elector and prior subsequent electors in certain cases; or

(iii) A dual consolidated loss is recaptured pursuant to paragraph (h) of this section. See §1.1503(d)–7(c) *Examples 32* through *34*.

(2) *Termination of ability for foreign use*—(i) *In general.* A domestic use agreement filed with respect to a dual consolidated loss shall terminate and have no further effect as of the end of a taxable year if the elector—

(A) Demonstrates, to the satisfaction of the Commissioner, that as of the end of such taxable year no foreign use (as defined in §1.1503(d)-3) of the dual consolidated loss can occur in any other year by any means; and

(B) Prepares a statement described in paragraph (j)(2)(ii) of this section that is attached to, and filed by the due date (including extensions) of, its U.S. income tax return for such taxable year.

(ii) *Statement.* The statement described in this paragraph (j)(2)(ii) must be signed under penalties of perjury by the person who signs the return. The statement must be labeled ''Termination of Ability for Foreign Use'' at the top of the page and must include the following information, in paragraphs labeled to correspond with the following:

(A) A statement that the document is submitted under the provisions of paragraph (j)(2) of this section.

(B) The information required by paragraph (c)(2)(ii) of this section.

(C) A statement of the amount of the dual consolidated loss at issue and the year in which such dual consolidated loss was incurred.

(D) The information described in paragraph (c)(2)(iv) of this section that supports the conclusion that no foreign use can occur as provided in paragraph (j)(2)(i)(A) of this section.

(3) *Agreements filed in connection with stand-alone exception.* See §1.1503(d)–3(e)(2)(iii) for the termination of domestic use agreements filed in connection with the stand-alone exception to the mirror legislation rule when a subsequent election is made under paragraph (b) of this section (relating to agreements entered into between the United States and a foreign country).

[T.D. 9315, 72 FR 12914, Mar. 19, 2007]

§ 1.1503(d)–7 Examples.

(a) *In general.* This section provides examples that illustrate the application of §§1.1503(d)–1 through 1.1503(d)–6. This section also provides facts that are presumed for such examples.

(b) *Presumed facts for examples.* For purposes of the examples in this section, unless otherwise indicated, the following facts are presumed:

(1) Each entity has only a single class of equity outstanding, all of which is held by a single owner.

(2) P, a domestic corporation and the common parent of the P consolidated group, owns S, a domestic corporation and a member of the P consolidated group.

(3) DRC_X, a domestic corporation, is subject to Country X tax on its worldwide income or on a residence basis, and is a dual resident corporation.

(4) $DE1_X$ and $DE2_X$ are both Country X entities, subject to Country X tax on their worldwide income or on a residence basis, and disregarded as entities separate from their owners for U.S. tax purposes. $DE3_Y$ is a Country Y entity, subject to Country Y tax on its worldwide income or on a residence basis, and disregarded as an entity separate from its owner for U.S. tax purposes. All the interests in $DE1_X$, $DE2_X$, and $DE3_Y$ constitute hybrid entity separate units.

(5) FB_X is a Country X business operation that, if carried on by a U.S. person, would constitute a foreign branch, as defined in §1.367(a)–6T(g)(1), and is a Country X foreign branch separate unit.

(6) Neither the assets nor the activities of an entity constitute a foreign branch separate unit.

(7) FS_X is a Country X entity that is subject to Country X tax on its worldwide income or on a residence basis and is classified as a foreign corporation for U.S. tax purposes.

(8) The applicable foreign country has a consolidation regime that—

(i) Includes as members of a consolidated group any commonly controlled branches and permanent establishments in such jurisdiction, and entities that are subject to tax in such jurisdiction on their worldwide income or on a residence basis; and

(ii) Allows the losses of members of consolidated groups to offset income of other members.

(9) There is no mirror legislation, within the meaning of §1.1503(d)–3(e)(1), in the applicable foreign country.

(10) There is no elective agreement described in §1.1503(d)–6(b) between the United States and the applicable foreign country.

(11) There is no income tax convention between the United States and the applicable foreign country.

(12) If a domestic use election, within the meaning of §1.1503(d)–6(d), is made, all the necessary filings related to such election are properly completed on a timely basis.

(13) If there is a triggering event requiring recapture of a dual consolidated loss, the amount of recapture is not reduced pursuant to §1.1503(d)–6(h)(2).

(14) There are no other items of income, gain, deduction, and loss. In addition, the United States and the applicable foreign country recognize the same items of income, gain, deduction, and loss in each taxable year.

(15) All taxpayers use the calendar year as their taxable year.

(c) *Examples*. The following examples illustrate the application of §§1.1503(d)–1 through 1.1503(d)–6:

Example 1. Separate unit combination rule. (i) *Facts*. P owns $DE3_Y$ which, in turn, owns $DE1_X$. $DE1_X$ owns FB_X. PRS, an entity treated as a partnership for both U.S. and Country X tax purposes, is owned 50 percent by P and 50 percent by an unrelated foreign person. PRS 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 §1.367(a)–6T(g)(1). In addition, P owns DRC_X, a member of the consolidated group of which P is the parent, which carries on business operations in Country X that constitute a foreign branch within the meaning of §1.367(a)–6T(g)(1). S owns $DE2_X$.

(ii) *Result*. Pursuant to §1.1503(d)–1(b)(4)(ii), the interest in $DE1_X$, the interest in $DE2_X$, FB_X, P's share of the Country X business operations carried on by PRS (which is owned by P indirectly through its interest in PRS), and DRC_X's Country X business operations are combined and treated as a single separate unit of the consolidated group of which P is the parent. This is the case regardless of whether the losses of each individual separate unit are made available to offset the income of the other individual separate units under Country X tax laws. Because DRC_X is a dual resident corporation, it is not combined and treated as part of this combined separate unit and, as a result, DRC_X's income or dual consolidated loss is not taken into account in determining the income or dual consolidated loss of the combined separate unit. In addition, P's interest in $DE3_Y$ is not combined and is another separate unit because it is subject to tax in Country Y, rather than Country X.

Example 2. Definition of a separate unit and application of domestic use limitation—foreign branch separate unit. (i) *Facts*. P carries on business operations in Country X that constitute a permanent establishment under the U.S.–Country X income tax convention. In year 1, a loss is attributable to P's Country X permanent establishment, as determined under §1.1503(d)–5.

(ii) *Result*. Under §§1.1503(d)–1(b)(4)(i)(A) and 1.367(a)–6T(g)(1), P's Country X permanent establishment constitutes a foreign branch separate unit. Therefore, the year 1 loss attributable to the foreign branch separate unit constitutes a dual consolidated loss pursuant to §1.1503(d)–1(b)(5)(ii). The dual consolidated loss rules apply to the dual consolidated loss even though there is no affiliate of the foreign branch separate unit in Country X, because it is still possible that all or a portion of the dual consolidated loss can be put to a foreign use. For example, there may be a foreign use with respect to a Country X affiliate acquired in a year subsequent to the year in which the dual consolidated loss was incurred. See §1.1503(d)–6(a)(2). Accordingly, unless an exception under §1.1503(d)–6 applies (such as a domestic use election), the year 1 dual consolidated loss attributable to P's Country X permanent establishment is subject to the domestic use limitation rule of §1.1503(d)–4(b). As a result, pursuant to §1.1503(d)–4(c), the year 1 dual consolidated loss cannot offset income of P that is not attributable to its Country X foreign branch separate unit, nor can it offset income of any other domestic affiliate. The loss can, however, offset income of the Country X foreign branch separate unit, subject to the application of §1.1503(d)–4(c). The result would be the same even if Country X did not have a consolidation regime that includes as members of consolidated groups Country X branches or permanent establishments of nonresident corporations. The dual consolidated loss rules apply even in the absence of a consolidation regime in the foreign country because it is possible that all or a portion of a dual consolidated loss can be put to a foreign use by other means, such as through a sale, merger, or similar transaction. See §1.1503(d)–6(a)(2).

(iii) *Alternative Facts*. The facts are the same as in paragraph (i) of this *Example 2*, except that P's Country X business operations constitute a foreign branch as defined in §1.367(a)–6T(g)(1), but do not constitute a permanent establishment under the U.S.–Country X income tax convention. Although the activities carried on by P in Country X would otherwise constitute a foreign branch separate unit as described in §1.1503(d)–1(b)(4)(i)(A), the exception under §1.1503(d)–1(b)(4)(iii) applies because the activities do not constitute a permanent establishment under the U.S.–Country X income tax convention. Thus, the Country X business operations do not constitute a foreign branch separate unit, and the year 1 loss is not subject to the dual consolidated loss rules. If P instead carried on its Country X business operations through $DE1_X$, then the exception under §1.1503(d)–1(b)(4)(iii) would not apply because P carries on the business operations through a hybrid entity and, as a result, the business operations would constitute a foreign branch separate unit. Thus, in such a case the year 1 loss would be subject to the dual consolidated loss rules.

Example 3. Domestic use limitation—foreign branch separate unit owned through a partnership. (i) *Facts.* P and S organize a partnership, PRS_X, under the laws of Country X. PRS_X is treated as a partnership for both U.S. and Country X tax purposes. PRS_X owns FB_X. PRS_X earns U.S. source income that is unconnected with its FB_X branch operations, and such income is not subject to tax by Country X. In addition, such U.S. source income is not attributable to FB_X under §1.1503(d)–5.

(ii) *Result.* Under §1.1503(d)–1(b)(4)(i)(A), P's and S's shares of FB_X owned indirectly through their interests in PRS_X are individual foreign branch separate units. Pursuant to §1.1503(b)–1(b)(4)(ii), these individual separate units are combined and treated as a single separate unit of the consolidated group of which P is the parent. Unless an exception under §1.1503(d)–6 applies, any dual consolidated loss attributable to FB_X cannot offset income of P or S (other than income attributable to FB_X, subject to the application of §1.1503(d)–4(c)), including their distributive share of the U.S. source income earned through their interests in PRS_X, nor can it offset income of any other domestic affiliates.

Example 4. Definition of a separate unit and domestic use limitation—interest in hybrid entity partnership and indirectly owned foreign branch separate unit. (i) *Facts.* HPS_X is a Country X entity that is subject to Country X tax on its worldwide income. HPS_X is classified as a partnership for Federal tax purposes. P, S, and FS_X, are the sole partners of HPS_X. For U.S. tax purposes, P, S, and FS_X each has an equal interest in each item of HPS_X's profit or loss. HPS_X carries on operations in Country Y that, if carried on by a U.S. person, would constitute a foreign branch within the meaning of §1.367(a)–6T(g)(1).

(ii) *Result.* Under §1.1503(d)–1(b)(4)(i)(B), the partnership interests in HPS_X held by P and S are individual hybrid entity separate units. These individual separate units are combined into a single separate unit under §1.1503(d)–1(b)(4)(ii). In addition, P's and S's share of the Country Y operations owned indirectly through their interests in HPS_X are individual foreign branch separate units under §1.1503(d)–1(b)(4)(i)(B). These individual separate units are also combined into a single separate unit under §1.1503(d)–1(b)(4)(ii). Unless an exception under §1.1503(d)–6 applies, dual consolidated losses attributable to P's and S's combined interests in HPS_X can only be used to offset income attributable to their combined interests in HPS_X (other than income attributable to P's and S's combined interests in the Country Y foreign branch separate unit), subject to the application of §1.1503(d)–4(c). Similarly, dual consolidated losses attributable to P's and S's combined interests in the Country Y operations of HPS_X can only be used to offset income attributable to their combined interests in such Country Y operations, subject to the application of §1.1503(d)–4(c). Neither FS_X's interest in HPS_X, nor its share of the Country Y operations owned by HPS_X, is a separate unit because FS_X is not a domestic corporation.

Example 5. Foreign use—general rule and de minimis reduction exception. (i) *Facts.* P owns $DE1_X$. $DE1_X$ owns FS_X. In year 1, there is a \$100x loss attributable to P's interest in $DE1_X$ that is a dual consolidated loss. Also in year 1, FS_X earns \$200x of income. $DE1_X$ and FS_X file a Country X consolidated tax return. For Country X tax purposes, the year 1 \$100x loss of $DE1_X$ is used to offset \$100x of year 1 income generated by FS_X. Under Country X tax law, unused losses are carried forward and available to offset income in subsequent taxable years.

(ii) *Result.* The \$100x loss attributable to P's interest in $DE1_X$ is available to, and in fact does, offset FS_X's income under the laws of Country X. In addition, under U.S. tax principles, such income is considered to be an item of FS_X, a foreign corporation. As a result, under §1.1503(d)–3(a), there has been a foreign use of the year 1 dual consolidated loss attributable to P's interest in $DE1_X$. Therefore, P cannot make a domestic use election with respect to the loss as provided under §1.1503(d)–6(d)(2), and such loss will be subject to the domestic use limitation rule of §1.1503(d)–4(b). The result would be the same even if FS_X, under Country X tax law, had no income against which the dual consolidated loss of $DE1_X$ could be offset (unless FS_X's ability to use the loss under Country X tax law requires an election, and no such election is made).

