

the scope of the exclusion, the proposed regulations explain that Congress's decision to incorporate language in I.R.C. § 1256(b)(2)(B) that parallels language used in the definition of a notional principal contract in Treas. Reg. § 1.446-3(c) indicates an attempt to harmonize the category of swaps excluded from the definition of section 1256 contracts with swaps that qualify as notional principal contracts. Excluding notional principal contracts from section 1256 treatment eliminates taxpayer uncertainty (a good thing) and ensures that taxpayers will not be subjected to the consequences imposed by section 1256.

The section 1256 exception is critical for insurance companies that are using swaps to hedge capital assets that do not qualify for tax hedging treatment under section 1221(a)(7).¹⁴ A capital asset hedge through a section 1256 contract results in insurance companies' gain/loss from contracts managing interest rate risk being capital instead of ordinary. Limitations on the ability to offset ordinary income and shorter carry-forward provisions reduce the utility of such capital losses. Additionally, the mark-to-market treatment imposed by section 1256 could result in a timing mismatch between the tax treatment of the hedge contract and the economic gain or loss on the hedged capital asset. Given the important role that derivatives play in managing risk in insurance companies' core business operations, these potential character and timing mismatches could have resulted in significant tax planning issues if a notional principal contract were treated as a section 1256 contract.¹⁵ For these reasons, the Dodd-Frank exception and the proposed regulations' confirmation that notional principal contracts are excluded from the definition of section 1256 contracts should be welcome news to insurance company taxpayers. ◀

END NOTES CONT.

Derivatives, *TAXING TIMES*, May 2011, at 33, for a detailed discussion of the issues presented by the Dodd-Frank Act's derivative reform provisions and the necessity for the I.R.C. § 1256(b)(2)(B) exclusion.

¹⁴ See Comments of Alan Fu of Prudential Financial Inc. (Apr. 23, 2010), Doc 2010-9908, 2010 TNT 86-22. Mr. Fu's letter was written to the Treasury Department explaining the problems that would result for insurance companies if certain provisions in Dodd-Frank resulted in additional derivative contracts being forced into section 1256 treatment.

¹⁵ See Newton, *supra* note 13, at 35, for more detailed discussion of the issues section 1256 contract treatment creates for corporate taxpayers.

IRS CONFIRMS APPLICATION OF SRLY CUMULATIVE REGISTER CONCEPT TO DUAL CONSOLIDATED LOSSES

By Lori J. Jones

Recent informal Internal Revenue Service (IRS) guidance confirms that the cumulative separate return limitation year (SRLY) register concept applies in determining whether a dual consolidated loss (DCL) can be utilized within a consolidated group. Many U.S. insurance groups own one or more offshore insurance companies to which the DCL limitations apply by reason of a section 953(d) election to treat the foreign insurer as a domestic insurer for U.S. tax purposes. Accordingly, the recent informal guidance facilitates utilization of a section 953(d) company's DCL in a U.S. consolidated income tax return.

The application of the cumulative register allows a DCL subject to the domestic use limitation rule, and in turn subject to the SRLY limitations (in Treas. Reg. § 1.1503(d)-4(c)(3)), to be utilized to the extent that the member or unit that incurred the DCL made a positive cumulative contribution to taxable income of the consolidated group in all prior consolidated return years. Prior to the IRS adoption of the SRLY cumulative register under the general consolidated return regulations, the SRLY limitation was computed on a year-by-year approach. In that case, a SRLY net operating loss (NOL) could not be utilized in a current year if the member that generated the SRLY NOL had no taxable income in the current year, even if the member had made a cumulative contribution to taxable income while a member of the consolidated group. IRS personnel had previously indicated orally that the cumulative approach also would apply to DCLs, but this is the first published guidance confirming the application.¹

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END NOTES

¹ See Notice 2004-52, 2004-2 C.B. 168.

² REG-111283-11.

³ Prop. Reg. § 1.446-3(c)(1)(iii).

⁴ Treas. Reg. § 1.446-3(d).

⁵ See Notice 2004-52, 2004-2 C.B. 168.

⁶ See Rev. Rul. 78-182, 1978-1 C.B. 265; I.R.C. § 1234.

⁷ See Notice 2004-52, 2004-2 C.B. 168.

⁸ New York State Insurance Department, Circular Letter No. 19 (Sept. 22, 2008).

⁹ Prop. Reg. § 1.446-3(j). See Amy S. Elliot and Lee A. Sheppard, *Proposed Derivatives Regulations Shouldn't Change Position on Bullet Swaps*, Highlights & Documents, Oct. 31, 2011, at 7903, for additional discussion on the prospective application of the proposed regulations.

¹⁰ Prop. Reg. § 1.1256(b)-1(a).

¹¹ I.R.C. § 1256(b)(1).

¹² I.R.C. § 1256(a).

