner of an interest in a hybrid entity that is not a separate unit.[23] An item of deduction or loss is considered to be made available indirectly if it is taken into account for foreign tax purposes but does not give rise to corresponding items of income or gain for US tax purposes and has the effect of making a loss available for a foreign use, unless the transactions were undertaken in the ordinary course of the taxpayer's trade or business and not for a principal purpose of avoiding section 1503(d).[24] A foreign use is deemed to occur in the first year in which "any portion of a deduction or loss taken into account in computing the dual consolidated loss is made available for an offset . . ., regardless of whether it actually offsets or reduces any items of income or gain under the income tax laws of the foreign country in such year, and regardless of whether any of the items that may be so offset or reduced are regarded as income under US tax principles."[25]

Certain exceptions to a foreign use apply, including:

- If the laws of a foreign country allow an election that would enable a foreign use, then a foreign use occurs only if the election is made.[26]
- If the foreign law provides for offset that would not constitute a foreign use before an offset that would constitute a foreign use.[27]
- In the case of certain basis transfers.[28]
- In the case of certain ordinary course assumptions of liabilities.[29]

Under the mirror legislation rule, a foreign use is generally deemed to occur if the income tax laws of a foreign country would deny any opportunity for the use of the DCL in the year in which the DCL is incurred, on the basis that either: (i) "The dual resident corporation or separate unit that incurred the loss is subject to income taxation by another country (for example, the United States) on its worldwide income or on a residence basis;" (ii) "The loss may be available to offset income (other than income of the dual resident corporation or separate unit) under the laws of another country (for example, the United States)," or (iii) "The deductibility of any portion of a deduction or loss taken into account in computing the dual consolidated loss depends on whether such amount is deductible under the laws of another country (for example, the United States)."[30]

17 *See* Treas. Reg. § 1.1503(d)-4(c).
18 Treas. Reg. § 1.1503(d)-6(b).
19 Treas. Reg. § 1.1503(d)-6(c).
20 Treas. Reg. § 1.1503(d)-6(d).
21 *See* Treas. Reg. § 1.1503(d)-6(d)(1).
22 Treas. Reg. § 1.1503(d)-6(d)(2).
23 Treas. Reg. § 1.1503(d)-3(a)(1).
24 Treas. Reg. § 1.1503(d)-3(a)(2).
25 Treas. Reg. § 1.1503(d)-3(b).
26 Treas. Reg. § 1.1503(d)-3(c)(2).
27 Treas. Reg. § 1.1503(d)-3(c)(3).
28 *See* Treas. Reg. § 1.1503(d)-3(c)(6).
29 *See* Treas. Reg. § 1.1503(d)-3(c)(7).
30 Treas. Reg. § 1.1503(d)-3(e)(1).

5. DCL Recapture Triggering Events

   Certain "triggering events," if they occur within the five-year certification period, require the recapture of a DCL for which a DUE has been made. Triggering events include, inter alia, a foreign use.[31] Triggering events may be rebutted in certain circumstances, including: (i) if the taxpayer demonstrates that there can be no foreign use of the DCL during the remaining certification period;[32] or (ii) in the case of an asset transfer, the taxpayer demonstrates that the transfer of assets did not result in a carryover under foreign law of the separate unit's losses, expenses or deductions to the transferee.[33]

B. The GloBE Model Rules

Beginning in 2023, a number of foreign jurisdictions have adopted rules implementing the GloBE Model Rules as promulgated by the OECD.

The GloBE Model Rules "provide for a co-ordinated system of taxation intended to ensure large multinational enterprise (MNE) groups pay a minimum level of tax on the income arising in each of the jurisdictions in which they operate. It does so by imposing a top-up tax on profits arising in a jurisdiction whenever the effective tax rate, determined on a jurisdictional basis, is below the minimum rate."[34]

Under the Income Inclusion Rule (IIR), a parent entity is required to pay tax in an amount equal to its allocable share of the Top-Up Tax for the Fiscal Year of a Low-Taxed Constituent Entity in which it owns an interest.[35] A Constituent Entity is any Entity that is included in a Group, and any Permanent Establishment of a Main Entity that is included in a Group.[36] No IIR tax is required to be paid by an intermediate parent entity if a higher-tier parent entity is subject to a Qualified IIR. The Top-Up Tax of a Low-Taxed Constituent Entity is determined under specific calculation rules as described below.[37]