(iii) *Alternative Facts.* The facts are the same as in paragraph (i) of this *Example 5*, except that FS_X cannot use the loss of $DE1_X$

under Country X tax law without an election, and no such election is made. Pursuant to the exception in §1.1503(d)–3(c)(2), there is no foreign use of the year 1 dual consolidated loss attributable to P's interest in $DE1_X$. In addition, P files a domestic use election with respect to the year 1 dual consolidated loss attributable to its interest in $DE1_X$ and, at the beginning of year 3, P sells its interest in $DE1_X$ to F, a Country Y entity that is a foreign corporation. The sale of the interest in $DE1_X$ to F results in a foreign use triggering event pursuant to §1.1503(d)–6(e)(1)(i) because, immediately after the sale, the loss attributable to the interest in $DE1_X$ carries over under Country X law and, therefore, is available under U.S. tax principles to offset income of the owner of the interest in $DE1_X$ which, in the hands of F, is not a separate unit. It is also a foreign use because the loss is available under U.S. tax principles to offset the income of F, a foreign corporation. See §1.1503(d)–3(a)(1). Finally, the transfer is a triggering event pursuant to §1.1503(d)–6(e)(1)(iv) and (v).

(iv) *Alternative Facts.* The facts are the same as in paragraph (iii), of this *Example 5*, except that P only sells 5 percent of its interest in $DE1_X$ to F. Pursuant to Rev. Rul. 99–5 (1999–1 CB 434), see §601.601(d)(2)(ii)(*b*) of this chapter, the transaction is treated as if P sold 5 percent of its interest in each of $DE1_X$'s assets to F, and then immediately thereafter P and F transferred their interests in the assets of $DE1_X$ to a partnership in exchange for an ownership interest therein. The sale of the 5 percent interest in $DE1_X$ generally results in a foreign use triggering event because a portion of the dual consolidated loss carries over under Country X tax law and is available under U.S. tax principles to offset income of the owner of the interest in $DE1_X$, a hybrid entity, which in the hands of F is not a separate unit. It is also a foreign use because the loss is available under U.S. tax principles to offset the income of F, a foreign corporation. See §1.1503(d)–3(a)(1). However, pursuant to the exception under §1.1503(d)–3(c)(5) (relating to a de minimis reduction of an interest in a separate unit), such availability does not result in a foreign use. In addition, pursuant to §1.1503(d)–6(f)(1) and (3), the deemed transfers pursuant to Rev. Rul. 99–5 as a result of the sale are not treated as triggering events described in §1.1503(d)–6(e)(1)(iv) or (v).

Example 6. Foreign use and indirect foreign use—foreign reverse hybrid structure and disregarded payments. (i) *Facts.* P owns $DE1_X$. $DE1_X$ owns 99 percent and S owns 1 percent of FRH_X, a Country X partnership that elected to be treated as a corporation for U.S. tax purposes. FRH_X conducts a trade or business in Country X. In year 1, $DE1_X$ incurs interest expense on a third-party loan, which constitutes a dual consolidated loss attributable to P's interest in $DE1_X$. In year 1, for Country X tax purposes, $DE1_X$ takes into account its distributive share of income generated by FRH_X and offsets such income with its interest expense.

(ii) *Result.* In year 1, the dual consolidated loss attributable to P's interest in $DE1_X$ is available to, and in fact does, offset income recognized in Country X and, under U.S. tax principles, the income is considered to be income of FRH_X, a foreign corporation. Accordingly, pursuant to §1.1503(d)–3(a)(1), there is a foreign use of the dual consolidated loss. Therefore, P cannot make a domestic use election with respect to the year 1 dual consolidated loss attributable to its interest in $DE1_X$, as provided under §1.1503(d)–6(d)(2), and such loss will be subject to the domestic use limitation rule of §1.1503(d)–4(b).

(iii) *Alternative Facts.* (A) The facts are the same as in paragraph (i) of this *Example 6*, except as follows. Instead of owning $DE1_X$, P owns $DE3_Y$ which, in turn, owns $DE1_X$. In addition, $DE3_Y$, rather than $DE1_X$, is the obligor on the third-party loan and therefore incurs the interest expense on such loan. Finally, $DE3_Y$ on-lends the loan proceeds from the third-party loan to $DE1_X$, and $DE1_X$ pays interest to $DE3_Y$ on such loan that is generally disregarded for U.S. tax purposes.

(B) Pursuant to §1.1503(d)–5(c)(1)(ii), for purposes of calculating income or a dual consolidated loss, $DE3_Y$ and $DE1_X$ do not take into account interest income or interest expense, respectively, with respect to amounts paid on the disregarded loan from $DE3_Y$ to $DE1_X$. As a result, such items neither create a dual consolidated loss with respect to the interest in $DE1_X$, nor do they reduce (or eliminate) the dual consolidated loss attributable to the interest in $DE3_Y$. Thus, in year 1, there is a dual consolidated loss attributable to P's interest in $DE3_Y$, but not to P's indirect interest in $DE1_X$.

(C) In year 1, interest expense paid by $DE1_X$ to $DE3_Y$ on the disregarded loan is taken into account as a deduction in computing $DE1_X$'s taxable income for Country X tax purposes, but does not give rise to a corresponding item of income or gain for U.S. tax purposes (because it is generally disregarded). In addition, such interest has the effect of making an item of deduction or loss composing the dual consolidated loss attributable to P's interest in $DE3_Y$ available for a foreign use. This is the case because it may reduce or offset items of deduction or loss composing the dual consolidated loss for foreign tax purposes, and creates another deduction or loss that may reduce or offset income of $DE1_X$ for foreign tax purposes that, under U.S. tax principles, is treated as income of FRH_X, a foreign corporation. Moreover, because the disregarded item is incurred or taken into account as interest for foreign tax purposes, it is deemed to have been incurred or taken into account with a principal purpose of avoiding the provisions of section 1503(d). Accordingly, there is an indirect foreign use of the year 1 dual consolidated loss attributable to P's interest in $DE3_Y$, and P cannot make a domestic use election with respect to such loss as provided under §1.1503(d)–6(d)(2). Thus, the loss will be subject to the domestic use limitation rule of §1.1503(d)–4(b).

Example 7. Indirect foreign use—hybrid instrument. (i) *Facts.* P owns $DE1_X$ which, in turn, owns FS_X. $DE1_X$ borrows cash from an unrelated lender and transfers the cash to FS_X in exchange for an instrument (hybrid instrument). The hybrid instrument is treated as equity for U.S. tax purposes and debt for Country X tax purposes. Interest expense on the loan from the unrelated lender results in a dual consolidated loss being attributable to P's interest in $DE1_X$ in year 1. $DE1_X$ does not elect under Country X law to consolidate with FS_X. In year 1, FS_X distributes its stock as a payment on the hybrid instrument to $DE1_X$. For U.S. tax purposes, such payment is excluded from P's gross income under section 305. However, for Country X tax purposes, such payment is treated as interest and gives rise to a deduction taken into account in computing FS_X's Country X tax liability; the payment also gives rise to interest income to $DE1_X$ for Country X tax purposes.

(ii) *Result.* The payment on the hybrid instrument does not give rise to an item of income or gain for U.S. tax purposes and therefore does not reduce (or eliminate) the dual consolidated loss attributable to P's interest in $DE1_X$. In addition, such payment is taken into account as a deduction in computing FS_X's taxable income for Country X tax purposes. Moreover, such payment has the effect of making an item of deduction or loss composing the dual consolidated loss attributable to P's interest in $DE1_X$ available for a foreign use. This is the case because it may reduce or offset items of deduction or loss composing the dual consolidated loss for foreign tax purposes, and creates a deduction that reduces or offsets income of FS_X for foreign tax purposes that, under U.S. tax principles, is income of a foreign corporation. Further, because the item is incurred, or taken into account, using an instrument that is treated as equity for U.S. tax purposes and debt for foreign tax purposes, it is deemed to have been engaged in with the principal purpose of avoiding the provisions of section 1503(d). As a result, there has been an indirect foreign use of the year 1 dual consolidated loss, and P cannot make a domestic use election with respect to such loss, as provided under §1.1503(d)–6(d)(2). Thus, the year 1 dual consolidated loss will be subject to the domestic use limitation rule of §1.1503(d)–4(b).

Example 8. No indirect foreign use—transaction entered into in the ordinary course of business. (i) *Facts.* P owns $DE1_X$ and FB_Y. FB_Y is a foreign branch separate unit located in Country Y. $DE1_X$ owns FB_X and FS_X. P's interest in $DE1_X$ and FB_X are combined and treated as a single separate unit (Country X separate unit) pursuant to §1.1503(d)–1(b)(4)(ii). Under Country X tax laws, $DE1_X$ elects to consolidate with FS_X. FB_Y engages in the business of providing services and, in connection with its ordinary course of business, provides services to unrelated third parties and to $DE1_X$. As compensation for services, $DE1_X$ makes a payment to FB_Y. Under Country X tax law, the payment is deductible. However, the payment is generally disregarded for U.S. tax purposes and, pursuant to §1.1503(d)–5(c)(1)(ii), is not taken into account in calculating the income or dual consolidated loss attributable to the Country X separate unit or FB_Y. In year 1, the Country X separate unit and FB_Y each has a dual consolidated loss. The dual consolidated loss attributable to the Country X separate unit is subject to the domestic use limitation under §1.1503(d)–4(b) because $DE1_X$ and FS_X elect to consolidate and, as a result, the dual consolidated loss is put to a foreign use.

(ii) *Result.* The payment made by $DE1_X$ to FB_Y in connection with the performance of services is taken into account as a deduction in computing $DE1_X$'s taxable income for Country X tax purposes, but does not give rise to an item of income or gain for U.S. tax purposes. In addition, such payment has the effect of making an item of deduction or loss composing the dual consolidated loss attributable to FB_Y available for a foreign use. This is the case because it may reduce or offset items of deduction or loss composing the dual consolidated loss of FB_Y for foreign tax purposes, and creates another deduction that reduces or offsets income of FS_X for foreign tax purposes (because $DE1_X$ and FS_X elect to file a consolidated return) that, under U.S. tax principles, is income of a foreign corporation. However, the transaction between $DE1_X$ and FB_Y was entered into in the ordinary course of FB_Y's trade or business. As a result, if P can demonstrate to the satisfaction of the Commissioner that the transaction was not entered into with a principal purpose of avoiding the provisions of section 1503(d), FB_Y's year 1 dual consolidated loss will not be treated as having been made available for an indirect foreign use. In such a case, P would be entitled to make a domestic use election with respect to such loss.

Example 9. Foreign use—dual resident corporation with hybrid entity joint venture. (i) *Facts.* P owns DRC_X, a member of the P consolidated group. DRC_X owns 80 percent of HPS_X, a Country X entity that is subject to Country X tax on its worldwide income. HPS_X is classified as a partnership for U.S. tax purposes. FS_X owns the remaining 20 percent of HPS_X. In year 1, DRC_X generates a $100x net operating loss (without regard to items attributable to DRC_X's interest in

HPS_X). Also in year 1, HPS_X generates $100x of income, $80x of which is attributable to DRC_X's interest in HPS_X. DRC_X and HPS_X file a consolidated tax return for Country X tax purposes, and HPS_X offsets its $100x of income with the $100x loss generated by DRC_X.

(ii) *Result.* DRC_X and its interest in HPS_X are not combined because DRC_X is a dual resident corporation and the combination rule under §1.1503(d)–1(b)(4)(ii) only applies to separate units. The $100x year 1 net operating loss incurred by DRC_X (without regard to items attributable to DRC_X's interest in HPS_X) is a dual consolidated loss. In addition, HPS_X is a hybrid entity and DRC_X's interest in HPS_X is a hybrid entity separate unit; however, there is no dual consolidated loss attributable to such separate unit in year 1 (instead, there is $80x of income attributable to such separate unit). DRC_X's year 1 dual consolidated loss offsets $100x of income for Country X purposes, and $20x of such income is, under U.S. tax principles, income of FS_X, which owns an interest in HPS_X that is not a separate unit (in addition, FS_X is a foreign corporation). As a result, pursuant to §1.1503(d)–3(a), there is a foreign use of the year 1 dual consolidated loss of DRC_X, and P cannot make a domestic use election with respect to such loss pursuant to §1.1503(d)–6(d)(2). Therefore, such loss will be subject to the domestic use limitation rule of §1.1503(d)–4(b). The result would be the same even if HPS_X, under Country X laws, had no income against which the dual consolidated loss could be offset (unless the ability to use the loss under Country X laws required an election, and no such election is made).

Example 10. Foreign use—foreign parent corporation. (i) *Facts.* F1 and F2, nonresident alien individuals, each owns 50 percent of FP_X, a Country X entity that is subject to Country X tax on its worldwide income. FP_X is classified as a foreign corporation for U.S. tax purposes. FP_X owns DRC_X. DRC_X is the parent of a consolidated group that includes as a member DS, a domestic corporation. In year 1, DRC_X incurs a dual consolidated loss of $100x and, for Country X tax purposes, FP_X generates $100x of income. In year 1, FP_X elects to consolidate with DRC_X for Country X tax purposes, and the $100x year 1 loss of DRC_X is used to offset the income of FP_X under the laws of Country X. For U.S. tax purposes, the items of FP_X do not constitute items of income in year 1.

(ii) *Result.* The year 1 dual consolidated loss of DRC_X offsets the income of FP_X under the laws of Country X. Pursuant to §1.1503(d)–3(a), the offset constitutes a foreign use because the items constituting such income are considered under U.S. tax principles to be items of a foreign corporation. This is the case even though the United States does not recognize such items as income in year 1. Therefore, DRC_X cannot make a domestic use election with respect to its year 1 dual consolidated loss pursuant to §1.1503(d)–6(d)(2). As a result, such loss will be subject to the domestic use limitation rule of §1.1503(d)–4(b).