¹³ Dodd-Frank Wall Street Reform and Consumer Protection Act, P.L. 111-203 (2010), § 1601. See John R. Newton, *Deactivating the Weapons of Mass Volatility: The Dodd-Frank Act, Section 1256 and the Taxation of*

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Confirmation of the application of the cumulative SRLY register to DCLs is beneficial to section 953(d) corporations because they are unable to take advantage of certain exceptions under Treas. Reg. § 1.1503(d)-6 to the domestic use limitation rule on a DCL; e.g., under section 953(d)(3), the section 1503(d)(2)(B) exceptions to DCL treatment where there is no foreign use do not apply.² A section 953(d) election can be made for a foreign insurance company to be treated as a domestic corporation if: (i) the foreign corporation is a controlled foreign corporation (as defined in section 953(d)(1)(A)), (ii) such foreign corporation would qualify as an insurance company (life or property and casualty) for federal tax purposes, (iii) such foreign corporation meets the requirements imposed by the Secretary, and (iv) such corporation makes an election and waives all benefits to such corporation granted by the United States under any treaty. Rev. Proc. 2003-47, 2003-2 C.B. 55, provides guidance for making this election. Thus, the ability to utilize the DCL within the consolidated group using the cumulative SRLY register is important because of the section 953(d) corporation's otherwise limited ability to utilize the DCLs within a consolidated return.

BACKGROUND

Section 1503(d) provides that a DCL shall not be allowed to reduce the taxable income of any other member of the affiliated group for the taxable year or any other taxable year. A DCL is an NOL of a dual resident corporation or the net loss attributable to a separate unit under the relevant regulations.³ The purpose of the domestic use limitation is to prevent a loss generated by a dual resident corporation, which reduces foreign income tax, to reduce U.S. taxable income a second time. Although that is the purpose, the regulations provide a mechanical rule that has much broader application and has been upheld by courts.⁴ In the insurance context, a DCL arises frequently for foreign captive insurance companies (e.g., Triple X reinsurers) that elect under section 953(d) to be taxed as a domestic corporation. Specifically, Treas. Reg. § 1.1503(d)-4(c)(3) provides that a DCL is treated as a loss incurred in a separate return year, and subject to all of the limitations of Treas. Reg. § 1.1502-21(c) (the SRLY provisions), with certain modifications, when the general limitation on the domestic use of a DCL applies.⁵ This brings into play the SRLY cumulative register concept contained in Treas. Reg. § 1.1502-21(c)(1)(i).

SUMMARY OF AM 2011-002 (AUG. 1, 2011)

In AM 2011-002 (Memorandum), the U.S. parent of a consolidated group owned the stock of USS, a domestic corporation, which owned 100 percent of the interests in FEX, an

entity organized under the laws of Country X, and subject to Country X tax on its worldwide income, but disregarded as a separate entity for U.S. tax purposes.⁶ The FEX Separate Unit included both USS's interest in FEX as well as USS's indirect interest in its share of the business operations conducted by FEX. Because no domestic use election under Treas. Reg. § 1.1503(d)-6(d) through (j) was made and no other exception in Treas. Reg. § 1.1503(d)-6 applied, any DCL generated by FEX (a dual resident corporation) was subject to the domestic use limitation rule on its use in the U.S. parent's consolidated return. As stated in the Memorandum, the issue was "whether the application of the SRLY rules to a DCL subject to the domestic use limitation rule may, in certain cases, allow the DCL to be used to offset income of a domestic affiliate in the year the DCL is incurred."

In the Memorandum, the IRS concluded that the DCL attributable to the FEX Separate Unit could be utilized in the U.S. parent's consolidated return *in Year 2* as long as the separate unit had contributed to the cumulative consolidated taxable income of the group during consolidated return years. The IRS noted that, if the FEX Separate Unit had \$120x of income in Year 1, the consolidated group may utilize a DCL generated by the FEX Separate Unit in Year 2 in the amount of \$100x. By contrast, if the FEX Separate Unit generated only \$60x of income in Year 1, only \$60x of the \$100x DCL could be utilized in Year 2. There was some potential uncertainty on this issue because Treas. Reg. § 1.1503(d)-4 was finalized in 2007 with no explicit reference to the cumulative register concept despite the fact that the IRS had previously adopted the cumulative register concept under the general SRLY regulations in 1999 and could have been explicit on the issue when the DCL regulations were finalized in 2007.

The IRS had several grounds for its conclusion that the cumulative SRLY register approach applies to DCLs. First, the IRS concluded that, because the DCL regulations fully incorporate the SRLY limitations (except for the modifications contained in Treas. Reg. § 1.1503(d)-4(c)(3)), the cumulative register concept applies to DCLs that are subject to the domestic use limitation. Footnote 13 in the Memorandum also lists several provisions in the DCL regulations which the IRS views as implicitly referencing the cumulative register concept.⁷ Second, the IRS acknowledged that, unlike a DCL, a SRLY NOL is not generated within a consolidated return year. However, it then referenced the last sentence of Treas. Reg. § 1.1503(d)-4(c)(2) dealing with separate units which states that the DCL may be carried over or back for use in other taxable years as a separate NOL carryover or carryback of

the separate unit arising in the year incurred. The IRS relied on this principle as additional support for application of the SRLY limitation to the DCL as a SRLY NOL carryover or carryback even if the DCL is utilized in the year it is generated. Third, the IRS analogized the DCL to a built-in loss subject to a SRLY limitation under Treas. Reg. § 1.1502-15(a), which can be incurred within a consolidated return year, and utilized subject to a SRLY limitation. Finally, the IRS concluded that the policy behind the DCL limitations is not violated by the use of the DCL using the SRLY cumulative register concept because it concluded that the FEX Separate Unit's DCL was in effect only offsetting its "own" income.