The GloBE Model Rules contemplate the existence of a "Qualified Domestic Minimum Top-Up Tax" (QDMTT), pursuant to which a jurisdiction imposes a top-up tax on Constituent Entities located in that jurisdiction, generally on the same basis as the IIR, and which takes precedence over another jurisdiction's IIR.[38] For purposes of the GloBE Model Rules, income or loss of a Constituent Entity is determined on the basis of financial accounting for such entity and making certain specified adjustments.[39] The determination is made on an entity-by-entity basis.[40] Adjustments are made for net tax expense, excluded dividends, excluded equity gain or loss, included revaluation method gain or loss, gain or loss from asset dispositions, asymmetric foreign currency gains or losses, policy disallowed expenses, prior period errors and changes in accounting, and accrued pension expense.[41] Special adjustments may be made for stock-based compensation.[42] In addition, non-arm's length transactions must be adjusted so as to be arm's length.[43]

For purposes of the GloBE Model Rules, Adjusted Covered Taxes of a Constituent Entity for each fiscal year are the current tax expense accrued for financial accounting purposes, with certain adjustments.[44] Covered Taxes include taxes on income and profits, as well as on the income and profits of a constituent entity in which the entity owns an interest; taxes on distributed profits and deemed profit distributions; taxes in lieu of corporate income tax; and taxes on retained earnings.[45] Covered Taxes do not include Top-Up Taxes under a Qualified IIR or under a QDMTT.[46]

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31 Treas. Reg. § 1.1503(d)-6(e)(1)(i).
32 Treas. Reg. § 1.1503(d)-6(e)(2)(i).
33 Treas. Reg. § 1.1503(d)-6(e)(2)(ii).
34 Pillar Two Rules, Executive Summary, available at https://www.oecd-ilibrary.org/deliver/782bac33-en.pdf?itemId=%2Fcontent%2Fpublication%2F782bac33-en&mimeType=pdf.
35 Pillar Two Rules, Article 2.1.
36 Pillar Two Rules, Article 1.3.
37 Pillar Two Rules, Article 2.2.
38 Pillar Two Rules, Article 10.1.1, definition of "Qualified Domestic Minimum Top-Up Tax"; Article 5.2.3 (calculation of Jurisdictional Top-Up Tax under the IIR, which gives precedence to amounts payable under a QDMTT).
39 Pillar Two Rules, Article 3.
40 Pillar Two Rules, Article 3.1.2.
41 Pillar Two Rules, Article 3.2.1.
42 Pillar Two Rules, Article 3.2.2.
43 Pillar Two Rules, Article 3.2.3.
44 Pillar Two Rules, Article 4.
45 Pillar Two Rules, Article 4.2.1.
46 Pillar Two Rules, Article 4.2.2.

Under the GloBE Model Rules, an MNE group must calculate its effective tax rate (ETR) for each jurisdiction in which it operates.[47] This is equal to the sum of the Adjusted Covered Taxes of each Constituent Entity located in the jurisdiction, divided by the Net GloBE Income of the jurisdiction for the Fiscal Year.[48] All of the GloBE Income of Constituent Entities in the jurisdiction is added together, and then all of the GloBE Losses of all Constituent Entities in the jurisdiction is subtracted from this amount.[49] A Top-Up Tax Percentage is determined as the 15% GloBE minimum rate minus the ETR determined above.[50] Excess Profit in a jurisdiction is the Net GloBE Income minus the Substance Based Income Exclusion (SBIE), which provides carve-outs for a percentage of certain payroll costs and a percentage of the carrying value of certain tangible assets located in the jurisdiction.[51]

The Jurisdictional Top-Up Tax is generally equal to the Top-Up Tax Percentage multiplied by the Excess Profit, with certain adjustments.[52] The Top-Up Tax of a Constituent Entity generally is determined as the total Jurisdictional Top-Up Tax multiplied by the GloBE Income of such Constituent Entity divided by the Aggregate GloBE Income of all Constituent Entities in the jurisdiction that have positive income amounts. Any Top-Up Tax that is not collected under a QDMTT can be collected under an IIR or a UTPR.

Under a transitional safe harbor rule, the top up tax that is required for a jurisdiction is reduced to zero if one of three criteria are met: (i) a de minimis test, (ii) a simplified ETR test, or (iii) a routine profits test. Under the de minimis test, if the jurisdiction has total CbCR revenue of less than EUR 10 million and the CbCR profit before income tax is less than EUR 1 million, the top up tax is zero. The simplified ETR test similarly reduces the top up tax to zero if the jurisdictional ETR is equal to or greater than a transitional rate for the fiscal year (15% for 2023 and 2024; 16% for 2025; and 17% for 2026). The simplified ETR is calculated by dividing income tax reported on the financial statements minus taxes that are not covered taxes or taxes related to uncertain tax positions) by the profit or loss reported on the group's CbCR. Finally, the routine profits test safe harbor applies when the tested jurisdiction's profit or loss before income tax for the jurisdiction is less than or equal to the SBIE for constituent entities reported in that jurisdiction under the CbCR.

The GloBE Model Rules are model rules, which are intended to be the basis for rules adopted in specific jurisdictions. A number of foreign jurisdictions have already adopted rules that are based on the GloBE Model Rules.

