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U.S. and U.K. Agree to Alleviate Double Tax under Dual Consolidated Loss Regimes

United Kingdom/United States Dual Consolidated Loss Competent Authority Agreement (Oct. 6, 2006)

Overview

Under the mutual agreement provision of the United States-United Kingdom Income Tax Treaty (the "Treaty"), the U.S. and the U.K. competent authorities have agreed to alleviate potential double taxation under the dual consolidated loss ("DCL") regimes of both countries. This is the first bilateral agreement under section 1.1503-2(g)(1) of the regulations.

Background

Under code section 1503(d), a DCL is a net operating loss (determined under U.S. law) of a U.S. corporation (a "DRC") that is subject to income tax both in the U.S. as well as in a foreign country on a residence basis, or on its income without regard to the source of its income. This is not uncommon because many foreign countries determine residency based on where the company is managed and controlled as opposed to where it is incorporated. A DRC cannot use a DCL to reduce taxable income of any other member of its affiliated group. However, similar to the consolidated return separate return limitation year (or "SRLY") rules, it is permitted to use the DCL to offset its own income from other sources.

A separate unit of a U.S. corporation, including a permanent establishment (or "PE"), as well as an LLC or partnership interest, is treated as a separate U.S. corporation that is a DRC for purposes of the DCL regime. The separate unit is treated as a DRC whether or not it is taxed by the foreign country on its worldwide income. Consequently, any net operating loss of a separate unit cannot be used to offset other income of the U.S. corporation that owns the separate unit. Under the SRLY principal, the separate unit loss can be used to offset other income of the separate unit.

The (g)(2) Agreement

Under section 1.1503-2(g)(2)(i) of the regulations, the taxpayer may use a DCL against income of domestic affiliates provided it enters into an agreement (a "(g)(2) agreement") to the effect that the taxpayer will not use the DCL under foreign income tax law to offset income of any foreign affiliate. Among other things, a (g)(2) agreement requires the taxpayer to certify each year for the 15 years following the year in which the DCL was incurred that no portion of the DCL has been or will be used under the laws of a foreign country to offset income of any other person (proposed regulations reduce this certification period to 7 years). If any part of the DCL is used to offset income of a foreign affiliate or "made available" for such use, or if other "triggering events" (including certain dispositions of the DCR or its assets) occur within the 15 year period, the U.S. taxpayer must take into gross income an amount equal to the entire DCL. The taxpayer is also subject to an interest charge to compensate for any benefit the taxpayer may have derived from using all or part of the DCL in earlier years.

Mirror Legislation

Under the "mirror legislation rule," a DRC is not permitted to use a DCL to offset income of domestic affiliates if a foreign jurisdiction has a regime that operates in a manner that is similar to the U.S. DCL regime. More specifically, the rule provides that if foreign law bars use of a DCL against income of affiliates, then for purposes of the U.S. DCL regime, the DRC is treated as if it used the DCL to offset income of a foreign affiliate. Consequently, the DCL is ineligible for a (g)(2) agreement and use of the loss in the U.S. against income of an affiliate is barred. The mirror legislation rule is intended to prevent

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foreign countries from pushing DCLs into the U.S. The sole exception to the mirror legislation rule is an election described in section 1.1503-2(g)(1) of the regulations (the "(g)(1) election"), which has a prerequisite that the U.S. and the foreign country establish a procedure to ensure that the DCL is used in only a single country.

The United Kingdom generally allows its resident corporations to deduct losses realized in a PE except where the loss realized by the PE can be deducted against income that is not subject to the U.K. corporate income tax. In determining whether a PE loss can be utilized outside the U.K., the U.K. disregards any rule in a foreign jurisdiction that limits the use of the loss derived by the PE. The U.S. DCL regime is such a rule and, as a result, the PE loss cannot be utilized against the U.K. income.

The U.S.-U.K. Income Tax Treaty and the Modified (g)(2) Agreement

Generally speaking, if a DRC realizes a DCL in the U.K., it cannot use the DCL to offset income of affiliates in either country because of the interaction of the U.S. and U.K. mirror legislation rules. Pursuant to the mutual agreement procedure in the Treaty, the U.S. and the U.K. competent authorities have agreed to a procedure that allows taxpayers to elect to use certain DCLs that arise in a PE in one or the other country (the "Agreement").

The Agreement applies to a U.S. company with a PE in the U.K. that has realized losses in U.K. accounting periods ending after April 1, 2000. The Agreement applies separately to each loss realized by a DCR. However, the Agreement has limited application. It applies only to a DCL of a U.S. company that is attributable to a PE; it does not apply to a DCL of a U.S. company that is a resident of the U.K. on account of being managed and controlled there (this rule does not treat a separate unit as a DRC). The Agreement is also inapplicable to a DCL realized by a hybrid entity (i.e., an entity taxed as a partnership in the U.S. and as a corporation in the U.K.), or a separate unit owned through a hybrid entity.

Under the Agreement, a U.S. company may make a section (g)(1) election to use a DCL either against income of affiliates in the U.S. or the U.K., but not both. If the U.S. company opts to use the loss in the U.S. it must enter a "modified (g)(2) agreement," which is essentially the same as the regular (g)(2) (including the 15 year certification requirement). The modified (g)(2) agreement requires the taxpayer to notify both U.K. and U.S. competent authorities if a triggering event occurs.

In general, a U.S. company makes the (g)(1) election on its income tax return for the year in which the DCL was incurred. It may make the election for any open year for which the return is due on or before January 4, 2007, (including extensions) by filing an amended federal income tax return for that year. The (g)(1) election is unavailable for a DCL incurred in a taxable year for which the statute of limitations for assessment of additional income tax has expired.

Planning Considerations

The Agreement is a positive development that eliminates a harsh result under the DCL regime. The exclusion of losses incurred by a hybrid entity may limit the utility of the provision. The Agreement will hopefully serve as a model for agreements with countries with similar DCL regimes – most notably Germany.

For additional information call Sam Kaywood (404-881-7481), Kevin Rowe (212-210-9505), or Edward Tanenbaum (212-210-9425).

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