SUTHERLAND

LEGAL ALERT

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"SRLY? You Can't Be Serious." "I Am Serious...and Don't Call Me SRLY." The IRS Issues Helpful Guidance on the Application of the SRLY Register Rules to Dual Consolidated Losses

On August 5, 2011, the Internal Revenue Service (the IRS) issued a generic legal advice – AM 2011-002 (the Chief Counsel Memo) – explaining how the separate return limitation year (SRLY) rules apply to the computation of consolidated taxable income for an affiliated group with a dual consolidated loss (a DCL) that is attributable to a separate unit. In the Chief Counsel Memo, the IRS concluded that a *current year* DCL of the separate unit should be taken into account for purposes of calculating the consolidated taxable income of the affiliated group for that taxable year to the extent that income was attributable to the separate unit in a prior taxable year of the affiliated group. Stated differently, the IRS allowed the affiliated group to use the separate unit's current year DCL to the extent of the separate unit's positive "SRLY register" (which also is referred to as the "cumulative register"). Significantly, the Chief Counsel Memo constitutes the first piece of written guidance issued by the IRS on this issue.

Background

In general, a DCL is a net operating loss of a dual resident corporation or the net loss attributable to a separate unit. Pursuant to § 1503(d)(1) of the Internal Revenue Code of 1986, a DCL for any taxable year of any corporation generally is not allowed to reduce the taxable income of any other member of the affiliated group of which that corporation is a member for the taxable year or any other taxable year. As a complement to the general rule of § 1503(d)(1), § 1503(d)(3) provides that, to the extent provided in Treasury regulations, any loss of a "separate unit" of a domestic corporation will be subject to the limitations of § 1503(d) in the same manner "as if such [separate] unit were a wholly owned subsidiary of such corporation." Thus, pursuant to this rule, any loss that is attributable to a separate unit of a domestic corporation, whether or not that domestic corporation is a member of a consolidated group for U.S. federal tax purposes, generally will be treated as a DCL.

The IRS and Treasury Department (Treasury) issued new final regulations under § 1503(d) in March 2007 (the 2007 Regulations). *See generally* T.D. 9315, 2007-1 C.B. 891. The 2007 Regulations generally apply to DCLs incurred in taxable years beginning on or after April 18, 2007, although taxpayers may elect to have the 2007 Regulations apply in their entirety to taxable years beginning on or after January 1, 2007. The IRS and Treasury initially issued final regulations under § 1503(d) in 1992 (the 1992 Regulations) that generally apply to DCLs incurred in taxable years beginning before the 2007 Regulations apply. *See generally* T.D. 8434, 1992-2 C.B. 240. The Chief Counsel Memo concerns the application of the 2007 Regulations.

Treas. Reg. § 1.1503(d)-4 of the 2007 Regulations prescribes rules that apply when the general limitation on the domestic use of a DCL under Treas. Reg. § 1.1503(d)-4(b) applies. In general, when the domestic use limitation applies (for example, on account of the inability to make a domestic use election under Treas. Reg. § 1.1503(d)-6), the DCL of a dual resident corporation or a separate unit is subject to the SRLY rules of Treas. Reg. § 1.1502-21(c), as modified by Treas. Reg. § 1.1503(d)-4.

As relevant to the issue addressed in the Chief Counsel Memo, Treas. Reg. § 1.1503(d)-4(c) provides rules that determine the effect of a DCL on, *inter alia*, a consolidated group. In particular, the rules that apply to a DCL that is attributable to a separate unit are set forth in Treas. Reg. § 1.1503(d)-4(c)(2), which provides, in pertinent part, as follows:

> (2) Separate unit.—This paragraph (c)(2) applies to a dual consolidated loss that is attributable to a separate unit. The . . . consolidated group of an affiliated domestic owner of a separate unit[] shall compute its . . . consolidated taxable income (or loss) . . . without taking into account those items of deduction and loss that compose the separate unit's dual consolidated loss. For this purpose, the dual consolidated loss shall be treated as composed of a pro rata portion of each item of deduction and loss of the separate unit taken into account in computing the dual consolidated loss. *The dual consolidated loss is subject to the limitations contained in paragraph (c)(3) of this section as if the separate unit to which the dual consolidated loss is attributable were a separate domestic corporation that filed a consolidated return . . . with the consolidated group of its affiliated domestic owner* . . . . *Subject to such limitations, the dual consolidated loss may be carried over or back for use in other taxable years as a separate net operating loss carryover or carryback of the separate unit arising in the year incurred.* [Emphasis added.]