C. Notice 2023-80

In Notice 2023-80, the IRS addressed the potential interaction of the DCL rules with laws that implement the GloBE Model Rules. The Notice explains that the

> Jurisdictional Top-up Tax is based on, among other factors such as Adjusted Covered Taxes, the Net GloBE Income of Constituent Entities within the jurisdiction. For this purpose the GloBE Model Rules take a jurisdictional blending approach under which all income and loss of Constituent Entities in the same jurisdiction are generally aggregated. This aggregation can be viewed as giving rise to double dipping concerns that the DCL rules were intended to address. For example, if, in determining Net GloBE Income of a jurisdiction, a loss giving rise to a DCL is aggregated with items that under US tax principles are items of a foreign corporation in that jurisdiction, the loss would be available to reduce both US tax (if a domestic use election were permitted) and the Jurisdictional Top-up Tax.[53]

The Notice also recognizes that the GloBE Model rules do not allow taxpayers to decline aggregation, "with the result that the taxpayer might effectively be required to put a DCL to a foreign use (thereby removing what otherwise may have been a choice between a domestic use and a foreign use)."[54] The Notice further recognizes that in situations where the ETR of a jurisdiction is above the minimum rate, a loss may never produce a benefit under a QDMTT.[55]

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47 Pillar Two Rules, Article 5.
48 Pillar Two Rules, Article 5.1.1.
49 Pillar Two Rules, Article 5.1.2.
50 *Id.*
51 Pillar Two Rules, Article 5.2.2.
52 Pillar Two Rules, Article 5.2.3.
53 Notice 2023-80, § 3.02.
54 *Id.*
55 *Id.*

The Notice indicated the IRS's intent to issue regulations providing, with respect to DCLs incurred in taxable years ending before December 31, 2023, that a foreign use is not deemed to occur with respect to the application of GloBE Model Rules.[56] The Notice allowed taxpayers to rely on the Notice until additional guidance is issued.[57]

D. The Proposed DCL Regulations

The Proposed Regulations follow from the study that was undertaken by IRS and Treasury in connection with the Notice and can be separated into three parts: (i) clarification and modification of existing rules affecting the computation of DCLs, (ii) applicability of the DCL Rules with respect to the operation of the GloBE Model Rules, and (iii) proposed rules relating to certain disregarded payments that give rise to foreign losses.

– Clarification and Modification of Existing Rules

1. Coordination with the Intercompany Transaction Rules

Initially, the Proposed Regulations address certain questions regarding the interaction of the DCL rules with the intercompany transaction rules of section 1502 and Treasury Regulation section 1.1502-13. Under general tax accounting rules, an entity that receives income with respect to the performance of services is required to recognize such income when the "all events test" is satisfied.[58] However, these rules are modified in the case of transactions between members of a consolidated group.[59] The DCL rules provide that for the purpose of determining the income or dual consolidated loss attributable to a separate unit, the determination is made in accordance with the intercompany transaction rules set forth in the consolidated return regulations.[60]

Under those rules, an "intercompany transaction" is a transaction between corporations that are members of the same consolidated group immediately after the transaction.[61] In the case of a services transaction, S is the member performing the services and B is the member receiving the services.[62] S's income, gain, deduction, and loss from an intercompany transaction are its "intercompany items."[63] The regulations provide that costs or expenses related to an intercompany transaction are included in determining intercompany items.[64] B's income, gain, deduction, and loss from an intercompany transaction are its "corresponding items."[65]

Under the "matching rule," S takes its intercompany item into account to reflect the difference for the year between B's corresponding item taken into account and the amount that would have been taken into account if S and B were divisions of a single corporation.[66] In other words, where S is performing services for B, S takes into account its intercompany income item as B takes into account the related deductions.[67]

The Proposed Regulations clarify that a "section 1503(d) member" has "special status" under the intercompany transaction rules with respect to its intercompany or corresponding items for purposes of applying the DCL rules to those items.[68] A section 1503(d) member is an affiliated dual resident corporation or a member of the affiliated group that is acting through a separate unit that is disregarded from such member.[69] In determining the section 1503(d) member's intercompany or corresponding items, the intercompany transaction rules apply before the DCL rules.[70] To the extent an item of deduction or loss that

