Global Tax Perspectives

Double Trouble: BEPS Action 2 Stares Back in the Mirror Legislation Rule

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This past spring, Treasury released final regulations under Code Secs. 245A(e), 267A, and 1503(d).[1] Very generally, these regulations (collectively, the "Hybrid Regulations") addressed certain hybrid arrangements involving transactions and entities that have different classifications for U.S. and foreign tax law purposes.[2]

In particular, the Hybrid Regulations finalized a whole raft of new rules intended to implement Code Secs. 245A(e) and 267A, which Congress added as part of the 2017 Tax Cuts and Jobs Act. By contrast, Treasury's additions to the final regulations under Code Sec. 1503(d) (the "DCL Regulations") contained more modest updates to the rules governing dual consolidated losses ("DCLs"). Despite this relatively light touch, Treasury nonetheless made an important change to the so-called "mirror legislation rule" under Reg. §1.1503(d)-3(e). Interestingly, Treasury effected this change through a new example with two sets of alternative facts, and not through an operative rule.[3] The *second* set of alternative facts strongly indicates that a foreign hybrid mismatch rule may constitute "mirror legislation" for purposes of the DCL Regulations.[4]

Effectively, if a foreign hybrid mismatch rule were to deny a deduction for a payment, the mirror legislation rule could operate to likewise deny a deduction for that very same payment for U.S. federal income tax purposes. With the rapid proliferation of foreign hybrid mismatch rules around the globe, and particularly in Europe, the mirror legislation rule thus seems primed to play a more significant role in U.S. international tax planning than ever before.

In this column, we focus on the impact of foreign hybrid mismatch rules as mirror legislation under the DCL Regulations. First, we provide an overview of the relevant rules under the DCL Regulations, with examples of how they apply. Then, we explain the mirror legislation rule and its exceptions and how they apply, particularly in the context of a foreign hybrid mismatch rule as mirror legislation. Finally, we discuss circumstances that may serve to mitigate the impact of the mirror legislation rule.

Background: The Domestic Use Limitation Rule and the Domestic Use Election Exception

Domestic Use Limitation Rule

Congress enacted Code Sec. 1503(d), and Treasury issued the DCL Regulations, to prevent "double dipping" with respect to a single economic loss, particularly in cases where a loss of a domestic corporation offsets both U.S. and foreign taxable income of that corporation's affiliates.[5] Absent Code Sec. 1503(d) and the DCL Regulations, double dipping might occur where a member of a U.S. consolidated group incurs a loss that offsets the group's U.S. taxable income, with that same economic loss offsetting foreign taxable income—for example, under a foreign consolidation regime because the loss-making member is also a foreign tax resident or otherwise has a foreign taxable presence.

The combination of the mirror legislation rule and a foreign hybrid mismatch rule could leave a taxpayer without a deduction in the United States or the relevant foreign country.

To that end, the DCL Regulations provide a general "domestic use limitation" ("DUL") rule that prohibits the "domestic use" of a DCL.[6] At a high level, the DUL rule applies to three categories of U.S. taxpayers: (1) any unaffiliated dual resident corporation ("DRC"), (2) any unaffiliated domestic corporation that owns a "separate unit," or (3) any consolidated group that includes a DRC or a domestic corporation that owns a separate unit.[7] In this column, we use the term, "taxpayer," to refer to any one of the above. Importantly, the DCL Regulations contain exceptions to this rule where the taxpayer (1) can demonstrate that the DCL has no actual, or theoretical, "foreign use,"[8] or, as we discuss below, (2) makes a domestic use election ("DUE").[9]

In general, a DRC is a domestic corporation that is subject to a foreign income tax on its worldwide income or on a residence basis.[10] In addition, the Hybrid Regulations expanded the definition of a DRC to include a "domestic consenting corporation" ("DCC"), defined as a domestic eligible entity that elects to be treated as an association taxable as a corporation,[11] that is both (1) "fiscally transparent" for foreign tax purposes (*e.g.*, a domestic reverse hybrid) and (2) related to a "specified foreign tax resident." Very generally, a specified foreign tax resident is a related foreign corporation that takes into account certain items of the DCC.[12] As a simple illustration, if a U.S. LLC that elects to be treated as a corporation is a subsidiary of a foreign parent, and that foreign parent's tax law treats the U.S. LLC as fiscally transparent, the U.S. LLC is a DCC.