(iii) *Alternative Facts.* The facts are the same as in paragraph (i) of this *Example 10*, except that FP_X is classified as a partnership for U.S. tax purposes. The result would be the same as in paragraph (ii) of this *Example 10*, because the offset of the income generated by FP_X is a foreign use pursuant to §1.1503(d)–3(a). This is the case because the items constituting such income are considered under U.S. tax principles to be items of F1 and F2, the owners of interests in FP_X (a hybrid entity), that are not separate units. Moreover, the result would be the same if F1 and F2 owned their interests in FP_X indirectly through another partnership.

Example 11. No foreign use—absence of foreign loss allocation rules. (i) *Facts.* P owns $DE1_X$ and DRC_X. DRC_X is a member of the P consolidated group and owns FS_X. $DE1_X$ owns FB_X. P's interest in $DE1_X$ and P's indirect interest in FB_X are individual separate units that are combined into a single separate unit (Country X separate unit) pursuant to §1.1503(d)–1(b)(4)(ii). In year 1, DRC_X incurs a $200x net operating loss and $200x of income is attributable to P's Country X separate unit. The $200x net operating loss incurred by DRC_X is a dual consolidated loss. FS_X also earns $200x of income in year 1. DRC_X, $DE1_X$, and FS_X file a Country X consolidated tax return. However, Country X has no applicable rules for determining which income is offset by DRC_X's year 1 $200x loss.

(ii) *Result.* Under §1.1503(d)–3(c)(3), DRC_X's $200x loss shall be treated as having been made available to offset the $200x of income attributable to P's Country X separate unit. P's Country X separate unit is not, under U.S. tax principles, a foreign corporation, and there is no interest in $DE1_X$ (which is a hybrid entity) that is not a separate unit. As a result, DRC_X's loss being made available to offset the income attributable to P's Country X separate unit is not considered a foreign use of such loss. Therefore, P can make a domestic use election with respect to DRC_X's year 1 dual consolidated loss.

(iii) *Alternative Facts.* The facts are the same as in paragraph (i) of this *Example 11*, except that in year 1 only $150x of income is attributable to P's Country X separate unit. Because only $150x of income is attributed to P's Country X separate unit, $50x of DRC_X's year 1 dual consolidated loss is treated as being made available to offset the income of FS_X, a foreign corporation, and therefore constitutes a foreign use. As a result, DRC_X cannot make a domestic use election with respect to its year 1 dual consolidated loss pursuant to §1.1503(d)–6(d)(2), and such loss will be subject to the domestic use limitation rule of §1.1503(d)–4(b).

Example 12. No foreign use—absence of foreign loss usage ordering rules. (i) *Facts.* (A) P owns DRC_X, a member of the P consolidated group. DRC_X owns FS_X. Under the Country X consolidation regime, a consolidated group may elect in any given year to use all or a portion of the losses of one consolidated group member to offset income of other consolidated group members. If no such election is made in a year in which losses are generated by a consolidated member, such losses carry forward and are available, at the election of the consolidated group, to offset income of consolidated group members in subsequent taxable years. Country X law does not provide ordering rules for determining when a loss from a particular taxable year is used because, under Country X law, losses never expire. In addition, Country X law does not provide ordering rules for determining when a particular type of loss (for example, capital or ordinary) is used.

(B) In year 1, DRC_X incurs a capital loss of $80x which, under §1.1503(d)–5(b)(2), is not a dual consolidated loss. DRC_X also incurs a net operating loss of $80x in year 1 which is a dual consolidated loss. FS_X generates $60x of capital gain in year 1 which, for Country X purposes, can be offset by capital losses and net operating losses. Under the laws of Country X, DRC_X elects to use $60x of its total year 1 loss of $160x to offset the $60x of capital gain generated by FS_X in year 1; the remaining $100x of year 1 loss carries forward. In both year 2 and year 3, DRC_X incurs a net operating loss of $100x, while FS_X incurs no income or loss in years 2 and 3. DRC_X's $100x losses incurred in year 2 and year 3 are dual consolidated losses. Because DRC_X does not elect under the laws of Country X to use all or a portion of its year 2 or year 3 net operating losses of $100x to offset the income of other members of the Country X consolidated group, P is permitted to make (and in fact does make) a domestic use election with respect to both the year 2 and year 3 dual consolidated losses of DRC_X. In year 4, DRC_X has a net operating loss of $10x and FS_X generates $125x of income. Country X law permits, upon an election, FS_X's $125x of income generated in year 4 to be offset by losses (including carryover losses from prior years) of other group members. Accordingly, in year 4, DRC_X elects to use $125x of its accumulated losses to offset the $125x of year 4 income generated by FS_X.

(ii) *Result.* (A) Under the ordering rules of §1.1503(d)–3(d)(3), a pro rata amount of DRC_X's year 1 net operating loss ($30x) and capital loss ($30x) is considered to be used to offset FS_X's year 1 $60x capital gain. As a result, P cannot make a domestic use election with respect to DRC_X's year 1 $80x dual consolidated loss because a portion of such loss is put to a foreign use.

(B) DRC_X's $10x year 4 net operating loss is also a dual consolidated loss. Under the ordering rules of §1.1503(d)–3(d)(1), such loss is considered to be used to offset $10x of FS_X's year 4 $125x of income. Consequently, P cannot make a domestic use election with respect to such loss. Under the ordering rules of §1.1503(d)–3(d)(2), $50x of capital loss carryover and $50x of ordinary loss from year 1 will be considered to offset $100x of FS_X's year 4 income because the income is first deemed to have been offset by losses the use of which would not constitute a triggering event that would result in the recapture of a dual consolidated loss. The remaining $15x of FS_X's year 4 income is considered to be offset by losses from year 3 because it is the most recent taxable year from which a loss may be carried forward. Thus, a portion of the year 3 dual consolidated loss has been put to a foreign use and the entire year 3 dual consolidated loss is recaptured. However, none of DRC_X's $100x year 2 net operating loss will be deemed to offset FS_X's year 4 income. As a result, DRC_X's year 2 dual consolidated loss will not be recaptured.

Example 13. Exception to foreign use through partnership interest. (i) *Facts.* (A) P owns 80 percent of HPS_X, a Country X entity subject to Country X tax on its worldwide income. FS_Z, an unrelated foreign corporation, owns the remaining 20 percent of HPS_X. HPS_X is classified as a partnership for Federal tax purposes and carries on operations in Country X that, if carried on by a U.S. person, would constitute a foreign branch within the meaning of §1.367(a)–6T(g)(1). P's interest in HPS_X and P's indirect interest in the Country X branch are individual separate units that are combined into a single separate unit (Country X separate unit) pursuant to §1.1503(d)–1(b)(4)(ii).

(B) In year 1, HPS_X incurs a loss of $100x, $80x of which is attributable to P's Country X separate unit. The $80x of loss attributable to P's Country X separate unit constitutes a dual consolidated loss and P makes a domestic use election with respect to such loss. In year 2, HPS_X generates $50x of income, $40x of which is attributable to P's interest in the Country X separate unit. Under Country X income tax laws, the $100x of year 1 loss incurred by HPS_X is carried forward and offsets the $50x of income generated by HPS_X in year 2; the remaining $50x of loss is carried forward and is available to offset income generated by HPS_X in subsequent years. P and FS_Z maintain their ownership interests in HPS_X throughout years 1 and 2.

(ii) *Result.* In year 2, under the laws of Country X, the $100x of year 1 loss, which includes the $80x dual consolidated loss attributable to P's Country X separate unit, is made available to offset income of HPS_X. Such income is attributable to P's interest in HPS_X, which is a separate unit. Such income also is income of FS_Z, a foreign corporation that is an owner of an interest in HPS_X, which is not a separate unit. However, pursuant to §1.1503(d)–3(c)(4), there is no foreign use of the year 1 dual consolidated loss in year 2. This is the case because P's interest in HPS_X as of the end of year 1 has not been reduced by more than a de minimis amount, and the portion of the $80x dual consolidated loss was made available for a foreign use in year 2 solely as a result of FS_Z's ownership in HPS_X and the allocation or carry forward of the dual consolidated loss as a result of such ownership.

(iii) *Alternative Facts.* The facts are the same as in paragraph (i) of this *Example 13*, except that P also owns FS_X. In addition, FS_X and HPS_X elect to file a consolidated return under Country X law. The exception to foreign use under §1.1503(d)–3(c)(4) does not apply because there is a foreign use other than by reason of the dual consolidated loss being made available as a result of FS_Z's ownership in HPS_X and the allocation or carry forward of the dual consolidated loss as a result of such ownership. That is, the exception does not apply because there is also a foreign use of the dual consolidated loss as a result of FS_X and HPS_X filing a consolidated return under Country X law.

(iv) *Alternative Facts.* The facts are the same as in paragraph (i) of this *Example 13*, except that at the end of year 2, FS_Z contributes cash to HPS_X in exchange for additional equity of HPS_X. As a result of the contribution, FS_Z's interest in HPS_X increases from 20 percent to 30 percent, and P's interest in HPS_X decreases from 80 percent to 70 percent. P's interest in HPS_X is reduced within a single 12-month period by 12.5 percent (10/80), as compared to P's interest in HPS_X as of the beginning of such 12-month period. Accordingly, pursuant to §1.1503(d)–3(c)(4)(iii), the exception to foreign use provided under §1.1503(d)–3(c)(4)(i) does not apply. Therefore, in year 2 there is a foreign use of the $80x year 1 dual consolidated loss attributable to P's Country X separate unit. Such foreign use constitutes a triggering event in year 2 and the $80x year 1 dual consolidated loss is recaptured. Alternatively, if FS_Z were a domestic corporation, there would not be a foreign use of the $80x year 1 dual consolidated loss because the loss would not be available to offset income that, under U.S. tax principles, is income of a foreign corporation or a direct or indirect owner of an interest in a hybrid entity that is not a separate unit.

Example 14. Exception to foreign use through partnership interest—combination rule. (i) *Facts.* (A) P and FS_X form PRS_X. P and FS_X each own 50 percent of PRS_X throughout years 1 and 2. PRS_X is treated as a partnership for both U.S. and Country X tax purposes. PRS_X owns DE_Y. DE_Y is a Country Y entity subject to Country Y tax on its worldwide income and disregarded as an entity separate from its owner for U.S. tax purposes. DE_Y conducts business operations in Country Y that, if carried on by a U.S. person, would constitute a foreign branch as defined in §1.367(a)–6T(g)(1). P's interest in the Country Y operations conducted by DE_Y is an individual foreign branch separate unit. P's interest in DE_Y, owned indirectly through PRS_X, is a hybrid entity individual separate unit. P also owns FB_Y, a Country Y foreign branch individual separate unit. Under §1.1503(d)–1(b)(4)(ii), FB_Y and P's indirect interests in DE_Y and DE_Y's Country Y business operations are treated as a combined separate unit (Country Y separate unit).

(B) In year 1, there is a $100x loss attributable to the Country Y business operations conducted by DE_Y. Thus, there is a $50x loss attributable to P's interest in DE_Y's Country Y business operations in year 1. Also in year 1, there is a $200x loss attributable to FB_Y. No income or loss is attributable to P's interest in DE_Y in year 1. Under §1.1503(d)–5(c)(4)(ii), the dual consolidated loss attributable to P's combined Country Y separate unit is $250x ($50x loss attributable to P's indirect interest in DE_Y's Country Y operations, plus $200x loss attributable to FB_Y). In year 2, neither DE_Y nor DE_Y's Country Y operations generates income or loss. Under Country Y law, the $100x of year 1 loss incurred by DE_Y is carried forward and is available to offset income of DE_Y in year 2.

(ii) *Result.* As a result of the carryover of the year 1 $100x loss (which includes $50x of the year 1 dual consolidated loss) under Country Y law, a portion of such loss will be available to offset income of DE_Y that is attributable to P's interest in DE_Y owned indirectly through PRS_X. A portion of such loss will also be available to offset income of DE_Y that is attributable to FS_X's indirect ownership of DE_Y. Accordingly, under §1.1503(d)–3(a), there would be a foreign use of a portion of P's $250x year 1 dual consolidated loss because it is available to offset an item of income of the owner of an interest in a hybrid entity, which is not a separate unit (there would also be a foreign use in this case because FS_X is a foreign corporation). However, there has not been a reduction of P's interest in DE_Y, DE_Y has not consolidated under the laws of Country Y, and there has not been any other foreign use of the dual consolidated losses. As a result, no foreign use occurs as a result of the carryforward pursuant to §1.1503(d)–3(c)(4)(i) and (ii).

Example 15. No foreign use—asset basis carryover exception. (i) *Facts.* P owns FB_X and FS_X. In year 1, there is a dual consolidated loss attributable to FB_X. P's items of income, gain, deduction, and loss that are taken into account in calculating FB_X's dual consolidated loss include depreciation deductions attributable to FB_X's assets. P makes a domestic use election under §1.1503(d)–6(d) with respect to the year 1 dual consolidated loss of FB_X. At the end of year 2, P contributes a portion of FB_X's assets to FS_X, in exchange for stock in FS_X. The aggregate adjusted basis of the assets transferred by P to FS_X is less than 10 percent of the aggregate adjusted basis of all of FB_X's assets held at the beginning of year 2. In addition, no other assets of FB_X are transferred during the certification period. Under Country X law, FS_X's basis in the transferred assets is determined by reference to P's basis in such assets. In addition, under Country X law, a portion of the depreciation deductions that were taken into account in year 1 for U.S. tax purposes, are taken into account in year 2 for Country X tax purposes.