56 *Id.* at § 3.03.
57 *Id.* at § 3.04.
58 Section 451(a).
59 *See generally,* Treas. Reg. § 1.1502-13.
60 *See* Treas. Reg. § 1.1503(d)-5(c)(1)(i).
61 Treas. Reg. § 1.1502-13(b)(1)(i).
62 *Id.*
63 Treas. Reg. § 1.1502-13(b)(2)(i).
64 Treas. Reg. § 1.1502-13(b)(2)(ii).
65 Treas. Reg. § 1.1502-13(b)(3)(i). For example, if S performs services for B for which it charges $100, but pays $80 of expenses and equipment in the performance of those services, S's intercompany item is $20. B's corresponding item is $100. *See* Treas. Reg. § 1.1502-13(c)(7)(ii)(G), Example 7.
66 *See* Treas. Reg. §§ 1.1502-13(c)(2)(i), (ii).
67 Using the example above, assuming that B is required to amortize its $100 of expense ratably over 10 years, S would recognize only $82 of gross income with respect to the services transaction in year 1, the $80 of gross income for which there were related expenses, and $2 of the $20 intercompany item under the matching rule.
68 *See* Treas. Reg. § 1.1502-13(c)(5).
69 Prop. Treas. Reg. § 1.1502-13(j)(10)(i).
70 Prop. Treas. Reg. § 1.1502-13(j)(10)(ii).

would be taken into account under the intercompany transaction rules is limited under the DCL rules, because of the special status of the section 1503(d) member, the matching rules do not apply to the counterparty in the intercompany transaction.[71] Absent this rule, the IRS and Treasury were concerned that taxpayers could effectively obtain the benefit of a loss that was subject to the domestic use limitation, by deferring the recognition of corresponding income under the matching rule.

<u>Eversheds Sutherland Observation:</u> *The examples to the Proposed Regulations highlight that, in the case of an affiliated group member with a separate unit, the rules only apply when such member is acting through the separate unit.[72] They also illustrate that recapture of dual consolidated losses for which a DUE has been made do not have any impact under the matching rules because the income from the intercompany item would have already been taken into account.[73]*

The Proposed Regulations relating to intercompany transactions are proposed to be effective for taxable years for which the federal income tax return is due (without regard to extensions) after final regulations are adopted.[74] However, taxpayers are permitted to apply the rules for an earlier open taxable year, once the regulations are finalized, provided that the rules are applied consistently by all members of the consolidated group for such year and all subsequent years.[75]

2. Items Arising from Ownership of Stock

As noted above, for purposes of computing the amount of a DCL, generally all items of income, gain or loss that are reflected on the books and records of the foreign branch or HESU are taken into account. The Proposed Regulations would modify this general rule to exclude items arising from the ownership of stock, including gains, dividends, and deemed dividends under the subpart F and GILTI rules.[76]

The proposed change is intended to address a perceived abuse where taxpayers structured into transactions that increased income of a separate unit for US federal income tax purposes, even though the separate unit is not subject to tax locally on the income because of, for example, a participation regime. The Proposed Regulations would not apply to dividends and income in respect of "portfolio stock," which is generally stock that represents less than 10% of the value of the issuing corporation.[77]

<u>Eversheds Sutherland Observation:</u> *The proposed rule departs from the general approach of the DCL regulations, which does not look to whether an item of income or loss that is attributable to a separate unit is taken into account for foreign income tax purposes. And, it is blunt in application as it makes the assumption that gains and dividends on stock generally are exempt from tax in foreign jurisdictions. Although participation exemption regimes are common, such regimes vary by jurisdiction and there can be a number of exceptions to application in a given jurisdiction. In other areas of the Proposed Regulations, particularly the disregarded payment loss rules discussed below, the foreign law tax treatment of an item is required to be taken into account, and it could be argued that in order to achieve the purposes of section 1503(d) a more targeted approach that considers the actual treatment of losses or deductions in a foreign jurisdiction is more appropriate. Given the level of complexity in tax laws generally, including the GloBE Model Rules, it is not clear that expressed concerns about administrability are well-founded.*

The proposed rules relating to the attribution of items from ownership of stock are proposed to apply to taxable years ending on or after August 7, 2024. Thus, these proposed rules, if finalized as proposed, would affect taxpayers' DCL determinations for the current year.

3. Adjustments to Conform to US Tax Principles

Under the existing regulations, for purposes of computing the amount of any DCL, regarded items of a domestic owner are attributable to an HESU to the extent they are reflected in the books and records of the HESU.[78] The regulations require, however, that such items are adjusted to conform to US tax principles,

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71 Prop. Treas. Reg. § 1.1502-13(j)(10)(iv).
72 *See* Prop. Treas. Reg. § 1.1502-13(j)(15)(x)(E).
73 *See* Prop. Treas. Reg. § 1.1502-13(j)(15)(x)(D).
74 Prop. Treas. Reg. § 1.1502-13(l)(11).
75 *Id.*
76 *See* Prop. Treas. Reg. §§ 1.1503(d)-5(b)(2)(iv), (c)(4)(iv).
77 Prop. Treas. Reg. §§ 1.1503(d)-5(b)(2)(iv)(B), (c)(4)(iv)(B).
78 Treas. Reg. § 1.1503(d)-5(c)(3)(i).