A separate unit can be either a foreign branch of a domestic corporation or an interest in a foreign hybrid entity (*e.g.*, a disregarded entity ("DRE")) that a domestic corporation owns.[13] The DCL Regulations treat any two or more separate units that the same domestic corporation (or another member of the same U.S. consolidated group that includes the domestic corporation) owns as a combined separate unit if they are both located in, or are both tax residents of, the same foreign country.[14]

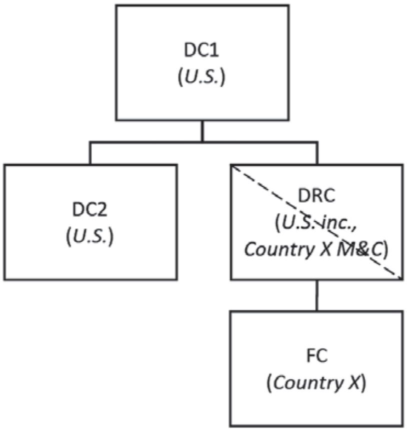
For a DRC, a DCL is any net operating loss (as defined in Code Sec. 172(c) and the related regulations) the DRC incurs in a year in which the corporation is a DRC.[15] For a separate unit, a DCL is any net loss attributable to a separate unit under certain attribution rules in Reg. §1.1503(d)-5(c) through (e).[16] In general, the DCL Regulations deem a domestic use of a DCL to occur when the DCL is "made available" to offset, directly or indirectly, the income of a domestic affiliate (other than the DRC or separate unit that incurred the DCL) in any taxable year.[17]

Example 1

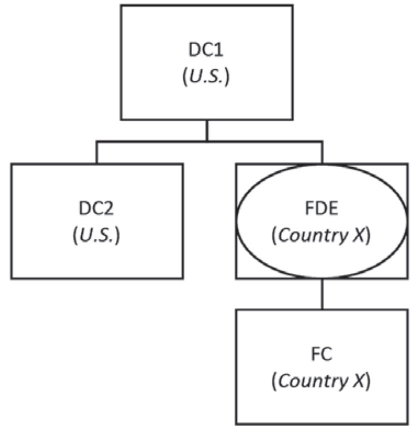
Examples 1 and 2 illustrate the DUL rule for a DRC and a separate unit, respectively.

In Example 1, DC1 is a domestic corporation and a member of a U.S. consolidated group that includes domestic corporation DC2 (the "DC1 U.S. consolidated group"). DC1 also owns DRC, a domestic corporation and a member of the DC1 U.S. consolidated group that is a Country X tax resident because it is managed and controlled in Country X. DRC wholly owns FC, a corporation that is tax resident in

EXAMPLE 1.



EXAMPLE 2.



Country X and treated as a corporation for U.S. tax purposes (*see* Example 1).

Assume that, in Year 1, DRC incurs a net operating loss as defined under Code Sec. 172(c). The loss is treated as a DCL. Absent an exception, the general DUL rule prohibits any domestic use of the DCL. Thus, the DCL may not offset income of any member of the DC1 U.S. consolidated group (other than the DRC) in Year 1 or any other taxable year.

Example 2

The facts in Example 2 are the same as in Example 1, except that DC1 owns FDE instead of DRC. FDE is a corporation for Country X tax purposes that is treated as a DRE for U.S. tax purposes. Therefore, FDE is a hybrid entity, and DC1's interest in FDE is a separate unit. FDE wholly owns FC (*see* Example 2).

Assume that, in Year 1, DC1 incurs a net loss attributable to its interest in FDE. The loss is treated as a DCL. Similar to Example 1, absent an exception, the general DUL rule prohibits the DCL from offsetting income of any member of the DC1 U.S. consolidated group (other than income attributable to FDE) in Year 1 or any other taxable year.

