



Securities Industry Association

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COMMENTS ON PROPOSED REGULATIONS UNDER SECTION 1503(d) OF THE
INTERNAL REVENUE CODE, RELATING TO THE CERTIFICATION PERIOD FOR
DUAL CONSOLIDATED LOSSES

The Securities Industry Association ("SIA")¹ submits this letter to comment on the proposed Treasury regulations released on May 24, 2005 by the Internal Revenue Service (the "IRS") under section 1503(d) of the Internal Revenue Code of 1986, as amended (the "Proposed Regulations" and the "Code", respectively).²

¹ The Securities Industry Association brings together the shared interests of more than 600 securities firms to accomplish common goals. SIA's primary mission is to build and maintain public trust and confidence in the securities markets. SIA members (including investment banks, broker-dealers, and mutual fund companies) are active in all U.S. and foreign markets and in all phases of corporate and public finance. According to the Bureau of Labor Statistics, the U.S. securities industry employs nearly 800,000 individuals, and its personnel manage the accounts of nearly 93-million investors directly and indirectly through corporate, thrift, and pension plans. In 2005, the industry generated an estimated \$322.4 billion in domestic revenue and \$474 billion in global revenues. (More information about SIA is available at: www.sia.com.)

² Unless indicated otherwise, all section references in this letter are to the Code, or to Treasury regulations promulgated thereunder. The Proposed Regulations were published in the Federal Register on May 24, 2005 (REG-102144-04) and corrected on July 11, 2005.

The Proposed Regulations would substantially revise the current Treasury regulations promulgated under section 1503(d). In many cases, these revisions would simplify and rationalize the application of the dual consolidated loss rules in common fact patterns. We commend the IRS and Treasury for these improvements.

Nonetheless, we believe that the Proposed Regulations can and should be refined further, to channel the application and consequences of the dual consolidated loss rules only to those cases where cross-border “double dips” of operating losses by different taxpayers are realistically both likely to occur and to arise from deliberate tax planning.

For this reason, the SIA joins with the simplification and rationalization recommendations made by many other commentators to date. We join in particular in (i) the recommendations that the Proposed Regulations be revised to eliminate, or at least further narrow, the so-called “all or nothing” recapture rule of current Treasury regulation sections 1.1503-2(g)(2)(iii) and - 2(g)(2)(vii), under which the impermissible foreign use of any quantum of dual consolidated loss triggers the recapture of *all* dual consolidated losses claimed by the taxpayer in the United States, and (ii) the recommendation that, in calculating whether a dual consolidated loss exists, interest expense be allocated by reference to foreign tax principles, not the *sui generis* rules of Treasury regulation section 1.882-5.

More fundamentally, we believe that section 1503(d)’s application to outbound investments by U.S. firms deserves to be completely rethought. The dual consolidated loss rules appear to advance no policy objective at all when applied to outbound investments, beyond (perhaps) a diffuse capital export neutrality agenda of

the sort reflected in now-repudiated Notice 98-11.³ We recognize, however, that the IRS and Treasury may feel constrained by history to continue to promote this agenda in regulations implementing section 1503(d), and that the most appropriate venue for a fundamental policy debate on the role of dual consolidated loss principles therefore lies with Congress. We hope that taxpayers, Treasury and Congress will use the occasion of this revamping of the section 1503(d) regulations to begin this larger discussion.

For the sake of brevity, this letter does not repeat the arguments already developed in other comment letters that support the above recommendations (as well as other recommendations for further simplifying and rationalizing the dual consolidated loss rules). Instead, this comment letter focuses on one issue of particular concern to our member firms, which is the duration of the “certification period” for domestic use elections, during which an inadvertent impermissible foreign use of a dual consolidated loss can trigger the application of the “all or nothing” recapture rule described above.⁴

The Proposed Regulations, if finalized, would shorten the certification period from 15 years, as provided in the current Treasury regulations promulgated under section 1503(d),⁵ to seven years. This submission recommends that the final Treasury regulations shorten the certification period for domestic use elections to five years. A five-year certification period would further reduce the administrative burden of monitoring compliance with the complex provisions of the dual consolidated loss rules, and thereby also reduce the risk of catastrophic tax consequences attendant on an inadvertent compliance error. Moreover, a five-year period is consistent with other Code sections, regulations and international tax provisions limiting tax avoidance.

³ 1998-1 C.B. 433, *withdrawn by* Notice 98-35, 1998-2 C.B. 34.

⁴ Prop. Treas. Reg. Section 1.1503(d)-4(d)(1)(v).

⁵ Treas. Reg. Section 1.1503-2T(g)(2)(vi)(B).

1. *Reducing the Administrative Burden of the DCL Rules and the Risk of Inadvertent Error.* The IRS and Treasury recognize the obvious tension between the administrative burdens imposed by the dual consolidated loss rules, on one hand, and ensuring compliance with the statute, on the other hand, by ensuring that the same losses are not used in different jurisdictions by different taxpayers. The preamble to the Proposed Regulations in fact states that one of three goals in drafting the new regulations was to reduce the administrative burden of the current dual consolidated loss regulations on both taxpayers and the IRS.⁶

The preamble specifically notes with respect to the certification period that “requiring taxpayers to comply with the dual consolidated loss regulations, including the need to monitor potential triggering events and to comply with the various filing requirements, for a fifteen-year period is unnecessarily burdensome to both taxpayers and the Commissioner”. The preamble also concludes that a fifteen-year certification period is not required to deter and monitor “double dipping” of losses and deductions. For this reason, the Proposed Regulations reduce the certification period to seven years.