The fourth sentence of Treas. Reg. § 1.1503(d)-4(c)(2) sets forth the operative rule that subjects a separate unit's DCL to the SRLY limitation of Treas. Reg. § 1.1503(d)-4(c)(3) (and, thus, the SRLY rules of Treas. Reg. § 1.1502-21(c)). Furthermore, the fifth sentence of that paragraph provides that, subject to the limitations of Treas. Reg. § 1.1503(d)-4(c)(3), the DCL may be carried over or carried back for use in other taxable years.

Treas. Reg. § 1.1502-21(c)(1)(i) sets forth the general limitation on including a net operating loss of a member arising in a SRLY (a SRLY NOL) in the consolidated net operating loss (CNOL) deduction for a consolidated group for a taxable year. Under the SRLY rules, the aggregate amount of a member's SRLY NOL absorbed by a group as of the end of a consolidated return year may not exceed the positive balance of the member's SRLY register, *i.e.*, the member's aggregate contribution to the group's consolidated taxable income as of the end of the year. Specifically, Treas. Reg. § 1.1502-21(c)(1)(i), provides, in pertinent part, as follows:

> [T]he aggregate of the net operating loss carryovers and carrybacks of a member arising (or treated as arising) in SRLYs that are included in the CNOL deductions for all consolidated return years of the group . . . may not exceed the aggregate consolidated taxable income for all consolidated return years of the group *determined by reference to only the member's items of income, gain, deduction, and loss*. [Emphasis added.]

With this background in mind, we review the Chief Counsel Memo below.

The Chief Counsel Memo

The Chief Counsel Memo considers the application of the 2007 Regulations to two situations. In the first situation, USP is a domestic corporation and the common parent of an affiliated group of corporations that files a consolidated federal income tax return on a calendar-year basis (the USP Group). USP wholly owns USS, a domestic corporation and member of the USP Group. In turn, USS owns all of the interests in FEX, an entity organized under the laws of Country X that is subject to Country X income tax on its worldwide income but is disregarded as an entity separate from USS for U.S. federal tax purposes. FEX carries on a business operation in Country X that, if carried on by a U.S. person, would constitute a foreign branch within the meaning of Temp. Treas. Reg. § 1.367(a)-6T(g)(1). USS's interest in FEX constitutes a hybrid entity separate unit within the meaning of Treas. Reg. § 1.1503(d)-1(b)(4)(i)(B), and USS's indirect interest in its share of the business operations conducted by FEX constitutes a foreign branch separate unit within the meaning of Treas. Reg. § 1.1503(d)-1(b)(4)(i)(A). These two individual separate units are combined and treated as a single separate unit under Treas. Reg. § 1.1503(d)-1(b)(4)(ii) (the FEX Separate Unit).

USS has conducted business operations in Country X through the FEX Separate Unit since January 1, Year 1. In Year 1, USS generates $120x of net income that is attributable to the FEX Separate Unit pursuant to Treas. Reg. § 1.1503(d)-5. In Year 2, USS incurs a net loss of $100x that is attributable to the FEX Separate Unit. USS has no other items of income or loss for Years 1 and 2. The taxable income attributable to the USP Group (without taking into account those items of income or loss attributable to the FEX Separate Unit) for Years 1 and 2 is $300x and $150x, respectively. The $100x net loss attributable to the FEX Separate Unit in Year 2 is a DCL. The USP Group does not make a domestic use election with respect to the FEX Separate Unit's DCL (the FEX DCL) under Treas. Reg. § 1.1503(d)-6(d), and no other exceptions in Treas. Reg. § 1.1503(d)-6 apply. Accordingly, the FEX DCL is subject to the domestic use limitation rule of Treas. Reg. § 1.1503(d)-4. The table set forth below summarizes these facts.

Year	**Net Income / (Net Loss) Attributable to the FEX Separate Unit**	**Taxable Income of the USP Group (without taking into account items attributable to the FEX Separate Unit)**
Year 1	$120x	$300x
Year 2	($100x)	$150x

In the second situation, the facts are the same as in the first situation, except that, in Year 1, USS generates only $60x of net income that is attributable to the FEX Separate Unit.

