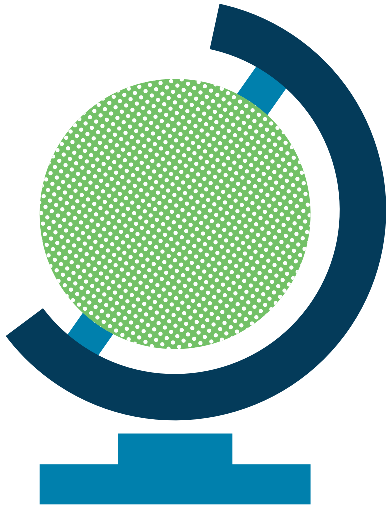
INTERNATIONAL TIDBIT:

FOREIGN LOSS FOR U.S. TAX PURPOSES – USE IT *AND* LOSE IT?



It is not uncommon for U.S. businesses to opt for a flow-through structure when investing offshore with the expectation that U.S. taxpayers can use start-up losses from foreign operations to offset income on their U.S. tax returns. While this is true, and the result may be lower taxes in the year the loss is incurred, a host of filing requirements is in store along with possible recapture of the loss in future years. As this article will show, even in cases where there was no intent to abuse the rules, for example, by offsetting income in both the U.S. and a foreign country, a dual consolidated loss and an overall foreign loss can result.

HISTORY OF DUAL CONSOLIDATED LOSS

Section 1503(d) of the Internal Revenue Code ("IRC") was enacted to prevent what was known as "double dipping" or using a single economic loss to offset income in two countries at the same time. While this initially arose in situations where, for example, a company incorporated in the U.S. was included in a consolidated group for U.S. tax purposes but was resident in the U.K. for purposes of group relief there. As a result, that company's loss could offset income in the U.S. and the U.K. in the same year Text

LOSSES ARISING IN THE CONTEXT OF "CHECK-THE-BOX" ENTITIES

In accordance with Treasury Regulations issued in 2007, a dual consolidated loss can arise if a U.S. company, we'll call USCO, is subject to tax in a foreign country because, for example, it has set up a company there that is eligible to be disregarded for U.S. tax purposes (a "hybrid entity"). USCO elects to treat the hybrid entity as a branch. During the start-up phase of its business, the branch incurs losses in the foreign country.

Under the Regulations, the branch is a foreign branch separate unit and the loss it incurred is a hybrid separate entity loss. This type of loss is included in the definition of a "dual consolidated loss." This result can occur without any requirement that USCO be part of a U.S. consolidated group, even though IRC §1503(d) is found in Chapter 6, entitled "Consolidated Returns."

Even if USCO's branch was profitable in its start-up phase and had taxable income under the rules for calculating the foreign entity's earnings for the year, a loss may still be the result for the branch when the 2007 Regulations are applied. The branch may have been profitable in the foreign country due, in part, to recognizing income for services it performs for USCO and for which USCO pays it. However, the requirement to disregard those intracompany transactions for U.S. tax purposes could cause the hybrid branch to have a loss covered by the dual consolidated loss rules.

USING THE LOSS IN THE U.S.

Prior to the 2007 Regulations, USCO could use the loss of its foreign branch to offset income of USCO, for example, if the loss could never have been used to offset the income of another person in a foreign country. Logical, and typical of the situations of many U.S. companies with one hybrid entity, treated as a branch in the foreign country, this rule was superseded by the 2007 Regulations. To use the loss in the U.S., USCO is now required to provide an agreement not to use the loss in a foreign country and to certify annually for the next five years that it has not been so used. This agreement is included in the tax return for the year in which the loss is incurred and the annual certifications are included in the tax return for the subsequent years. While there is still an option to demonstrate that the loss cannot possibly be used in the foreign country by another person, the Preamble to the Regulations states Treasury's expectation that this exception would apply only in rare and unusual circumstances, leaving USCO in the position of using the loss only if it agrees not to use the loss in a foreign country and then follows up with certifications each year that circumstances have not changed.

OVERALL FOREIGN LOSS

USCO's only foreign activity may be in the country where it has the hybrid branch, resulting in the dual consolidated loss also being an overall foreign loss of USCO for the year. In the alternative it may have other operations that incur losses or income, but if the result of all foreign sourced items for the year is a loss, then USCO has an overall foreign loss. For the sake of this discussion, we have assumed that none of its foreign source items would be passive, for purposes of determining the foreign tax credit category in which income or loss would belong.

If USCO uses the loss from the foreign branch to offset its income from U.S. sources, then future foreign source income will be recharacterized as U.S. source income until the benefit of that loss has been recaptured. IRC §904(f), and the regulations promulgated pursuant to it, include rules for determining how much of each subsequent year's foreign source income will be recharacterized as U.S. source.

INCORPORATION OF HYBRID BRANCH

If USCO decides in a future year that it would like to treat its hybrid branch as a foreign corporation for U.S. tax purposes, it may elect to change its status from disregarded entity to foreign corporation as, for example, part of a strategy to defer earnings offshore. USCO would be treated as if it contributed the hybrid branch's assets to a foreign corporation in exchange for stock, under IRC §§351(a) and 367(a). Such a transaction requires recapture of any previously deducted losses attributable to the time when the election was in place to treat the hybrid entity as a branch for U.S. tax purposes. Several types of gain, including loss recapture can be triggered in this situation, making it important for USCO to anticipate the consequences before deciding to change the U.S. tax characterization of the hybrid entity.

CONCLUSION

Given the complexity of the dual consolidated loss rules and the requirement to recapture an overall foreign loss, planning for the intersection of these two concepts is important along with including the appropriate agreement and annual certifications in the tax return.