including adjustments to reflect differences in the calculation of depreciation for accounting and tax purposes as well as to eliminate items reflected on the books and records that are not deductible for US tax purposes.[79]

The Proposed Regulations clarify that adjustments to conform to US tax principles do not include treating disregarded transactions (i.e., transactions between an owner and a HESU) as regarded for purposes of the DCL rules.[80] Specifically, the Proposed Regulations state that

> an adjustment to conform to US tax principles does not include the attribution to a hybrid entity separate unit or an interest in a transparent entity of any items that have not and will not be reflected on the books and records of the hybrid entity or transparent entity; for example, items that are reflected on the books and records of the domestic owner cannot be attributed to a hybrid entity separate unit or an interest in a transparent entity as a result of disregarded payments made between the domestic owner and the hybrid entity or transparent entity.[81]

As the preamble explains, "such adjustments account for discrepancies between accounting treatment and US tax treatment; they are not permitted to give effect to disregarded payments that [the DCL rules] explicitly excludes from the calculation of income or dual consolidated loss."

In other words, items that are taken into account for DCL purposes must be regarded for US federal income tax purposes <u>and</u> taken into account on the books and records of the HESU. Although the preamble explains the IRS view that this is clear under the existing rules, the Proposed Regulations make this explicit. Adjustments to conform to US tax principles do not permit attribution to an HESU of any item that has not been and will not be reflected on the books and records of the HESU.

This proposed rule is proposed to be effective for taxable years ending on or after August 7, 2024, and thus would apply to taxpayers in the current year if and when finalized.

4. Anti-avoidance Rule

The clarifications and modifications described above are generally addressed to transactions and structures that the IRS and Treasury are aware of and that attempt to obtain a double-deduction outcome while avoiding the application of the DCL rules. The Preamble explains that the IRS and Treasury are aware of other transactions where taxpayers attempt to avoid the purposes of the DCL rules, such as transfers of US assets to a separate unit in situations where the income from such assets is not taxable in the foreign jurisdiction. Rather than attempting to address such transactions on a case-by-case basis, the Proposed Regulations include a broad anti-avoidance rule.

The Proposed Regulations permit the IRS to make "appropriate adjustments" "if a transaction, series of transactions, plan, or arrangement is engaged in with a view to avoid the purposes of section 1503(d) and the regulations in this part issued under section 1503(d)."[82] A plan or arrangement includes an arrangement to reflect, or not to reflect, items on books and records, or any other plan that is entered into with a view to "reduce or eliminate a DCL or a disregarded payment loss while putting an item of deduction or loss that composes (or would compose) the DCL or disregarded payment loss to a foreign use."[83] An appropriate adjustment includes disregarding the transaction or modifying the items taken into account for purposes of applying the DCL rules.[84]

<u>Eversheds Sutherland Observation:</u> *The "with a view to" standard in the anti-avoidance rule leaves room for interpretation and could lead to uncertainty for taxpayers, particularly when undertaking transactions with disregarded entities. Clarification that the purpose of the DCL rules is to prevent double dipping, and thus only transactions that are undertaken with a view to obtaining a double deduction benefit, would be welcome in the final regulations.*

79 *Id.*
80 Prop. Treas. Reg. § 1.1503(d)-5(c)(3)(i).
81 *Id.*
82 Prop. Treas. Reg. § 1.1503(d)-1(f).
83 *Id.*
84 *Id.*

The anti-avoidance rule is proposed to apply to taxable years beginning on or after August 7, 2024.

- Interaction of the DCL Rules with the GloBE Model Rules

As noted above, in Notice 2023-80 the IRS requested comments regarding the interaction of the DCL rules with foreign laws that have been introduced to conform to the GloBE Model Rules. The Proposed Regulations recognize but reject comments that requested that the DCL rules not be applicable to foreign taxes that are based on the GloBE Model Rules because, among other things, the GloBE Model Rules have characteristics that are not typical of income taxes, they are not based on traditional concepts of tax residency, and they are based on financial accounting and not tax consolidation principles. The Preamble to the Proposed Regulations instead finds that the characteristics of the GloBE Model Rules exist in the US tax laws, and that they "can result in double-deduction outcomes that the dual consolidated loss rules were intended to address."