DUE Exception to the DUL Rule

As we indicate above, generally speaking there are two exceptions to the DUL rule: (1) the "no possibility of foreign use" exception and (2) the DUE exception.[18] As a technical matter, there is a third exception—which we might refer to as the "mutual agreement exception"—that is relevant in more limited circumstances. The mutual agreement exception requires the United States and the relevant foreign country to have entered into an agreement that establishes an elective procedure by which the taxpayer can elect to use the DCL in one (and only one) country.[19] Because a bilateral agreement is required, the mutual agreement exception applies only in certain cross-border contexts.[20]

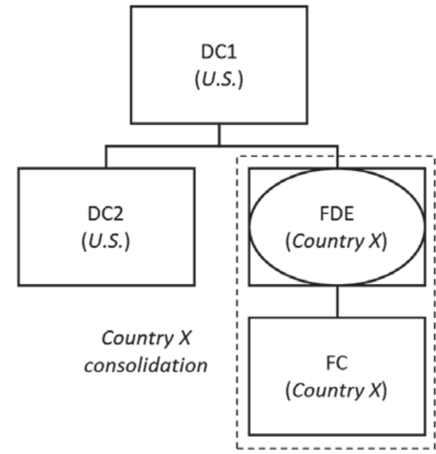
As a threshold matter, both the "no possibility of foreign use" and DUE exceptions effectively seek to ensure that there is no "foreign use" of a DCL. In general, a foreign use of a DCL occurs where two events happen. First, under foreign tax law, a deduction or loss that composes the DCL is available to offset or reduce an item of foreign taxable income.[21] Second, that item of foreign taxable income would be considered under U.S. tax principles to be an item of a foreign corporation (including where the foreign corporation includes the item because of its ownership of a foreign hybrid entity).[22] Treasury intended this second condition to limit a foreign use to situations where the foreign income that is, or would be, offset by the DCL is not subject to U.S. tax.[23]

In general, the definition of foreign use appears intended to capture "actual use," meaning that circumstances must exist for the DCL to offset or reduce foreign taxable income, even if not in the same taxable year.[24] The DCL Regulations provide special rules that broaden the concept of "use," however. First, the deduction or loss need only be "available" to offset or reduce foreign taxable income, meaning that foreign use can occur even where no offset or reduction happens (*e.g.*, because the foreign consolidated group has a loss for foreign tax purposes, but that loss creates a loss carryover for the group, and the loss carryover includes the DCL).[25] Second, although there may be no foreign use initially, foreign use may occur upon a sale, merger, or similar transaction if, as a result of that transaction, the DCL becomes available to offset or reduce income of a foreign corporation—*e.g.*, because the item may offset/reduce foreign taxable income of a foreign corporation that is a survivor in a merger.[26] Lastly, if foreign tax law provides an election that would enable a foreign use, a foreign use occurs only if the election is made.[27] This last rule provides the taxpayer with the option to use the item of deduction or loss to offset either U.S. or foreign taxable income (but not both).

To satisfy the "no possibility of foreign use" exception, the taxpayer bears the burden of demonstrating that a foreign use of the DCL cannot occur in any taxable year by any means.[28] In practice, this exception seems rarely to apply, as foreign tax laws often allow for carryover or transfer of tax attributes in many circumstances.

Fortunately, the DUE exception is more user-friendly. To satisfy the DUE exception, the taxpayer must attach a domestic use agreement with its U.S. return for the year that the taxpayer incurs the DCL. In that agreement, the taxpayer must certify, under penalties of perjury, that there has not been, and will not be, a foreign use of the DCL during a certification period that encompasses the subsequent five taxable years.[29] The taxpayer must also file annual certifications during the certification period stating that the taxpayer, or its affiliate under the relevant foreign group rules, has not made a foreign use of the DCL.[30]

EXAMPLE 3.

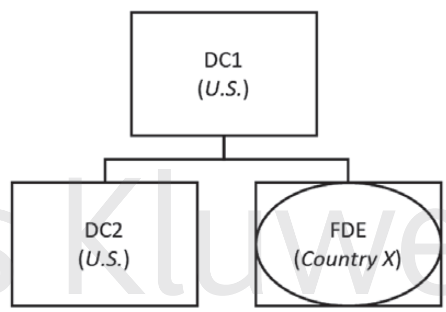


Example 3

Recall Example 2 where DC1 had a DCL on account of its interest in FDE. Now assume that Country X has a consolidation regime under which a deduction or loss of FDE may offset income of FC (or vice versa). As in Example 2, DC1 has a net loss attributable to its interest in FDE that is treated as a DCL (*see* Example 3).

The DUL rule generally prohibits a domestic use of the DCL attributable to DC1's interest in FDE. Further, under the Country X consolidation regime, FDE's loss for Country X purposes may offset income of FC, a foreign corporation. Therefore, there is a foreign use of the DCL, and neither the "no possibility of foreign use" exception nor the DUE exception applies.