(ii) *Result.* As a result of the transfer of assets from P to FS_X, a portion of the year 1 dual consolidated loss is available for a foreign use. This is the case because a portion of the basis in FB_X's assets, which gave rise to depreciation deductions that were taken into account in computing the year 1 dual consolidated loss, will give rise to a depreciation deduction under Country X laws that will be available, under U.S. tax principles, to offset the income of FS_X, a foreign corporation, in year 2. However, the aggregate adjusted basis of all the assets transferred by P to FS_X, within the 12-month period ending at the end of year 2, is less than 10 percent of the aggregate adjusted basis of all of FB_X's assets at the beginning of such 12-month period. Moreover, the aggregate adjusted basis of the assets transferred by P to FS_X at any time during the certification period is less than 30 percent of the aggregate adjusted basis of FB_X's assets held at the end of year 1. In addition, the item of deduction giving rise to the foreign use is being made available solely as a result of the adjusted basis of the transferred assets being determined in whole, or in part, by reference to the adjusted basis of such transferred assets in the hands of FB_X. As a result, this transfer will not result in a foreign use pursuant to §1.1503(d)–3(c)(6).

Example 16. No foreign use—liability assumption exception. (i) *Facts.* P owns FB_X. In year 1, there is a dual consolidated loss attributable to FB_X for which P makes a domestic use election under §1.1503(d)–6(d). The dual consolidated loss includes a deduction for salary expense that was deductible for U.S. tax purposes at the end of year 1, even though it was not paid until year 2. The deduction was incurred in the ordinary course of FB_X's trade or business. During year 2, and before the accrued salary expense liability was paid, P sells all the assets of FB_X to FS_X in exchange for cash and FS_X's assumption of the liabilities of the FB_X trade or business, including the obligation to pay the accrued salary expense. Under Country X law, the accrued salary expense of FB_X is deductible, and is taken into account for purposes of computing the taxable income of FB_X, when paid. FB_X pays the accrued salary expense after the sale of FB_X to FS_X.

(ii) *Result.* (A) As a result of FS_X's assumption of the FB_X liabilities, including the accrued salary expense, a portion of the dual consolidated loss is available for a foreign use in year 2. This is the case because the deduction that was taken into account in year 1 in computing the dual consolidated loss under U.S. tax principles will, under Country X tax law, be taken into account and will be available to offset the income of FS_X, a foreign corporation, in year 2. However, because this item of expense is made available solely as a result of the assumption of a liability of FB_X, and such liability was incurred in the ordinary course of FB_X's trade or business, there will not be a foreign use of the year 1 dual consolidated loss pursuant to §1.1503(d)–3(c)(7).

(B) The transfer of all the assets of FB_X to FS_X is a triggering event under §1.1503(d)–6(e)(1)(iv), unless P can rebut the triggering event under §1.1503(d)–6(e)(2). For purposes of determining whether, under §1.1503(d)–6(e)(2)(ii), the transfer of assets resulted in a carryover under foreign law of FB_X's losses, expenses, or deductions, the exception to foreign use for the assumption of liabilities is taken into account. However, the other exceptions to foreign use do not apply for this purpose (or for purposes of demonstrating that no foreign use of a dual consolidated loss can occur in any other year under §1.1503(d)–6(c), (e)(2)(i) or (j)(2)). See §1.1503(d)–3(c)(1). Provided the other requirements of §1.1503(d)–6(e)(2)(ii) and (iii) are satisfied, P may be able to rebut the occurrence of a triggering event upon the transfer of FB_X's assets to FS_X.

Example 17. Mirror legislation rule—dual resident corporation and hybrid entity separate unit. (i) *Facts.* P owns DRC_X, a member of the P consolidated group. DRC_X owns FS_X. In year 1, DRC_X incurs a \$100x net operating loss that is a dual consolidated loss. To prevent corporations like DRC_X from offsetting losses both against income of affiliates in Country X and against income of foreign affiliates under the tax laws of another country, Country X mirror legislation prevents a corporation that is subject to the income tax of another country on its worldwide income or on a residence basis from using the Country X form of consolidation. Accordingly, the Country X mirror legislation prevents the loss of DRC_X from being made available to offset income of FS_X.

(ii) *Result.* Under §1.1503(d)–3(e), because the losses of DRC_X are subject to Country X's mirror legislation, there is a deemed foreign use of DRC_X's year 1 dual consolidated loss. The stand-alone exception to the mirror rule in §1.1503(d)–3(e)(2) does not apply because, absent the mirror legislation, DRC_X's year 1 dual consolidated loss would be available for a foreign use (as defined in §1.1503(d)–3), without regard to whether such availability is limited by election or similar procedure. That is, absent the mirror legislation, all or a portion of the dual consolidated loss would be available to offset the income of FS_X under the Country X consolidation regime. This is the case even if Country X did not recognize DRC_X as having a loss in year 1. Therefore, P may not make a domestic use election with respect to DRC_X's year 1 dual consolidated loss pursuant to §1.1503(d)–3(d)(2).

(iii) *Alternative Facts.* The facts are the same as in paragraph (i) of this *Example 17,* except that P owns $DE1_X$ (rather than DRC_X) and, in year 1, there is a $100 dual consolidated loss attributable to P's interest in $DE1_X$ (rather than of DRC_X). The Country X mirror legislation only applies to Country X dual resident corporations and, therefore, does not apply to losses attributable to P's interest in $DE1_X$. As a result, the mirror legislation rule under §1.1503(d)–3(e) would not deny the opportunity of such loss from being put to a foreign use (for example, by offsetting the income of FS_X through the Country X consolidation regime). Therefore, a domestic use election can be made with respect to the dual consolidated loss (provided the conditions for such an election are otherwise satisfied).

Example 18. Mirror legislation rule—standalone foreign branch separate unit. (i) *Facts.* P owns FB_X. In year 1, there is a $100x dual consolidated loss attributable to FB_X. Country X enacted mirror legislation to prevent Country X branches and permanent establishments of nonresident corporations from offsetting losses both against income of Country X affiliates and against other income of its owner (or foreign affiliates thereof) under the tax laws of another country. The Country X mirror legislation prevents a Country X branch or permanent establishment of a nonresident corporation from offsetting its losses against the income of Country X affiliates if such losses may be deductible against income (other than income of the Country X branch or permanent establishment) under the laws of another country.

(ii) *Result.* In general, under §1.1503(d)–3(e), because the losses of FB_X are subject to Country X's mirror legislation, there is a deemed foreign use of FB_X's year 1 dual consolidated loss. However, in the absence of the Country X mirror legislation, no item of deduction or loss composing FB_X's year 1 dual consolidated loss would be available in the year incurred for a foreign use (as defined in §1.1503(d)–3), without regard to whether such availability is limited by election or otherwise. This is the case because there is no Country X entity through which the dual consolidated loss could be put to a foreign use (absent a sale, merger, or similar transaction involving FB_X). As a result, the standalone exception in §1.1503(d)–3(e)(2) may apply, provided P complies with the requirements of §1.1503(d)–3(e)(2)(ii). Accordingly, P may make a domestic use election with respect to the year 1 dual consolidated loss of FB_X pursuant to §1.1503(d)–6(d). If, however, any item of the dual consolidated loss would otherwise be available for a foreign use during the certification period (for example, as a result of P acquiring a foreign corporation that is organized under the laws of Country X such that losses of FB_X could be put to a foreign use through consolidation or similar means), then such loss would be recaptured pursuant to §1.1503(d)–6(e)(1)(ix).

(iii) *Alternative Facts.* The facts are the same as in paragraph (i) of this *Example 18,* except that the Country X mirror legislation operates in a manner similar to the rules under section 1503(d). That is, it allows the taxpayer to elect to use the loss to either offset income of an affiliate in Country X, or income of an affiliate (or other income of the owner of the Country X branch or permanent establishment) in the other country, but not both. Because the Country X mirror legislation permits the taxpayer to choose to put the dual consolidated loss to a foreign use, it does not deny the opportunity to put the loss to a foreign use. Therefore, there is no deemed foreign use of the dual consolidated loss pursuant to §1.1503(d)–4(e) and a domestic use election can be made for such loss.

Example 19. Application of mirror legislation rule to combined separate unit. (i) *Facts.* P owns FB_X, FS_X, and $DE1_X$. In year 1, there is a $50x dual consolidated loss attributable to FB_X and $10x of income attributable to P's interest in $DE1_X$. FS_X has income of $100x. Pursuant to §1.1503(d)–1(b)(4)(ii), FB_X and P's interest in $DE1_X$ are combined and treated as a single separate unit (Country X separate unit) which has a year 1 dual consolidated loss of $40x. Country X enacted mirror legislation to prevent Country X branches or permanent establishments of nonresident corporations from offsetting losses both against income of Country X affiliates and against other income of its owner (or foreign affiliates thereof) under the tax laws of another country. The Country X mirror legislation prevents a Country X branch or permanent establishment of a nonresident corporation from offsetting its losses against the income of Country X affiliates if such losses may be deductible against income (other than income of the Country X branch or permanent establishment) under the laws of another country. However, the United States and Country X have entered into an agreement described in §1.1503(d)–6(b) pursuant to the U.S.-Country X income tax convention (mirror agreement). The mirror agreement applies to Country X foreign branch separate units of domestic corporations, but not to

Country X hybrid entity separate units. The mirror agreement provides that neither the Country X mirror legislation nor the mirror legislation rule under §1.1503(d)–3(e) will apply to losses attributable to Country X foreign branch separate units, provided certain conditions and reporting requirements are satisfied (including a domestic use election, if the loss is to be used to offset income of a domestic affiliate). Thus, losses attributable to Country X foreign branch separate units can, subject to the requirements of the mirror agreement, be used to offset income of a domestic affiliate or a Country X affiliate (but not both).

(ii) *Result.* The Country X mirror legislation only applies to Country X foreign branch separate units and does not apply to hybrid entity separate units. In addition, if P complies with the terms and conditions of the mirror agreement, the Country X mirror legislation would not apply to FB_X. As a result, the income tax laws of Country X would not deny the opportunity of a loss of either individual separate unit that composes P's combined Country X separate unit from being put to a foreign use. Therefore, notwithstanding §1.1503(d)–3(e), a domestic use election can be made with respect to the dual consolidated loss attributable to P's Country X separate unit, provided the terms and conditions of the mirror agreement are satisfied. See §1.1503(d)–6(b)(2).

(iii) *Alternative Facts.* The facts are the same as in paragraph (i) of this *Example 19*, except that the Country X mirror legislation also applies to losses attributable to $DE1_X$, but the mirror agreement does not apply to such losses. The mirror legislation rule would apply with respect to P's interest in $DE1_X$ and, as a result, there is a deemed foreign use of the dual consolidated loss attributable to the Country X separate unit and a domestic use election cannot be made for such loss. This is the case even though, pursuant to §1.1503(d)–5(c)(4)(ii)(A), P's interest in $DE1_X$ (which is subject to the Country X mirror legislation) does not, as an individual separate unit, have a dual consolidated loss in year 1. Further, the stand-alone exception to the mirror legislation rule in §1.1503(d)–3(e)(2) does not apply because, absent the mirror legislation, the Country X combined separate unit's dual consolidated loss would be available in the year incurred for a foreign use (as defined in §1.1503(d)–3) because it could be used to offset income of FS_X under the Country X consolidation regime. This is the case even if Country X requires an election to consolidate and no such election is made. The result would be the same even if Country X did not recognize $DE1_X$ as having a loss.

Example 20. Dual consolidated loss limitation after section 381 transaction. disposition of assets and subsequent liquidation of dual resident corporation. (i) *Facts.* P owns DRC_X, a member of the P consolidated group. In year 1, DRC_X incurs a dual consolidated loss and P does not make a domestic use election with respect to such loss. Under §1.1503(d)–4(b), DRC_X's year 1 dual consolidated loss is subject to the limitations under §1.1503(d)–4(c) and, therefore, may not be used to offset the income of P or S (or any other domestic affiliate) on the group's U.S. income tax return. At the beginning of year 2, DRC_X sells all of its assets for cash and distributes the cash to P pursuant to a liquidation that qualifies under section 332.

(ii) *Result.* In general, under section 381, P would succeed to, and be permitted to use, DRC_X's net operating loss carryover. However, §1.1503(d)–4(d)(1)(i) prohibits the dual consolidated loss of DRC_X from carrying over to P. Therefore, DRC_X's year 1 net operating loss carryover is eliminated.

Example 21. Dual consolidated loss limitation applied to a separate unit transferred in a section 381 transaction. (i) *Facts.* S owns $DE1_X$ which, in turn, owns FB_X. S's interest in $DE1_X$ and its indirect interest in FB_X are combined and treated as a single separate unit (Country X separate unit) pursuant to §1.1503(d)–1(b)(4)(ii). In year 1, a dual consolidated loss is attributable to the Country X separate unit, and P does not make a domestic use election with respect to such loss. Under §1.1503(d)–4(b), the year 1 dual consolidated loss attributable to the Country X separate unit may not be used to offset the income of P or S (other than income attributable to the Country X separate unit, subject to the application of §1.1503(d)–4(c)) on the group's consolidated U.S. income tax return (nor may it be used to offset the income of any other domestic affiliates). At the beginning of year 2, S transfers its entire interest in $DE1_X$, and thus its entire indirect interest in FB_X, to FS_X in a transaction described in section 381.