Eversheds Sutherland Observation: *The one example identified in the Proposed Regulations in support of the above conclusion is a situation where the taxing jurisdiction otherwise does not impose an income tax on entities organized in the jurisdiction.[85] While the inappropriate double-deduction outcome is apparent in this hypothetical example, it does not recognize that this case is in fact an outlier. Where a taxing jurisdiction otherwise has a comprehensive income tax regime that provides for tax at rates that are approximately equal to the US federal income tax rate, subjecting the GloBE Model Rules taxes to the DCL rules creates unnecessary complexity and likely will result in limitations on the use of losses that were not intended by the statute (i.e., situations that do not result in double-deduction outcomes).*

Initially, in order to address the interaction of the DCL rules with the GloBE Model Rules, the Proposed Regulations adopt the terminology of the GloBE Model Rules, specifically incorporating the relevant OECD publications.[86]

Eversheds Sutherland Observation: *Because the GloBE Model Rules are, as their name suggests, model rules and the adoption of such rules may vary by jurisdiction, it will be necessary to monitor impacts that any departures from the model rules may have on the application of the DCL rules. In addition, it will be important to understand how future modifications to the GloBE Model Rules are expected to be incorporated into the application of the DCL rules.*

The Proposed Regulations provide that an income tax may include a tax that is intended to ensure a minimum level of taxation of income or computes income or loss by reference to financial accounting net income or loss.[87] As a result, an IIR or a QDMTT may be an income tax for purposes of the DCL rules and a foreign use may occur by reason of a loss being included in the calculation of Net Globe Income or being considered in applying the Transitional CbCR Safe Harbour.

Eversheds Sutherland Observation: *The Proposed Regulations reserve on whether a UTPR that is enacted pursuant to the GloBE Model Rules is also an income tax that is taken into account in applying the DCL rules.*

The Proposed Regulations expand the definitions of separate unit and hybrid entity separate unit to incorporate the GloBE Model Rules. Specifically, a separate unit includes a place of business or deemed place of business outside the United States that is a permanent establishment with respect to a QDMTT or an IIR;[88] and a hybrid entity separate unit includes an interest in a foreign entity other than a Tax Transparent Entity with respect to an IIR that is not taxed as an association for US federal income tax purposes and the net income or loss of which is taken into account in determining the amount of tax under an IIR.[89] The Preamble makes clear that the application of an IIR to a US corporation does not cause the US corporation to be treated as a dual resident corporation or a hybrid entity. This is because to the extent any loss is taken into account, it is likely available only to offset dual inclusion income, so the double deduction benefit to which the DCL rules are addressed is not present.

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85 *See* Treas. Reg. 1.1503(d)-7(c)(3)(ii), Example 3A.
86 *See* Treas. Reg. § 1.1503(d)-1(b)(21).
87 Treas. Reg. § 1.1503(d)-1(b)(6)(ii).
88 Prop. Treas. Reg. § 1.1503(d)-1(b)(4)(i)(A)(2).
89 Prop. Treas. Reg. § 1.1503(d)-1(b)(4)(i)(B)(2).

The Preamble also explicitly rejects arguments made in response to Notice 2023-80 that a foreign use should not occur under the DCL rules solely because a loss is taken into account for purposes of applying the Transitional CbCR Safe Harbour. These comments noted that the safe harbor is not a taxing or collection mechanism, but instead determines whether the GloBE Model Rules apply. In other words, it is a "gating" mechanism that commenters argued should not be considered to give rise to a foreign use.

The IRS and Treasury reject arguments that the application of the safe harbor cannot give rise to a foreign use on the basis that even under the safe harbor, a loss can be used to reduce the amount of top-up tax. Put another way, the IRS and Treasury view the application of the safe harbor as itself giving rise to a potential foreign use of a dual consolidated loss.[90] The Proposed Regulations do provide, however, that no foreign use is deemed to occur where the transitional safe harbor applies and there is no foreign use because of the application of duplicate loss arrangement rules under the GloBE Model Rules.[91]

Regarding the duplicate loss arrangement rules under the GloBE Model Rules, the Proposed Regulations provide that these rules are not considered to be "mirror legislation," because taxpayers have the ability to choose to either take a loss into account in a foreign jurisdiction or (through a DUE) in the US. Thus, application of the duplicate loss arrangement rules does not itself constitute a foreign use under the mirror legislation rule.

The Proposed Regulations recognize the uncertainty taxpayers face with respect to the proper treatment of the GloBE Model Rules in applying the DCL rules, and accordingly expand and extend the relief granted in Notice 2023-80. Subject to an anti-abuse rule, the Proposed Regulations provide that, with respect to losses incurred in taxable years beginning before August 7, 2024, the DCL rules apply without taking into account QDMTTs or IIRs.[92]

> Thus, for example, a foreign use is not considered to occur with respect to a dual consolidated loss incurred in a taxable year beginning before August 7, 2024 solely because all or a portion of the deductions or losses that comprise the dual consolidated loss is taken into account (including in a taxable year beginning on or after August 7, 2024) in determining the Net GloBE Income for a jurisdiction or whether the Transitional CbCR Safe Harbour applies for a jurisdiction. As an additional example, an entity is not treated as a hybrid entity in a taxable year beginning before August 7, 2024 solely because it is subject to a QDMTT.[93]