We commend the Treasury Department and the IRS for recognizing that a fifteen-year certification period is “unnecessarily burdensome to both taxpayers and the Commissioner” and is not required to deter and monitor double dipping of losses and deductions. We believe, however, that a five-year period would alleviate the administrative burden even further, while continuing to promote the goals of the Proposed Regulations.

⁶ 70 Fed. Reg. 29,869 (May 24, 2005).

A five-year certification period would reduce the risk of catastrophic tax consequences occurring from an inadvertent compliance error. The dual consolidated loss rules are complex and difficult to apply. Under these complex rules, an otherwise-inconsequential change in the organization of a U.S. taxpayer's foreign affiliates can trigger the unexpected application of the dual consolidated loss rules. In turn, the draconian consequences that follow from triggering the "all or nothing" rule described earlier mean that enormously consequential tax liabilities can arise from these otherwise-inconsequential restructurings of foreign affiliates. And of course the likelihood that such an event might occur through inadvertence increases exponentially with the passage of time from the year in which the taxpayer employs the loss in question for a domestic use. A shorter period would materially reduce the risk of such an inadvertent error from occurring.

As described in the next section, a five-year certification period would be in line with other similar trade-offs made by the Treasury and the IRS between administrative burdens and international tax policy goals. Moreover, a five-year certification period would directly reduce compliance costs. As a taxpayer must re-certify annually that no portion of the dual consolidated loss had been used to offset any foreign income,⁷ the longer the certification period, the more costly the burden of compliance. Finally, we believe that five years is in itself a substantial deterrence penalty and a longer period is unnecessary to deter deliberate cross-border "double dipping" of losses.

2. *A Five-Year Certification Period is Consistent with other Code Provisions and Regulations.* As noted above, the IRS and Treasury have been required to weigh

⁷ Treas. Reg. Section 1.1503-2T(g)(2)(vi)(B).

compliance burdens against policy objectives in other international anti-tax avoidance tax provisions — for example sections 367, 897(c), 7701 and 1248. In these cases, the consensus position has been that a five-year “hazard period” strikes the right balance. The same conclusion should be reached here.

Recently, the duration of “gain recognition agreements” under the section 367(a) regulations was shortened from ten years to five years.⁸ T.D. 8770⁹, the Treasury Decision under which the new regulations were promulgated, noted that a number of commentators had suggested that a ten-year gain recognition agreement was too restrictive. In response to those comments, the final regulations provide that the term of gain recognition agreements would be reduced to five years. By revising the section 367(a) regulations in this manner, the IRS and Treasury implicitly concluded that a five-year “hazard period” was sufficient to ensure that a transaction was not entered into for tax avoidance purposes.

Under section 897, gain or loss realized by a foreign taxpayer from the disposition of a U.S. real property interest is subject to U.S. tax. Section 897(c) provides that the appropriate look-back period for determining whether or not a U.S. corporation is a U.S. real property interest is a five-year period ending on the date of disposition of the interest in such corporation. Again, a five-year term implies that five years is the period necessary to assure the IRS and Treasury there has been no tax avoidance.

Similarly, Treasury regulation section 301.7701-3(c)(1)(iv) restricts the ability of an eligible entity to change its classification by making a check the box election

⁸ Treas. Reg. § 1.367(a)-8.

⁹ T.D. 8770, 1998-27 I.R.B. 7.

more than once in any five-year period. A five-year period implies that checking the box again after five years would not be for the purpose of tax avoidance.

Finally, section 1248(a) applies to a U.S. person that owns stock having ten percent or more of the voting power in a controlled foreign corporation at any time during a five-year period ending on the date of the sale or exchange of the stock.

Section 1248(a) treats gain on the sale or exchange as a dividend, *i.e.*, as ordinary income, to prevent the avoidance of U.S. tax at ordinary income tax rates. A five-year period again implies that a sale or exchange of the foreign corporation stock after five years would not be for the purpose of tax avoidance.

In summary, we believe that the Proposed Regulations should be amended to shorten the certification period for domestic use of dual consolidated losses to five years. Doing so would reduce the risk of catastrophic tax consequences arising from the inadvertent triggering of the “all or nothing” recapture rule, would reduce compliance burdens for both taxpayers and the IRS, and would be consistent with comparable balancings of administrative and policy concerns in potential international tax avoidance situations.

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Thank you for your consideration of our views. Please do not hesitate to contact Patti McClanahan, Vice President and Director for Tax Policy at the SIA (202-216-2031), or Edward Kleinbard of Cleary Gottlieb Steen & Hamilton LLP, SIA's outside

counsel on this matter (212-225-2480), if we can be of assistance with respect to any aspect of your ongoing work on these regulations.

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