(ii) *Result.* Section 1.1503(d)–4(d)(1)(ii) provides that the dual consolidated loss attributable to a separate unit that is subject to the domestic use limitation under §1.1503(d)–4(b) is eliminated if the separate unit ceases to be a separate unit of its affiliated domestic owner and all other members of the affiliated domestic owner's separate group. As a result of the transfer of the Country X separate unit to FS_X, the Country X separate unit ceases to be a separate unit of S, and is not a separate unit of any other member of the P consolidated group. In addition, the exceptions in §1.1503(d)–4(d)(2)(iii) do not apply because FS_X is not a domestic corporation. Thus, the year 1 dual consolidated loss attributable to the Country X separate unit is eliminated.

(iii) *Alternative Facts.* Assume the same facts as in paragraph (i) of this *Example 21*, except S transfers its assets to DC, a domestic corporation that is not a member of the

P consolidated group, in a transaction described in section 381(a). Immediately after the transaction, the Country X separate unit is a separate unit of DC. Under §1.1503(d)–4(d)(1)(ii), the year 1 dual consolidated loss of the Country X separate unit would be eliminated because it ceases to be a separate unit of S, and is not a separate unit of any other member of the P consolidated group. However, because the transferee is a domestic corporation and the Country X separate unit is a separate unit in the hands of DC immediately after the transaction, the exception under §1.1503(d)–4(d)(2)(iii)(A) applies. As a result, the year 1 dual consolidated loss of the Country X separate unit is not eliminated and any income generated by DC that is attributable to the Country X separate unit following the transfer may be offset by the carryover dual consolidated losses attributable to the Country X separate unit, subject to the limitations of §1.1503(d)–4(b) and (c) applied as if DC generated the dual consolidated loss and such loss was attributable to the Country X separate unit.

(iv) *Alternative Facts*. Assume the same facts as in paragraph (iii) of this *Example 21*, except that P owns $DE2_X$ and the interest in $DE2_X$ is combined with and therefore included in the Country X separate unit. In addition, a portion of the dual consolidated loss of the Country X separate unit is attributable to P's interest in $DE2_X$. Pursuant to §1.1503(d)–4(d)(2)(iii)(A), the result would be the same as in paragraph (iii) of this *Example 21*, with respect to the portion of the dual consolidated loss attributable to the combined separate unit that is succeeded to and taken into account by DC pursuant to section 381. The portion of the dual consolidated loss attributable to P's interest in $DE2_X$, however, does not carry over to DC but is retained by P and continues to be subject to the limitations of §1.1503(d)–4(b) and (c) with respect to P's interest in $DE2_X$.

(v) *Alternative Facts*. Assume the same facts as in paragraph (iv) of this *Example 21*, except that DC is a member of the P consolidated group. Pursuant to §1.1503(d)–4(d)(2)(iii)(B), the dual consolidated loss of the Country X separate unit is not eliminated and income attributable to the Country X separate unit may continue to be offset by the dual consolidated loss that is succeeded to and taken into account by DC pursuant to section 381, subject to the limitations of §1.1503(d)–4(b) and (c). The result would be the same even if the interest in $DE1_X$ ceased to be a separate unit in the hands of DC (for example, because it dissolved under Country X law in connection with the transaction), provided P, or another member of the P consolidated group, continued to own a portion of the Country X separate unit.

Example 22. Tainted income. (i) *Facts*. P owns 100 percent of DRC_Z, a domestic corporation that is included as a member of the P consolidated group. DRC_Z conducts a business in the United States. During year 1, DRC_Z was managed and controlled in Country Z and therefore was subject to tax as a resident of Country Z and was a dual resident corporation. In year 1, DRC_Z incurred a dual consolidated loss of $200x, and P did not make a domestic use election with respect to such loss. As a result, such loss is subject to the domestic use limitation rule of §1.1503(d)–4(b). At the end of year 1, DRC_Z moved its management and control to the United States and, as a result, ceased being a dual resident corporation. At the beginning of year 2, P transferred asset A, a non-depreciable asset, to DRC_Z in exchange for common stock in a transaction that qualified for nonrecognition under section 351. At the time of the transfer, P's tax basis in asset A equaled $50x and the fair market value of asset A equaled $100x. The tax basis of asset A in the hands of DRC_Z immediately after the transfer equaled $50x pursuant to section 362. Asset A did not constitute replacement property acquired in the ordinary course of business. DRC_Z did not generate income or gain during years 2, 3, or 4. On June 30, year 5, DRC_Z sold asset A to a third party for $100x, its fair market value at the time of the sale, and recognized $50x of income on such sale. In addition to the $50x income generated on the sale of asset A, DRC_Z generated $100x of operating income in year 5. At the end of year 5, the fair market value of all the assets of DRC_Z was $400x.

(ii) *Result*. DRC_Z ceased being a dual resident corporation at the end of year 1. Therefore, its year 1 dual consolidated loss cannot be offset by tainted income. Asset A is a tainted asset because it was acquired in a nonrecognition transaction after DRC_Z ceased being a dual resident corporation (and was not replacement property acquired in the ordinary course of business). As a result, the $50x of income recognized by DRC_Z on the disposition of asset A is tainted income and cannot be offset by the year 1 dual consolidated loss of DRC_Z. In addition, absent evidence establishing the actual amount of tainted income, $25x of the $100x year 5 operating income of DRC_Z (($100x/$400x) × $100x) also is treated as tainted income and cannot be offset by the year 1 dual consolidated loss of DRC_Z under §1.1503(d)–4(e)(2)(ii). Therefore, $75x of the $150x year 5 income of DRC_Z constitutes tainted income and may not be offset by the year 1 dual consolidated loss of DRC_Z; however, the remaining $75x of year 5 income of DRC_Z may be offset by such dual consolidated loss. The result would be the same if, instead of P transferring asset A to DRC_Z, such asset was received from a separate unit or a transparent entity of DRC_Z.

Example 23. Treatment of disregarded item and books and records of a hybrid entity. (i) *Facts*. P owns $DE1_X$ which, in turn, owns FS_X. In year 1, P borrows from a third party and on-lends the proceeds to $DE1_X$. In year 1, P incurs interest expense attributable to the third-party loan. Also in year 1, $DE1_X$ incurs interest expense attributable to its loan from P, but such expense is generally disregarded for U.S. tax purposes because $DE1_X$ is disregarded as an entity separate from P. The third-party loan and related interest expense are reflected on the books and records of P (and not on the books and records of $DE1_X$). The loan from P to $DE1_X$ and related interest expense are reflected on the books and records of $DE1_X$. There are no other items of income, gain, deduction, or loss reflected on the books and records of $DE1_X$ in year 1.

(ii) *Result.* Because the interest expense on P's third-party loan is not reflected on the books and records of $DE1_X$, no portion of such expense is attributable to P's interest in $DE1_X$ pursuant to §1.1503(d)–5(c)(3) for purposes of calculating the year 1 dual consolidated loss, if any, attributable to such interest. In addition, even though P's interest in $DE1_X$ is treated as a separate domestic corporation for purposes of determining the amount of income or dual consolidated loss attributable to it pursuant to §1.1503(d)–5(c)(1)(ii), such treatment does not cause the interest expense incurred on the loan from P to $DE1_X$ that is generally disregarded for U.S. tax purposes to be regarded for purposes of calculating the year 1 dual consolidated loss, if any, attributable to P's interest in $DE1_X$. As a result, even though the disregarded interest expense is reflected on the books and records of $DE1_X$, it is not taken into account for purposes of calculating income or a dual consolidated loss. Therefore, there is no dual consolidated loss attributable to P's interest in $DE1_X$ in year 1.

Example 24. Dividend income attributable to a separate unit. (i) *Facts.* P owns $DE1_X$ which, in turn, owns FB_X. P's interest in $DE1_X$ and its indirect interest in FB_X are combined and treated as a single separate unit (Country X separate unit) pursuant to §1.1503(d)–1(b)(4)(ii). $DE1_X$ owns $DE3_Y$. $DE3_Y$ owns the stock of FS_X. P's Country X separate unit would, without regard to year 1 dividend income (or related section 78 gross-up) received from FS_X, have a dual consolidated loss of $75x in year 1. In year 1, FS_X distributes $50x to $DE3_Y$ that is taxable as a dividend. $DE3_Y$ distributes the same amount to $DE1_X$. P computes foreign taxes deemed paid on the dividend under section 902 of $25x and includes that amount in gross income under section 78.

(ii) *Result.* The $50x dividend is reflected on the books and records of $DE3_Y$ and, therefore, is attributable to P's interest in $DE3_Y$ pursuant to §1.1503(d)–5(c)(3)(i). In addition, the $25x section 78 gross-up is attributable to P's interest in $DE3_Y$ pursuant to §1.1503(d)–5(c)(4)(iv). The distribution of $50x from $DE3_Y$ to $DE1_X$ is generally disregarded for U.S. tax purposes and, therefore, does not give rise to an item that is taken into account for purposes of calculating income or a dual consolidated loss. This is the case even though the item would be reflected on the books and records of $DE1_X$. In addition, pursuant to §1.1503(d)–5(c)(1)(iii), each separate unit must calculate its own income or dual consolidated loss, and each item of income, gain, deduction, and loss must be taken into account only once. As a result, the dual consolidated loss of $75x attributable to P's Country X separate unit in year 1 is not reduced by the amount of dividend income attributable to P's indirect interest in $DE3_Y$.

Example 25. Items reflected on books and records of a combined separate unit. (i) *Facts.* P owns $DE1_X$ which, in turn, owns FB_X. P's interest in $DE1_X$ and its indirect interest in FB_X are combined and treated as a single separate unit (Country X separate unit) pursuant to §1.1503(d)–1(b)(4)(ii). The following items are reflected on the books and records of $DE1_X$ in year 1: Sales, depreciation expense, a political contribution, royalty expense paid to P, repairs and maintenance expense paid to a third party, and Country X income tax expense. The amount of sales under U.S. tax principles equals the amount of sales reported for accounting purposes. The depreciation expense is calculated on a straight-line basis over the useful life of the asset for accounting purposes, but is subject to accelerated depreciation for U.S. tax purposes. In addition, the repairs and maintenance expense, which is deducted when paid for accounting purposes, is properly capitalized and amortized over five years for U.S. tax purposes. Finally, P elects to claim as a credit under section 901 the Country X income tax expense that was paid in year 1.

(ii) *Result.* (A) For purposes of determining the income or dual consolidated loss attributable to P's Country X separate unit, items of income, gain, deduction, and loss must first be attributed to the individual separate units (that is, P's interest in $DE1_X$ and its indirect interest in FB_X). For purposes of attributing items to P's interest in $DE1_X$, P's items that are reflected on $DE1_X$'s books and records, as adjusted to conform to U.S. tax principles, are taken into account. See §1.1503(d)–5(c)(3)(i). For purposes of attributing items (other than interest expense) to FB_X, the principles of section 864(c)(2), (c)(4), and (c)(5) (as set forth in §1.864–4(c) and §§1.864–5 through 1.864–7) must be applied and, for interest expense, the principles of §1.882–5, as modified under §1.1503(d)–5(c)(2)(ii), must be applied; however, for these purposes, pursuant to §1.1503(d)–5(c)(4)(i)(A), FB_X only takes into account items attributable to P's interest in $DE1_X$ and the assets, liabilities, and activities of such interest. In addition, to the extent such items are taken into account by FB_X, they are not taken into account in determining the items attributable to P's interest in $DE1_X$. § 1.1503(d)–5(c)(4)(i)(B). Because P's interest in $DE1_X$ has no assets or liabilities, and conducts no activities, other than through its ownership of FB_X, all of the items that are reflected on the books and records of $DE1_X$, as adjusted to conform to U.S. tax principles, are attributable to FB_X; no items are attributable to P's interest in $DE1_X$.

(B) The items reflected on the books and records of $DE1_X$ must be adjusted to conform to U.S. tax principles. No adjustment is required to sales because the amount of sales under U.S. tax principles equals the amount of sales for accounting purposes. The amount of straight-line depreciation expense reflected on $DE1_X$'s books and records must be adjusted to reflect the amount of depreciation on the asset that is allowable for U.S. tax purposes. The political contribution is not taken into account because it is not deductible for U.S. tax purposes. Similarly, because the royalty expense is paid to P, and therefore is generally disregarded for U.S. tax purposes, it is not taken into account. The repair and maintenance expense that is deducted in year 1 for accounting purposes also must be adjusted to conform to U.S. tax principles. Thus, the repair and maintenance expense will be taken into account in computing the income or dual consolidated loss attributable to P's Country X separate unit over five years (even though no item related to such expense would be reflected on the books and records of $DE1_X$ for years 2 through 5). Finally, because P elected to claim as a credit the Country X foreign taxes paid during year 1, no deduction is allowed for such amount pursuant to section 275(a)(4) and, therefore, the Country X tax expense is not taken into account.