As noted above, this relief is not available with respect to "a loss that was incurred or increased with a view to reduce the amount of tax under a QDMTT or IIR, or to qualify for the Transitional CbCR Safe Harbour."[94]

Eversheds Sutherland Observation: *The relief provided by the Proposed Regulations is broader than the relief provided in Notice 2023-80 in that it applies to all DCL rules, not just with respect to a foreign use. But, even this extended relief only provides a limited amount of time for calendar year taxpayers to address the application of the new rules, considering comments are not due on the Proposed Regulations until October 2024. A longer transition rule may be warranted in order to facilitate taxpayers coming into compliance.*

Eversheds Sutherland Observation: *The preamble to the Proposed Regulations states that taxpayers may rely on the Proposed Regulations for any taxable year ending on or after August 7, 2024, and beginning on or before the date on which related final regulations are published, provided that the taxpayer and all members of its consolidated group apply the Proposed Regulations in their entirety and in a consistent manner for all taxable years beginning with the first taxable year of reliance. Accordingly, in order to rely on the transition period provided in the Proposed Regulations in accordance with the terms of the preamble, a taxpayer is seemingly required to adopt the other provisions of the Proposed Regulations for its current taxable year as well.*

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90 *See* Prop. Treas. Reg. § 1.1503(d)-7(c)(3)(ii)(C), Example 3A.
91 Prop. Treas. Reg. § 1.1503(d)-3(c)(9).
92 Prop. Treas. Reg. §§ 1.1503(d)-8(b)(12)(i), (13), (14).
93 Prop. Treas. Reg. § 1.1503(d)-8(b)(12)(i).
94 Prop. Treas. Reg. § 1.1503(d)-8(b)(12)(ii).

– The Proposed Disregarded Payment Loss Rules

The Proposed Regulations also include a new set of rules that are designed to address what are referred to as "disregarded payment losses" or "DPLs". Generally, these structures involve payments from foreign disregarded entities to their regarded owners that give rise to deductions for foreign tax purposes but are disregarded for US federal income tax purposes. As noted above, the DCL rules do not take into account disregarded transactions, and as a result these transactions are not addressed by the current DCL rules, even though they potentially give rise to double deduction outcomes, more specifically, a deduction/no-inclusion outcome.

1. Application of the Entity Classification Regulations

Initially, the DPL rules are made applicable through an amendment to the entity classification rules under Treasury Regulation section 301.7701-3 (entity classification rules). The entity classification rules generally govern whether a business entity is treated as a corporation or as a pass-through entity (i.e., a partnership or disregarded entity) for US federal income tax purposes, and except for certain "per se" corporations an entity is allowed to elect its treatment for US federal income tax purposes. The Proposed Regulations amend the entity classification rules to provide that domestic corporations that own certain eligible entities that are disregarded as separate from their owners consent to be subject to the DPL rules.[95]

Specifically, if a "specified eligible entity" elects to be disregarded as separate from its owner, or is formed after August 7, 2024, and is classified without election as an entity that is disregarded as separate from its owner, then any domestic owner of such specified eligible entity on the date of such election, formation or acquisition "consents to be subject to the disregarded payment loss rules."[96] A specified eligible entity is any entity, foreign or domestic, that is a foreign tax resident or is owned by a domestic corporation that has a foreign branch.[97] In the case of entities that are not newly formed, or where a domestic entity acquires an interest in an existing disregarded entity, the Proposed Regulations deem there to have been consent to the DPL rules.[98] In order to avoid the application of the deemed consent rule, the domestic corporate owner can elect to treat the specified eligible entity as an association taxable as a corporation effective prior to August 6, 2025.[99]

<u>Eversheds Sutherland Observation:</u> *Effectively, the Proposed Regulations require taxpayers with existing disregarded foreign subsidiaries to either agree to be subject to the DPL rules, or suffer the consequences of an outbound transfer of the foreign entity's assets, which could have material US federal tax implications.*

The proposed amendments to the entity classification rules are proposed to be effective as of August 7, 2024, except for the deemed consent rule, which is proposed to apply beginning on August 6, 2025, consistent with the timing of the election to avoid deemed consent.[100]

2. Operation of the DPL Rules

The operative DPL rules are embedded within the DCL rules, specifically in proposed Treasury Regulation section 1.1503(d)-1(d). Under that provision, if a specified eligible entity or a foreign branch of a domestic corporation, referred to as a "disregarded payment entity," incurs a DPL, and a triggering event occurs with respect to the DPL during the "DPL certification period," then the domestic owner (referred to as the "specified domestic owner") includes in gross income the "DPL inclusion amount."[101]

A DPL with respect to a disregarded payment entity is the excess of certain specific items of deduction, over the sum of certain specified items of income.[102] Conversely, if the specified items of income exceed the specified items of deduction, that results in disregarded payment income.[103] The items of deduction that are relevant for this purposes are items that are (i) deductible in the taxable year under the relevant foreign tax