Ultimately, the IRS concluded that, under the operative rule of the fourth sentence of Treas. Reg. § 1.1503(d)-4(c)(2), a DCL incurred by a separate unit in the current year may be absorbed as an offset to the income of the consolidated group of its affiliated domestic owner in that year to the extent of the separate unit's cumulative prior contributions to consolidated taxable income. Stated differently, the IRS allowed the affiliated group to use the separate unit's current year DCL to the extent of the separate unit's positive SRLY register. Accordingly, in the first situation, the USP Group may use the FEX Separate Unit's $100x DCL in determining consolidated taxable income in Year 2. Thus, for Year 2, the USP Group has $50x of consolidated taxable income, and the FEX Separate Unit has $20x of SRLY register remaining. Furthermore, in the second situation, the USP Group may utilize the FEX DCL in Year 2 to the extent of the FEX Separate Unit's SRLY register. Because the FEX DCL exceeds FEX's SRLY register of $60x, only $60x of the $100x DCL may be utilized by the USP Group. The remaining $40x of the FEX DCL remains subject to the domestic use limitation rule. Notably, in reaching these conclusions, the IRS reasoned as follows:

- Although the 2007 Regulations do not explicitly adopt the SRLY register concept in describing the applicability of the SRLY limitation, that concept predates the issuance of those Treasury regulations. Thus, because the 2007 Regulations fully incorporate the SRLY rules of Treas. Reg. § 1.1502-21(c) (except for the modifications provided in Treas. Reg. § 1.1503(d)-4(c)(3)), the SRLY register concept applies to DCLs made subject to the domestic use limitation. This concept is applied in Example 40 of Treas. Reg. § 1.1503(d)-7(c), where the recapture of a DCL for which a domestic use election was made was reduced, under Treas. Reg. § 1.1503(d)-6(h)(2)(i), by the amount of the DCL that would have been usable as a result of the separate unit's SRLY register.

- The language in Treas. Reg. § 1.1503(d)-4(c)(2) allowing carryovers or carrybacks of a DCL subject to the domestic use limitation may be interpreted as providing that a DCL may be carried back or carried forward to the extent that it is not used in the current year. In other words, under the SRLY rules, if a separate unit incurs a DCL after having contributed to consolidated taxable income in prior years, the DCL may be absorbed currently as an offset to the income of domestic affiliates in the year of the DCL (limited by the amount of the separate unit's prior contributions to consolidated taxable income).

- The rules of Treas. Reg. § 1.1502-15(a), which apply the SRLY rules and the SRLY register concept in a manner that allows a built-in loss to be used currently (to the extent of a positive SRLY register balance and current income of other members) before the loss is carried back or carried over to other taxable years, are analogous to the DCL rules because a member that recognizes a built-in loss in a taxable year may find its loss segregated into a SRLY and subject to the SRLY limitations, even where the group has positive consolidated taxable income for the year.

- Allowing the USP Group to offset Year 2 consolidated taxable income with the FEX DCL is consistent with the policies underlying § 1503(d). In general, the DCL provisions are intended to prevent a "double-dip," in which a single economic loss is used to offset two streams of income – one reported on a U.S. federal tax return, and one reported on a foreign tax return and not subject to tax in the United States. Here, this concern is not present because the FEX DCL is in effect only offsetting the FEX Separate Unit's "own" income. That is, the FEX Separate Unit's positive SRLY register ensures that the FEX DCL will be available only to offset consolidated taxable income to the extent that the FEX Separate Unit has contributed to aggregate consolidated taxable income in previous years.

Implications

The Chief Counsel Memo provides some much needed clarification concerning the interaction of the DCL rules and the SRLY rules that should prove helpful to foreign insurance companies that have made an election under § 953(d) to be treated as a domestic corporation for U.S. federal tax purposes and that are members of a consolidated group. In particular, § 953(d)(3) provides that "any loss of such corporation shall be treated as a dual consolidated loss for purposes of section 1503(d) without regard to paragraph (2)(B) thereof." Moreover, pursuant to Treas. Reg. § 1.1503(d)-6(a)(3), such companies and their separate units are not eligible to make a domestic use election or otherwise take advantage of the exceptions set forth in Treas. Reg. § 1.1503(d)-6. Thus, the DCLs of such companies and their separate units always remain subject to the general domestic use limitation set forth in Treas. Reg. § 1.1503(d)-4.

A lingering question remains as to whether a similar analysis applies with respect to the application of the 1992 Regulations to the DCLs of separate units. *See generally* Treas. Reg. § 1.1503-2(d)(2)(ii). As noted above, the 1992 Regulations remain relevant to taxable years beginning prior to April 18, 2007 (or, in some cases, ending on or before December 31, 2006), and an issue analogous to the one discussed in the Chief Counsel Memo exists under those Treasury regulations. Although the language of the 1992 Regulations relating to the application of the SRLY rules for purposes of § 1503(d) differs somewhat from the comparable language in the 2007 Regulations, our understanding is that the IRS National Office correctly believes that the same result should occur under both sets of Treasury regulations. Nevertheless, written guidance concerning the interaction of the DCL rules and the SRLY rules in the context of the 1992 Regulations would be very helpful in confirming that position.

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