In summary, the IRS provided ample support for its reasonable conclusion, although commentators have requested that the guidance be adopted in the form of regulations or other more formal guidance.⁸ The guidance is particularly welcome since no real policy purpose would be served by barring the use of the DCL in a consolidated return year when the company had already contributed to consolidated income in a previous year. Moreover, the Memorandum's support of the cumulative SRLY register concept to DCLs is particularly helpful in the context of a section 953(d) corporation, which has no ability to apply an exception to the domestic use limitation. ◀

END NOTES

- ¹ At the ABA Section of Taxation meeting in September 2010, David Bailey, Branch 4 senior technician reviewer, IRS Office of Associate Chief Counsel (International), stated that a taxpayer should be able to utilize a current-year DCL to offset consolidated taxable income—at least to the extent of the cumulative register of the separate unit that had the loss. Amy S. Elliott, *SRLY Rules Allow Favorable Usage of Dual Consolidated Losses*, *IRS Official Says*, 2010 TNT 186-3, Sept. 27, 2010. See also Andrew J. Dubroff et al., *Federal Income Taxation of Corporations Filing Consolidated Returns* § 41.03[3][c] n.108.45 (2d edition 2008).
- ² Treas. Reg. § 1.1503(d)-6(a)(3) provides that the exceptions contained in -6 do not apply to losses of a foreign insurance company that is a dual resident corporation under Treas. Reg. § 1.1503(d)-1(b)(2)(ii), i.e., foreign insurance company treated as a domestic corporation pursuant to section 953(d) or to losses attributable to any separate unit of such foreign insurance company. In addition, these exceptions shall not apply to losses described in the preceding sentence that, subject to the rules of Treas. Reg. § 1.1503(d)-4(d), carry over to a domestic corporation pursuant to a transaction described in section 381(a).
- ³ Treas. Reg. § 1.1503(d)-5(c) through (e).
- ⁴ *British Car Auctions, Inc. v. U.S.*, 77 AFTR 2d 96-1441 (Fed. Cl. 1996).
- ⁵ Modifications include the inapplicability of the subgroup rules provided in Treas. Reg. § 1.1502-21(c)(2) or the overlap rule in Treas. Reg. § 1.1502-21(g). It is important to note that even though the loss is treated as incurred in a separate return year, the regulation does not state that the year is treated as a separate return year. This distinction is important because it allows the IRS to conclude that the loss can still be utilized in the year incurred because it is not a true SRLY loss.
- ⁶ AM 2011-02 (Aug. 1, 2011) was issued by Steven A. Musher, associate chief counsel (International) to Kathy Robbins, director, International Business Compliance (Large Business and International Division).

END NOTES CONT.

- ⁷ Specifically, the footnote states that:
The cumulative register concept is implicitly referenced in Treas. Reg. § 1.1503(d)-4(c)(3)(iii), which provides that the calculation of the separate unit's aggregate consolidated taxable income shall only include income arising in the same foreign country as the DCL. The concept also 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 cumulative register.
- ⁸ Douglas S. Holland & Guy A. Bracuti, *AM 2011-002: A DCL Carryover That Arrives Without Traveling*, *Tax Analysts*, Oct. 10, 2011, at 202-207.

NOTICE 2011-53 PROVIDES FATCA TRANSITIONAL RELIEF

By Frederic J. Gelfond

The prior edition of *TAXING TIMES* included an article describing several fundamental questions that remain unanswered as the deadline for compliance with the Foreign Account Tax Compliance Act (FATCA) draws near.¹ As discussed in that piece, FATCA was enacted in 2010 as part of the Hiring Incentives to Restore Employment Act, and imposes information reporting requirements on foreign financial institutions (FFIs) with respect to U.S. accounts and imposes withholding, documentation, and reporting requirements with respect to certain payments made to non-financial foreign entities, or NFFEs, in which U.S. taxpayers hold a substantial ownership interest.

A "participating FFI" can avoid the FATCA withholding requirements if it enters into an agreement with the Internal Revenue Service (Service or IRS), referred to as an FFI Agreement, to: (1) identify U.S. accounts; (2) report certain required information regarding the U.S. accounts to the Service; and (3) perform withholding on certain payments made to non-participating FFIs and "recalcitrant" account holders who do not provide the required information. If an FFI does not enter into an FFI Agreement, it will be subject to withholding on certain types of payments, including U.S. source interest and dividends, gross proceeds from the disposition of U.S. securities, and pass-thru payments.

As further explained in the prior *TAXING TIMES* piece, the Service provided preliminary guidance on the implementation of FATCA in Notice 2010-60 and Notice 2011-34. In response to those notices, the Service received numerous comment letters citing, among other things, the need for addi-

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