(C) Pursuant to § 1.1503(d)–5(c)(4)(ii)(B), the combined Country X separate unit of P calculates its income or dual consolidated loss by taking into account all the items of income, gain, deduction, and loss that were separately attributable to P's interest in $DE1_X$ and FB_X. However, in this case, there are no items attributable to P's interest in $DE1_X$. Therefore, the items attributable to the Country X separate unit are the items attributable to FB_X.

Example 26. Items attributable to a combined separate unit. (i) *Facts.* P owns $DE1_X$. $DE1_X$ owns a 50 percent interest in PRS_Z, a Country Z entity that is classified as a partnership both for Country Z tax purposes and for U.S. tax purposes. FS_X, which is unrelated to P, owns the remaining 50 percent interest in PRS_Z. PRS_Z carries on operations in Country X that, if carried on by a U.S. person, would constitute a foreign branch as defined in § 1.367(a)-6T(g)(1). Therefore, P's share of the Country X operations carried on by PRS_Z constitutes a foreign branch separate unit. PRS_Z also owns assets that do not constitute a part of its Country X branch, including all of the interests in TE_T, a disregarded entity. TE_T is an entity incorporated under the laws of Country T, a country that does not have an income tax. Under the laws of Country X, an interest holder of TE_T does not take into account on a current basis the interest holder's share of items of income, gain, deduction, and loss of TE_T.

(ii) *Result.* (A) Pursuant to § 1.1503(d)–1(b)(4)(ii), P's interest in $DE1_X$, and P's indirect ownership of a portion of the Country X operations carried on by PRS_Z, are combined and treated as a single separate unit (Country X separate unit). Pursuant to § 1.1503(d)–5(c)(4)(ii)(A), for purposes of determining P's items of income, gain, deduction, and loss attributable to the Country X separate unit, the items of P are first attributed to each separate unit that composes the Country X separate unit.

(B) Pursuant to § 1.1503(d)–5(c)(2)(i), the principles of section 864(c)(2), (c)(4), and (c)(5) (as set forth in § 1.864–4(c) and §§ 1.864–5 through 1.864–7), apply for purposes of determining P's items of income, gain, deduction (other than interest expense), and loss that are attributable to P's indirect interest in the Country X operations carried on by PRS_Z. For purposes of determining P's interest expense that is attributable to P's indirect interest in the Country X operations carried on by PRS_Z, the principles of § 1.882–5, as modified under § 1.1503(d)–5(c)(2)(ii), shall apply. For purposes of applying these rules, P is treated as a foreign corporation, the Country X operations carried on by PRS_Z are treated as a trade or business within the United States, and the assets of P (including its share of the PRS_Z assets, other than those of the Country X operations) are treated as assets that are not U.S. assets. In addition, because P carries on its share of the Country X operations through $DE1_X$, a hybrid entity, § 1.1503(d)–5(c)(4)(i)(A) provides that only the items attributable to P's interest in $DE1_X$, and only the assets, liabilities, and activities of P's interest in $DE1_X$, are taken into account for purposes of this determination.

(C) TE_T is a transparent entity as defined in § 1.1503(d)–1(b)(16) because it is not taxable as an association for Federal tax purposes, is not subject to income tax in a foreign country as a corporation (or otherwise at the entity level) either on its worldwide income or on a residence basis, and is not treated as a pass-through entity under the laws of Country X (the applicable foreign country). TE_T is not a pass-through entity under the laws of Country X because a Country X holder of an interest in TE_T does not take into account on a current basis the interest holder's share of items of income, gain, deduction, and loss of TE_T. For purposes of determining P's items of income, gain, deduction, and loss that are attributable to P's interest in TE_T, only those items of P that are reflected on the books and records of TE_T, as adjusted to conform to U.S. tax principles, are taken into account. §1.1503(d)–5(c)(3)(i). Because the interest in TE_T is not a separate unit, a loss attributable to such interest is not a dual consolidated loss and is not subject to section 1503(d) and these regulations. Items must nevertheless be attributed to the interests in TE_T. For example, such attribution is required for purposes of calculating the income or dual consolidated loss attributable to the Country X separate unit, and for purposes of applying the domestic use limitation under §1.1503(d)–4(b) to a dual consolidated loss attributable to the Country X separate unit.

(D) For purposes of determining P's items of income, gain, deduction, and loss that are attributable to P's interest in $DE1_X$, only those items of P that are reflected on the books and records of $DE1_X$, as adjusted to conform to U.S. tax principles, are taken into account. §1.1503(d)–5(c)(3)(i). For this purpose, $DE1_X$'s distributive share of the items of income, gain, deduction, and loss that are reflected on the books and records of PRS_Z, as adjusted to conform to U.S. tax principles, are treated as being reflected on the books and records of $DE1_X$, except to the extent such items are taken into account by the Country X operations of PRS_Z. See §1.1503(d)–5(c)(3)(ii) and (4)(i)(B). Because TE_T is a transparent entity, the items reflected on its books and records are not treated as being reflected on the books and records of $DE1_X$.

(E) Pursuant to §1.1503(d)–5(c)(4)(ii)(B), the combined Country X separate unit of P calculates its income or dual consolidated loss by taking into account all the items of income, gain, deduction, and loss that were separately attributable to P's interest in $DE1_X$ and the Country X operations of PRS_Z owned indirectly by P.

Example 27. Sale of separate unit by another separate unit. (i) *Facts.* P owns $DE3_Y$ which, in turn, owns $DE1_X$. $DE3_Y$ also owns other assets that do not constitute a foreign branch separate unit. $DE1_X$ owns FB_X. Pursuant to §1.1503(d)–1(b)(4)(ii), P's indirect interests in $DE1_X$ and FB_X are combined and treated as one Country X separate unit (Country X separate unit). $DE3_Y$ sells its interest in $DE1_X$ at the end of year 1 to an unrelated foreign person for cash. The sale results in an ordinary loss of $30x. Items of income, gain, deduction, and loss derived from the assets that gave rise to the $30x loss would be attributable to the Country X separate unit under §1.1503(d)–5(c) through (e). Without regard to the sale of $DE1_X$, no items of income, gain, deduction, and loss are attributable to P's Country X separate unit in year 1.

(ii) *Result.* Pursuant to §1.1503(d)–5(c)(4)(iii)(A), the $30x ordinary loss recognized on the sale is attributable to the Country X separate unit, and not P's interest in $DE3_Y$. This is the case because the Country X separate unit is treated as owning the assets that gave rise to the loss under §1.1503(d)–5(f). Thus, the loss attributable to the sale creates a year 1 dual consolidated loss attributable to the Country X separate unit. In addition, pursuant to §1.1503(d)–6(d)(2), P cannot make a domestic use election with respect to the dual consolidated loss because the sale of the interest in $DE1_X$ is a triggering event described in §1.1503(d)–6(e)(1)(iv) and (v). Further, although the year 1 dual consolidated loss would otherwise be subject to the domestic use limitation rule of §1.1503(d)–4(b), it is eliminated pursuant to §1.1503(d)–4(d)(1)(ii). Finally, if there were a dual consolidated loss attributable to P's interest in $DE3_Y$, the sale of the interest in $DE1_X$ would not be taken into account for purposes of determining whether there is an asset triggering event with respect to such dual consolidated loss under §1.1503(d)–6(e)(1)(iv).

Example 28. Gain on sale of tiered separate units. (i) *Facts.* P owns 75 percent of HPS_X, a Country X entity subject to Country X tax on its worldwide income. FS_X owns the remaining 25 percent of HPS_X. HPS_X is classified as a partnership for Federal tax purposes. HPS_X carries on operations in Country Y that, if carried on by a U.S. person, would constitute a foreign branch within the meaning of §1.367(a)–6T(g)(1). HPS_X also owns assets that do not constitute a part of its Country Y operations and would not themselves constitute a foreign branch within the meaning of §1.367(a)–6T(g)(1) if owned by a U.S. person. Neither HPS_X nor the Country Y operations has liabilities. P's indirect interest in the Country Y operations carried on by HPS_X, and P's interest in HPS_X, are each separate units. P sells its interest in HPS_X and recognizes a gain of $150x on such sale. Immediately prior to P's sale of its interest in HPS_X, P's portion of the assets of the Country Y operations (that is, assets the income, gain, deduction and loss from which would be attributable to P's Country Y foreign branch separate unit) had a built-in gain of $200x, and P's portion of HPS_X's other assets (that is, assets the income, gain, deduction and loss from which would be attributable to P's interest in HPS_X) had a built-in gain of $100x.

(ii) *Result.* Pursuant to §1.1503(d)–5(c)(4)(iii)(B), $100x of the total $150x of gain recognized ($200x/$300x × $150x) is attributable to P's indirect interest in its share of the Country Y operations carried on by HPS_X. Similarly, $50x of such gain ($100x/$300x × $150x) is attributable to P's interest in HPS_X.

Example 29. Effect on domestic affiliate. (i) *Facts.* (A) P owns $DE1_X$ which, in turn, owns FB_X. P's interest in $DE1_X$ and its indirect interest in FB_X are combined and treated as a single separate unit (Country X separate unit) pursuant to §1.1503(d)–1(b)(4)(ii). In years 1 and 2, the items of income, gain, deduction, and loss that are attributable to P's Country X separate unit pursuant to §1.1503(d)–5 are as follows:

Item	Year 1	Year 2
Sales income	$100x	$160x
Salary expense	($75x)	($75x)
Research and experimental expense	($50x)	($50x)
Interest expense	($25x)	($25x)
Income/(dual consolidated loss)	($50x)	$10x

(B) P does not make a domestic use election with respect to the year 1 dual consolidated loss attributable to its Country X separate unit. Pursuant to §1.1503(d)–4(b) and (c)(2), the year 1 dual consolidated loss of $50x is treated as a loss incurred by a separate domestic corporation and is subject to the limitations under §1.1503(d)–4(c)(3). The P consolidated group has $100x of consolidated taxable income in year 2.

(ii) *Result.* (A) P must compute its taxable income for year 1 without taking into account the $50x dual consolidated loss, pursuant to §1.1503(d)–4(c)(2). Such amount consists of a pro rata portion of the expenses that were taken into account in calculating the year 1 dual consolidated loss. Thus, the items of the dual consolidated loss that are not taken into account by P in computing its taxable income are as follows: $25x of salary expense ($75x/$150x × $50x); $16.67x of research and experimental expense ($50x/$150x × $50x); and $8.33x of interest expense ($25x/ $150x × $50x). The remaining amounts of each of these items, together with the $100x of sales income, are taken into account by P in computing its taxable income for year 1 as follows: $50x of salary expense ($75x − $25x); $33.33x of research and experimental expense ($50x − $16.67x); and $16.67x of interest expense ($25x − $8.33x).

(B) Subject to the limitations provided under §1.1503(d)–4(c), the year 1 $50x dual consolidated loss is carried forward and is available to offset the $10x of income attributable to the Country X separate unit in year 2. Pursuant to §1.1503(d)–4(c)(4), a pro rata portion of each item of deduction or loss included in such dual consolidated loss is considered to be used to offset the $10x of income, as follows: $5x of salary expense ($25x / $50x × $10x); $3.33x of research and experimental expense ($16.67x/$50x × $10x); and $1.67x of interest expense ($8.33x / $50x × $10x). The remaining amount of each item shall continue to be subject to the limitations under §1.1503(d)–4(c).

Example 30. Exception to domestic use limitation—no possibility of foreign use because items are not deducted or capitalized under foreign law. (i) *Facts.* P owns $DE1_X$ which, in turn, owns FS_X. In year 1, the sole item of income, gain, deduction, and loss attributable to P's interest in $DE1_X$, as provided under §1.1503(d)–5, is $100x of interest expense paid on a loan to an unrelated lender. For Country X tax purposes, the $100x interest expense attributable to P's interest in $DE1_X$ in year 1 is treated as a repayment of principal and therefore cannot be deducted (at any time) or capitalized.

(ii) *Result.* The $100x of interest expense attributable to P's interest in $DE1_X$ constitutes a dual consolidated loss. However, because the sole item constituting the dual consolidated loss cannot be deducted or capitalized (at any time) for Country X tax purposes, P can demonstrate that there can be no foreign use of the dual consolidated loss at any time. As a result, pursuant to §1.1503(d)–6(c)(1), if P prepares a statement described in §1.1503(d)–6(c)(2) and attaches it to its timely filed tax return, the year 1 dual consolidated loss attributable to P's interest in $DE1_X$ will not be subject to the domestic use limitation rule of §1.1503(d)–4(b).

Example 31. No exception to domestic use limitation—inability to demonstrate no possibility of foreign use. (i) *Facts.* P owns $DE1_X$ which, in turn, owns FB_X. P's interest in $DE1_X$ and its indirect interest in FB_X are combined and treated as a single separate unit (Country X separate unit) pursuant to §1.1503(d)–1(b)(4)(ii). In year 1, the sole items of income, gain, deduction, and loss attributable to P's Country X separate unit, as provided under §1.1503(d)–5, are $75x of sales income and $100x of depreciation expense. For Country X tax purposes, $DE1_X$ also generates $75x of sales income in year 1, but the $100x of depreciation expense is not deductible until year 2.