95 Prop. Treas. Reg. § 301.7701-3(c)(4)(i).
96 *Id.*
97 *Id.* A special rule also applies to a dual resident corporation that owns a disregarded entity, and deems consent to the application of the DPL rules. *See* Treas. Reg. § 301.7701-3(c)(4)(ii).
98 Prop. Treas. Reg. § 301.7701-3(c)(4)(iii).
99 Prop. Treas. Reg. § 301.7701-3(c)(4)(iv). The Proposed Regulations call off the 60-month limitation on elections for this purpose.
100 Prop. Treas. Reg. § 301.7701-3(c)(4)(vi).
101 Prop. Treas. Reg. §1.1503(d)-1(d)(2)(i). The Proposed Regulations include a special rule for dual resident corporations that are subject to the DPL rules. Prop. Treas. Reg. § 1.1503(d)-1(d)(1)(ii).
102 Prop. Treas. Reg. § 1.1503(d)-1(d)(6)(ii)(B).
103 Prop. Treas. Reg. § 1.1503(d)-1(d)(6)(ii)(A).

law; (ii) the result of a payment that is disregarded for US federal income tax purposes as a transaction between a disregarded entity and its tax owner or between a foreign branch and its home office; and (iii) attributable to an amount the payment or accrual of which would, if regarded for US tax purposes, be interest, a structured payment, or a royalty within the meaning of the section 267A rules.[104] Similar rules apply to determine the items of income that are relevant.[105]

If a disregarded payment entity has a DPL and there is a triggering event with respect to the DPL, the domestic owner is required to include in its gross income the DPL inclusion amount. There are two triggering events under the Proposed Regulations: (1) a "foreign use" and (2) a certification failure.[106] A foreign use is determined by applying the principles of the DCL rules, treating the disregarded payment entity as a separate unit and only taking into account persons that are related to the specified domestic owner of the disregarded payment entity.[107] The certification requirements are similarly analogous to the DCL rules, and require annual certification of the amount of any DPL and that there has not been a foreign use of such DPL for a period of 5 years from the year in which the DPL is incurred.[108]

If there is a triggering event with respect to a DPL, the amount of the inclusion may be reduced by the amount of the DPL cumulative register, which is the net amount of disregarded payment income and disregarded payment loss for the disregarded payment entity, excluding the triggered DPL.[109] To qualify for a reduction of the DPL inclusion amount, a taxpayer must demonstrate the reduction to the satisfaction of the Commissioner, including by attaching a statement to its return showing the disregarded payment income or DPL of the entity "for each foreign taxable year up to and including the foreign taxable year during which the triggering event occurs," apparently beginning with the year in which the entity became a disregarded entity of its domestic owner.[110]

Similar to the DCL rules, a disregarded payment entity combination rule treats all disregarded entities organized in the same foreign jurisdiction that are owned by the same domestic corporation or specified domestic owners that are part of a single consolidated group as one disregarded payment entity.[111] A special rule also applies to turn off the DPL rules in respect of an item for which foreign law denies a deduction in order to prevent a deduction/no-inclusion outcome.[112]

The operative DPL rules are proposed to taxable years ending on or after August 7, 2024, such that the effective date for the related change to the entity classification regulations is what practically controls when the DPL rules would apply to a particular disregarded entity.[113]

<u>Eversheds Sutherland Observation:</u> *The DPL rules will introduce material additional compliance burdens for taxpayers that operate through disregarded entities. Because they take into account a more limited set of transactions (i.e., interest, royalties and structured payments), the impact is reduced relative to the operation of the DCL rules; but, it is an additional compliance burden for taxpayers and includes potential traps for the unwary.*

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104 Prop. Treas. Reg. § 1.1503(d)-1(d)(6)(ii)(C).
105 Prop. Treas. Reg. § 1.1503(d)-1(d)(6)(ii)(D).
106 Prop. Treas. Reg. § 1.1503(d)-1(d)(3).
107 Prop. Treas. Reg. § 1.1503(d)-1(d)(3)(i).
108 Prop. Treas. Reg. §§ 1.1503(d)-1(d)(4), (6)(iii).
109 Prop. Treas. Reg. § 1.1503(d)-1(d)(5)(i)-(ii).
110 Prop. Treas. Reg. § 1.1503(d)-1(d)(5)(iii).
111 Prop. Treas. Reg. § 1.1503(d)-1(d)(7)(i).
112 Prop. Treas. Reg. § 1.1503(d)-1(d)(7)(v).
113 Prop. Treas. Reg. § 301.7701-3(c)(4)(vi).

If you have any questions about this Legal Alert, please feel free to contact any of the attorneys listed or the Eversheds Sutherland attorney with whom you regularly work.

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