(ii) *Result.* The year 1 $25x net loss attributable to P's interest in the Country X separate unit constitutes a dual consolidated loss. In addition, even though $DE1_X$ has positive income in year 1 for Country X tax purposes, P cannot demonstrate that there is no possibility of foreign use with respect to the Country X separate unit's dual consolidated loss as provided under §1.1503(d)–6(c)(1)(i). P cannot make such a demonstration because the depreciation expense, an item composing the year 1 dual consolidated loss, is deductible (in a later year) for Country X tax purposes and, therefore, may be available to offset or reduce income for Country X purposes that would constitute a foreign use. For example, if $DE1_X$ elected to be classified as a corporation pursuant to §301.7701–3(c) of this chapter effective as of the end of year 1, and the deferred depreciation expense were available for Country X tax purposes to offset year 2 income of $DE1_X$, an entity treated as a foreign corporation in year 2 for U.S. tax purposes, there would be a foreign use.

(iii) *Alternative Facts.* (A) The facts are the same as in paragraph (i) of this *Example 31*, except as follows. In year 1, the sole items of income, gain, deduction, and loss attributable to P's Country X separate unit, as provided in §1.1503(d)–5, are $75x of sales income, $100x of interest expense, and $25x of depreciation expense. For Country X tax purposes, $DE1_X$ generates $75x of sales income in year 1; the $100x interest expense is treated as a repayment of principal and therefore cannot be deducted or capitalized (at any time); and the $25x of depreciation expense is not deductible in year 1, but is deductible in year 2.

(B) In year 1, the $50x net loss attributable to P's Country X separate unit constitutes a dual consolidated loss. Even though the $100x interest expense, a nondeductible and noncapital item for Country X tax purposes, exceeds the $50x year 1 dual consolidated loss attributable to P's Country X separate unit, P cannot demonstrate that there is no possibility of foreign use of the dual consolidated loss as provided under §1.1503(d)–6(c)(1)(i). P cannot make such a demonstration because the $25x depreciation expense, an item of deduction or loss composing the year 1 dual consolidated loss, is deductible under Country X law (in year 2) and, therefore, may be available to offset or reduce income for Country X tax purposes that would constitute a foreign use.

Example 32. Triggering event rebuttal—expiration of losses in foreign country. (i) *Facts.* P owns DRC_X, a member of the P consolidated group. In year 1, DRC_X incurs a dual consolidated loss of $100x. P makes a domestic use election with respect to DRC_X's year 1 dual consolidated loss and such loss therefore is included in the computation of the P group's consolidated taxable income. DRC_X has no income or loss in year 2 through year 5. In year 5, P sells the stock of DRC_X to FS_X. At the time of the sale of the stock of DRC_X, all of the losses and deductions that were included in the computation of the year 1 dual consolidated loss of DRC_X had expired for Country X tax purposes because the laws of Country X only provide for a three-year carryover period for such items.

(ii) *Result.* The sale of DRC_X to FS_X generally would be a triggering event under §1.1503(d)–6(e)(1)(ii), which would require DRC_X to recapture the year 1 dual consolidated loss (and pay an applicable interest charge) on the P consolidated group's tax return for the year that includes the date on which DRC_X ceases to be a member of the P consolidated group. However, upon adequate documentation that the losses and deductions have expired for Country X tax purposes, P can rebut the presumption that a triggering event has occurred pursuant to §1.1503(d)–6(e)(2)(i). If the triggering event presumption is rebutted, the domestic use agreement filed by the P consolidated group with respect to the year 1 dual consolidated loss of DRC_X is terminated and has no further effect pursuant to §1.1503(d)–6(j)(1)(i). If the presumptive triggering event is not rebutted, the domestic use agreement would terminate and have no further effect pursuant to §1.1503(d)–6(j)(1)(iii) because the dual consolidated loss would be recaptured.

Example 33. Triggering events and rebuttals—tax basis carryover transaction. (i) *Facts.* (A) P owns $DE1_X$. $DE1_X$'s sole asset is A, which it acquired at the beginning of year 1 for $100x. $DE1_X$ does not have any liabilities. For U.S. tax purposes, $DE1_X$'s tax basis in A at the beginning of year 1 is $100x and $DE1_X$'s sole item of income, gain, deduction, and loss for year 1 is a $20x depreciation deduction attributable to A. As a result, the $20x depreciation deduction constitutes a dual consolidated loss attributable to P's interest in $DE1_X$. P makes a domestic use election with respect to the year 1 dual consolidated loss.

(B) For Country X tax purposes, $DE1_X$ has a $100x tax basis in A at the beginning of year 1, but A is not a depreciable asset. As a result, $DE1_X$ does not have any items of income, gain, deduction, and loss in year 1 for Country X tax purposes.

(C) During year 2, P sells its interest in $DE1_X$ to FS_X for $80x. P's disposition of its interest in $DE1_X$ constitutes a presumptive triggering event under §1.1503(d)–6(e)(1)(iv) and (v) requiring the recapture of the year 1 $20x dual consolidated loss (plus the applicable interest charge). For Country X tax purposes, $DE1_X$ retains its tax basis of $100x in A following the sale.

(ii) *Result.* The year 1 dual consolidated loss is a result of the $20x depreciation deduction attributable to A. Although no item of deduction or loss was recognized by $DE1_X$ at the time of the sale for Country X tax purposes, the deduction composing the dual consolidated loss was retained by $DE1_X$ after the sale in the form of tax basis in A. As a result, a portion of the dual consolidated loss may be available to offset income for Country X tax purposes in a manner that would constitute a foreign use. For example, if $DE1_X$ were to dispose of A, the amount of gain recognized by $DE1_X$ would be reduced (or an amount of loss recognized by $DE1_X$ would be increased) and, therefore, an item composing the dual consolidated loss would be available, under U.S. tax principles, to reduce income of a foreign corporation (and an owner of an interest in a hybrid entity that is not a separate unit). Thus, P cannot demonstrate pursuant to §1.1503(d)–6(e)(2)(i) that there can be no foreign use of the year 1 dual consolidated loss following the triggering event, and must recapture the year 1 dual consolidated loss. Pursuant to §1.1503(d)–6(j)(1)(iii), the domestic use agreement filed by the P consolidated group with respect to the year 1 dual consolidated loss is terminated and has no further effect.

(iii) *Alternative Facts.* The facts are the same as paragraph (i) of this *Example 33*, except that instead of P selling its interest in

$DE1_X$ to FS_X, $DE1_X$ sells asset A to FS_X for $80x and, for Country X tax purposes, FS_X's tax basis in A immediately after the sale is $80x. P's disposition of Asset A constitutes a presumptive triggering event under §1.1503(d)–6(e)(1)(iv) requiring the recapture of the year 1 $20x dual consolidated loss (plus the applicable interest charge). For Country X tax purposes, FS_X's tax basis in A was not determined, in whole or in part, by reference to the basis of A in the hands of $DE1_X$. As a result, the deduction composing the dual consolidated loss will not give rise to an item of deduction or loss in the form of tax basis for Country X tax purposes (for example, when FS_X disposes of A). Therefore, P may be able to demonstrate (for example, by obtaining the opinion of a Country X tax advisor) pursuant to §1.1503(d)–6(e)(2)(i) that there can be no foreign use of the year 1 dual consolidated loss and, thus, would not be required to recapture the year 1 dual consolidated loss.

Example 34. Triggering event resulting in a single consolidated group where acquirer files a new domestic use agreement. (i) *Facts.* P owns DRC_X, a member of the P consolidated group. In year 1, DRC_X incurs a dual consolidated loss and P makes a domestic use election with respect to such loss. No member of the P consolidated group incurs a dual consolidated loss in year 2. At the end of year 2, T, the parent of the T consolidated group, acquires all the stock of P, and all the members of the P group, including DRC_X, become members of a consolidated group of which T is the common parent.

(ii) *Result.* (A) Under §1.1503(d)–6(f)(2)(ii)(B), the acquisition by T of the P consolidated group is not an event described in §1.1503(d)–6(e)(1)(ii) requiring the recapture of the year 1 dual consolidated loss of DRC_X (and the payment of an interest charge), provided that the T consolidated group files a new domestic use agreement described in §1.1503(d)–6(f)(2)(iii)(A). If a new domestic use agreement is filed, then pursuant to §1.1503(d)–6(j)(1)(ii), the domestic use agreement filed by the P consolidated group with respect to the year 1 dual consolidated loss of DRC_X is terminated and has no further effect.

(B) Assume that T files a new domestic use agreement and a triggering event occurs at the end of year 3. As a result, the T consolidated group must recapture the dual consolidated loss that DRC_X incurred in year 1 (and pay an interest charge), as provided in §1.1503(d)–6(h). Each member of the T consolidated group, including DRC_X and any former members of the P consolidated group, is severally liable for the additional tax (and the interest charge) due upon the recapture of the dual consolidated loss of DRC_X. In addition, pursuant to §1.1503(d)–6(j)(1)(iii), the new domestic use agreement filed by the T group with respect to the year 1 dual consolidated loss of DRC_X is terminated and has no further effect.

Example 35. Triggering event exceptions for certain deemed transfers. (i) *Facts.* P owns $DE1_X$. In year 1, there is a $100x dual consolidated loss attributable to P's interest in $DE1_X$. P files a domestic use agreement under §1.1503(d)–6(d) with respect to such loss. During year 2, P sells 33 percent of its interest in $DE1_X$ to T, an unrelated domestic corporation.

(ii) *Result.* Pursuant to Rev. Rul. 99–5, the transaction is treated as if P sold 33 percent of its interest in each of $DE1_X$'s assets to T and then immediately thereafter P and T transferred their interests in the assets of $DE1_X$ to a partnership in exchange for an ownership interest therein. Upon the transfer of 33 percent of P's interest to T, a domestic corporation, no foreign use occurs and, therefore, there is no foreign use triggering event. However, P's deemed transfer of 67 percent of its interest in the assets of $DE1_X$ to a partnership is nominally a triggering event under §1.1503(d)–6(e)(1)(iv). Because the initial transfer of 33 percent of $DE1_X$'s interest was to a domestic corporation and there is only a triggering event because of the deemed transfer under Rev. Rul. 99–5, the deemed asset transfer is not treated as resulting in a triggering event pursuant to §1.1503(d)–6(f)(4).

(iii) *Alternative Facts.* The facts are the same as in paragraph (i) of this *Example 35*, except that P sells 60 percent (rather than 33 percent) of its interest in $DE1_X$ to T. The sale is a triggering event under §1.1503(d)–6(e)(1)(iv) and (v) without regard to the occurrence of a deemed transaction. Therefore, §1.1503(d)–6(f)(4) does not apply.

Example 36. Triggering event exception involving multiple parties. (i) *Facts.* P owns $DE1_X$ which, in turn, owns FB_X. P's interest in $DE1_X$ and its indirect interest in FB_X are combined and treated as a single separate unit (Country X separate unit) pursuant to §1.1503(d)–1(b)(4)(ii). In year 1, there is a $100x dual consolidated loss attributable to P's Country X separate unit and P makes a domestic use election with respect to such loss. No member of the P consolidated group incurs a dual consolidated loss in year 2. At the end of year 2, T, the parent of the T consolidated group, acquires all of P's interest in $DE1_X$ for cash.

(ii) *Result.* (A) Under §1.1503(d)–6(f)(2)(i)(B), the acquisition by T of the interest in $DE1_X$ is not an event described in §1.1503(d)–6(e)(1)(iv) or (v) requiring the recapture of the year 1 dual consolidated loss attributable to the Country X separate unit (and the payment of an interest charge), provided: (1) the T consolidated group files a new domestic use agreement described in §1.1503(d)–6(f)(2)(iii)(A) with respect to the year 1 dual consolidated loss of the Country X separate unit; and (2) the P consolidated group files a statement described in §1.1503(d)–6(f)(2)(iii)(B) with respect to the year 1 dual consolidated loss. If these requirements are satisfied, then pursuant to §1.1503(d)–6(j)(1)(ii) the domestic use agreement filed by the P consolidated group with respect to the year 1 dual consolidated loss is terminated and has no further effect (if these requirements are not satisfied such that the P consolidated group recaptures the dual consolidated loss, the domestic use agreement would terminate pursuant to §1.1503(d)–6(j)(1)(iii)).

(B) Assume a triggering event occurs at the end of year 3 that requires recapture by the T consolidated group of the year 1 dual consolidated loss, as well as the payment of an interest charge, as provided in §1.1503(d)–6(h). T continues to own the Country X separate unit after the triggering event. In that case, each member of the T consolidated group is severally liable for the additional tax (and the interest charge) due upon the recapture of the year 1 dual consolidated loss. The T consolidated group must prepare a statement that computes the recapture tax amount as provided under §1.1503(d)–6(h)(3)(iii). Pursuant to §1.1503(d)–6(h)(3)(iv)(A), the recapture tax amount is assessed as an income tax liability of the T consolidated group and is considered as having been properly assessed as an income tax liability of the P consolidated group. If the T consolidated group does not pay in full the income tax liability attributable to the recapture tax amount, the unpaid balance of such recapture tax amount may be collected from the P consolidated group in accordance with the provisions of §1.1503(d)–6(h)(3)(iv)(B). Pursuant to §1.1503(d)–6(j)(1)(iii), the new domestic use agreement filed by the T consolidated group is terminated and has no further effect. Finally, pursuant to §1.1503(d)–6(h)(6)(iii), T is treated as if it incurred the dual consolidated loss that is recaptured for purposes of applying §1.1503(d)–6(h)(6)(i). Thus, T has a reconstituted net operating loss equal to the amount of the year 1 dual consolidated loss that was recaptured, and such loss is attributable to the Country X separate unit (and subject to the rules and limitations under §1.1503(d)–6(h)(6)(i)). Because T is treated as if it incurred the year 1 dual consolidated loss, P shall not be treated as having a net operating loss under §1.1503(d)–6(h)(6)(i).

Example 37. No foreign use following multiple-party event exception to triggering event. (i) *Facts.* P owns $DE1_X$ which, in turn, owns FB_X. P's interest in $DE1_X$ and its indirect interest in FB_X are combined and treated as a single separate unit (Country X separate unit) pursuant to §1.1503(d)–1(b)(4)(ii). In year 1, there is a $100x dual consolidated loss attributable to P's Country X separate unit and P makes a domestic use election with respect to such loss. T, a domestic corporation unrelated to P, owns 95 percent of PRS, a partnership. FS_X owns the remaining 5 percent of PRS. At the beginning of year 3, PRS purchases 100 percent of the interest in $DE1_X$ from P for cash. For Country X tax purposes, the $100x loss incurred by $DE1_X$ in year 1 carries forward and is available to offset income of $DE1_X$ in subsequent years.

(ii) *Result.* P's sale of its interest in $DE1_X$ is a triggering event under §1.1503(d)–6(e)(1)(iv) and (v). However, if P and T comply with the requirements under §1.1503(d)–6(f)(2)(iii), the sale would qualify for the multiple-party event exception under §1.1503(d)–6(f)(2)(i). In addition, because the $100x loss of $DE1_X$ carries forward to subsequent years for Country X purposes and is available to offset income of $DE1_X$, there would be a foreign use of the dual consolidated loss immediately after the sale pursuant to §1.1503(d)–3(a)(1). This is the case because the dual consolidated loss would be available to offset or reduce income that is considered, under U.S. tax principles, to be an item of FS_X, a foreign corporation (it would also be a foreign use because FS_X is an indirect owner of an interest in a hybrid entity that is not a separate unit). However, there is no foreign use in this case as a result of FS_X's 5 percent interest in $DE1_X$ pursuant to §1.1503(d)–3(c)(8).

Example 38. Character and source of recapture income. (i) *Facts.* (A) P owns FB_X. In year 1, the items of income, gain, deduction, and loss that are attributable to FB_X for purposes of determining whether it has a dual consolidated loss are as follows:

Sales income	$100x
Salary expense	($75x)
Interest expense	($50x)
Dual consolidated loss	($25x)

(B) P makes a domestic use election with respect to the year 1 dual consolidated loss attributable to FB_X and, thus, the $25x dual consolidated loss is used to offset the P group's consolidated taxable income.

(C) Pursuant to §1.861–8, the $75x of salary expense incurred by FB_X is allocated and apportioned entirely to foreign source general limitation income. Pursuant to §1.861–9T, $25x of the $50x interest expense attributable to FB_X is allocated and apportioned to domestic source income, $15x of such interest expense is allocated and apportioned to foreign source general limitation income, and the remaining $10x of such interest expense is allocated and apportioned to foreign source passive income.

(D) During year 2, $5x of income is attributable to FB_X under the rules of §1.1503(d)–5, and the P consolidated group has $100x of consolidated taxable income. At the end of year 2, FB_X undergoes a triggering event described in §1.1503(d)–6(e)(1), and P continues to own FB_X following the triggering event. Pursuant to §1.1503(d)–6(h)(2)(i), P is able to demonstrate to the satisfaction of the Commissioner that the $25x dual consolidated loss attributable to FB_X in year 1 would have offset the $5x of income attributable to FB_X in year 2, if no domestic use election were made with respect to the year 1 loss such that it was subject to the limitations of § 1.1503(d)–4(b) and (c).

(ii) *Result.* P must recapture and report as ordinary income $20x ($25x − $5x) of FB_X's year 1 dual consolidated loss, plus applicable interest. The $20x recapture income is attributable to FB_X pursuant to § 1.1503(d)–5(c)(4)(vi). Pursuant to § 1.1503(d)–6(h)(5), the recapture income is treated as ordinary income whose source and character (including section 904 separate limitation character) is determined by reference to the manner in which the recaptured items of expense or loss taken into account in calculating the dual consolidated loss were allocated and apportioned. Further, pursuant to § 1.1503(d)–6(h)(5), the pro rata computation described in § 1.1503(d)–4(c)(4) shall apply. Thus, the character and source of the recapture income is determined in the same proportion as each item of deduction or loss that contributed to the dual consolidated loss being recaptured. Accordingly, P's $20x of recapture income is characterized and sourced as follows: $4x of domestic source income (($25x/$125x) × $20x); $14.4x of foreign source general limitation income (($75x + $15x)/$125x) × $20x); and $1.6x of foreign source passive income (($10x/$125x) × $20x). Pursuant to § 1.1503(d)–6(h)(6)(i), commencing in year 3, the $20x recapture amount is reconstituted and treated as a net operating loss incurred by FB_X in a separate return limitation year, subject to the limitation under § 1.1503(d)–4(b) (and therefore subject to the restrictions of § 1.1503(d)–4(c)). Pursuant to § 1.1503(d)–6(j)(1)(iii), the domestic use agreement filed by the P consolidated group with respect to the year 1 dual consolidated loss of FB_X is terminated and has no further effect.

Example 39. Interest charge without recapture. (i) *Facts.* P owns $DE1_X$ which, in turn, owns FB_X. P's interest in $DE1_X$ and its indirect interest in FB_X are combined and treated as a single separate unit (Country X separate unit) pursuant to § 1.1503(d)–1(b)(4)(ii). In year 1, a dual consolidated loss of $100x is attributable to P's Country X separate unit. P makes a domestic use election with respect to such loss and uses the loss to offset the P group's consolidated taxable income. In year 2, there is $100x of income attributable to P's Country X separate unit and the P consolidated group has $200x of consolidated taxable income. At the end of year 2, the Country X separate unit undergoes a triggering event within the meaning of § 1.1503(d)–6(e)(1). P demonstrates, to the satisfaction of the Commissioner, that if no domestic use election were made with respect to the year 1 dual consolidated loss such that it was subject to the limitations of § 1.1503(d)–4(b) and (c), the year 1 $100x dual consolidated loss would have been offset by the $100x of year 2 income.

(ii) *Result.* There is no recapture of the year 1 dual consolidated loss attributable to P's Country X separate unit because it is reduced to zero under § 1.1503(d)–6(h)(2)(i). However, P is liable for one year of interest charge under § 1.1503(d)–6(h)(1)(ii), even though P's recapture amount is zero. This is the case because the P consolidated group had the benefit of the dual consolidated loss in year 1, and the income that offset the recapture income was not recognized until year 2. Pursuant to § 1.1503(d)–6(j)(1)(iii), the domestic use agreement filed by the P consolidated group with respect to the year 1 dual consolidated loss is terminated and has no further effect.

Example 40. Reduced recapture and interest charge, and reconstituted dual consolidated loss. (i) *Facts.* S owns $DE1_X$ which, in turn, owns FB_X. S's interest in $DE1_X$ and its indirect interest in FB_X are combined and treated as a single separate unit (Country X separate unit) pursuant to § 1.1503(d)–1(b)(4)(ii). In year 1, there is a $100x dual consolidated loss attributable to S's Country X separate unit, and P earns $100x. P makes a domestic use election with respect to the Country X separate unit's year 1 dual consolidated loss. Therefore, the consolidated group is permitted to offset P's $100x of income with the Country X separate unit's $100x dual consolidated loss. In year 2, $30x of income is attributable to the Country X separate unit under the rules of § 1.1503(d)–5 and such income is offset by a $30x net operating loss incurred by P in such year. In year 3, $25x of income is attributable to the Country X separate unit under the rules of § 1.1503(d)–5, and P earns $15x of income. In addition, at the end of year 3 there is a foreign use of the year 1 dual consolidated loss that constitutes a triggering event. S continues to own the Country X separate unit after the triggering event.

(ii) *Result.* (A) Under the presumptive rule of § 1.1503(d)–6(h)(1)(i), S must recapture $100x (plus applicable interest). However, under § 1.1503(d)–6(h)(2)(i), S may be able to demonstrate that a lesser amount is subject to recapture. The lesser amount is the amount of the $100x dual consolidated loss that would have remained subject to § 1.1503(d)–4(c) at the time of the foreign use triggering event if a domestic use election had not been made for such loss.

(B) Although the combined separate unit earned $30x of income in year 2, there was no consolidated taxable income in such year. As a result, as of the end of year 2 the $100x dual consolidated loss would continue to be subject to § 1.1503(d)–4(c) if a domestic use election had not been made for such loss. However, the $30x earned in year 2 can be carried forward to subsequent taxable years and may reduce the recapture income to the extent of consolidated taxable income generated in subsequent years. In year 3, $25x of income was attributable to the Country X separate unit and P earns $15x of income. Thus, the P consolidated group has $40x of consolidated taxable income in year 3. As a result, the $100x of recapture income can be reduced by $40x. This is the case because if a domestic use election had not been made for the $100x year 1 dual consolidated loss such that it was subject to the limitations of §1.1503(d)–4(b) and (c), only $60x of the loss would have remained subject to such limitations at the time of the foreign use triggering event. Accordingly, if S can adequately document the lesser amount, the amount of recapture income is $60x ($100x − $40x). The $60x recapture income is attributable to the Country X separate unit pursuant to §1.1503(d)–5(c)(4)(vi).

(C) Pursuant to §1.1503(d)–6(h)(6)(i), commencing in year 4, the $60x recapture amount is reconstituted and treated as a net operating loss incurred by the Country X separate unit of S in a separate return limitation year, subject to the limitation under §1.1503(d)–4(b) (and therefore subject to the restrictions of §1.1503(d)–4(c)). The loss is only available for carryover to taxable years after year 3 (and is not available for carryback). The carryover period of the loss, for purposes of section 172(b), will start from year 1, when the dual consolidated loss that was subject to recapture was incurred. In addition, such reconstituted net operating loss is not eligible for the exceptions contained in §1.1503(d)–6(b) through (d). Pursuant to §1.1503(d)–6(j)(1)(iii), the domestic use agreement filed by the P consolidated group with respect to the year 1 dual consolidated loss of the Country X separate unit is terminated and has no further effect.

(iii) *Alternative Facts.* The facts are the same as in paragraph (i) of this *Example 40,* except that the triggering event that occurs at the end of year 3 is a sale by S of its entire interest in $DE1_X$ to B, an unrelated domestic corporation. The sale does not qualify as a transaction described in section 381. The results are the same as in paragraph (ii) of this *Example 40,* except that pursuant to §1.1503(d)–6(h)(6)(ii) the $60x net operating loss is not reconstituted (with respect to either S or B). The loss is not reconstituted with respect to S because the Country X separate unit ceases to be a separate unit of S (or any other member of the consolidated group that includes S) and therefore would have been eliminated pursuant to §1.1503(d)–4(d)(1)(ii) if no domestic use election had been made with respect to such loss. The loss is not reconstituted with respect to B because B was not the domestic owner of the combined separate unit when the dual consolidated loss that is recaptured was incurred, and B did not acquire the Country X separate unit in a section 381 transaction.

[T.D. 9315, 72 FR 12914, Mar. 19, 2007; 72 FR 20424, Apr. 25, 2007]

§ 1.1503(d)–8 Effective dates.

(a) *General rule.* Except as provided in paragraph (b) of this section, this paragraph (a) provides the dates of applicability of §§1.1503(d)–1 through 1.1503(d)–7. Sections 1.1503(d)–1 through 1.1503(d)–7 shall apply to dual consolidated losses incurred in taxable years beginning on or after April 18, 2007. However, a taxpayer may apply §§1.1503(d)–1 through 1.1503(d)–7, in their entirety, to dual consolidated losses incurred in taxable years beginning on or after January 1, 2007, by filing its return and attaching to such return the domestic use agreements, certifications, or other information in accordance with these regulations. For purposes of this section, the term *application date* means either April 18, 2007, or, if the taxpayer applies these regulations pursuant to the preceding sentence, January 1, 2007. Section 1.1503–2 applies for dual consolidated losses incurred in taxable years beginning on or after October 1, 1992, and before the application date.

(b) *Special rules*—(1) *Reduction of term of agreements filed under §§1.1503–2A(c)(3), 1.1503–2A(d)(3), 1.1503–2(g)(2)(i), or 1.1503–2T(g)(i).* If an agreement is filed in accordance with §§1.1503–2A(c)(3), 1.1503–2A(d)(3), 1.1503–2(g)(2)(i), or 1.1503–2T(g)(2)(i) with respect to a dual consolidated loss incurred in a taxable year beginning prior to the application date and an event requiring recapture with respect to the dual consolidated loss subject to the agreement has not occurred as of the application date, then such agreement will be considered by the Internal Revenue Service to apply only for any taxable year up to and including the fifth taxable year following the year in which the dual consolidated loss that is the subject of the agreement was incurred and thereafter will have no effect.

(2) *Reduction of term of agreements filed under §§1.1503–2(g)(2)(iv)(B)(2)(i) (1992), 1.1503–2(g)(2)(iv)(B)(3)(i), or Rev. Proc. 2000–42.* Taxpayers subject to the terms of a closing agreement entered into with the Internal Revenue Service pursuant to §§1.1503–2(g)(2)(iv)(B)(*2*)(*i*)