EXAMPLE 4.



Example 4

The facts are the same as in Example 3, except that FC does not exist and there is no other Country X corporation with which FDE may share any part of its Country X loss. DC1 has a net loss attributable to its interest in FDE, which is treated as a DCL (*see* Example 4).

Here, as in Example 3, the DUL rule applies. However, an exception may be available. In particular, DC1 may satisfy the DUE exception if, among other things, DC1 can certify that FDE's Country X loss has not, and will not, offset income of another Country X corporation. Depending on the particulars of the Country X consolidation regime, the "no possibility of foreign use" exception may not apply. For example, the exception could be frustrated if the Country X consolidation regime would enable FDE's Country X loss to be shared with another Country X corporation pursuant to a sale, merger, or similar transaction. Accordingly, the DUE exception is likely the best avenue to allowing the DC1 U.S. consolidated group to use the DCL to offset consolidated income.

The Mirror Legislation Rule

In General

The mirror legislation rule expands the definition of foreign use to deem a foreign use to occur where the relevant foreign tax law includes "mirror legislation" that, in a manner similar to the DCL Regulations, denies any opportunity for a foreign use of the DCL in the taxable year in which the DCL arises.[31] In effect, this deemed foreign use denies the taxpayer access to the "no possibility of foreign use" and DUE exceptions, all but ensuring that the DUL rule prohibits a domestic use of the DCL.

Treasury intended the mirror legislation rule to protect against a foreign tax law that also disallows a "double dip" and thus categorically denies foreign use for purposes the DCL Regulations.[32] For example, a country could craft a rule that denies a local deduction if the loss-making corporation is incorporated abroad (*e.g.*, in the United States). Absent the mirror legislation rule, a taxpayer could claim that there is no foreign use of a DCL in that country and, in turn, satisfy the DUE exception. The taxpayer could then make a domestic use of its DCL, leaving the U.S. fisc to suffer the loss of tax revenue and shift the revenue gain to the foreign country.[33]

The mirror legislation rule avoids this result and ensures that the DUL rule continues to apply. Presumably, the foreign mirror legislation also continues to disallow any deduction or loss against foreign taxable income. Accordingly, the taxpayer may be unable to use its deduction/loss against any taxable income, U.S. or foreign. This double disallowance may in fact result in double taxation.

Treasury was aware of this potential result when it issued the mirror legislation rule.[34] Yet, Treasury apparently believed that the benefit of protecting the U.S. fisc from legislation that would shift losses to U.S companies outweighed the cost of double taxation that a limited number of companies would bear. In fact, at the time Treasury issued this rule, very few instances of mirror legislation existed.[35] Thus, Treasury could credibly argue that it intended the mirror legislation rule to function as a deterrent. Moreover, in the unlikely event that mirror legislation were to result in double taxation, the U.S. foreign tax credit regime could possibly provide an avenue for relief. However, as we discuss below, the proliferation of foreign hybrid mismatch rules makes it much more likely that taxpayers will trigger the mirror legislation rule, with the result that double taxation may become a more common occurrence. In the GILTI context particularly, the unforgiving annual nature of Code Sec. 960(d) might frustrate a taxpayer's ability to credit against its U.S. tax liability any marginal increase in foreign taxes caused by a foreign hybrid mismatch rule disallowing a deduction against foreign taxable income.

Foreign Hybrid Mismatch Rules as Mirror Legislation

Taxpayers and advisors have wondered whether a foreign hybrid mismatch regime could constitute mirror legislation since the OECD kicked off its Base Erosion Profit Shifting ("BEPS") initiative in 2013. In 2015, the OECD released a report entitled, "Neutralising the Effects of Hybrid Mismatch Arrangements" ("BEPS Action 2"), which recommended that countries adopt tax legislation targeting certain hybrid arrangements.[36] The recommendations in Chapter 6 of BEPS Action 2 targeted a "double deduction" or "DD" scenario, where two jurisdictions allow a deduction for the same payment.[37] For example, a foreign branch or hybrid entity could make a deductible payment, and both the jurisdiction of that branch or entity and the jurisdiction of its investor parent could allow a deduction for that payment. To prevent these results, BEPS Action 2 recommended that the parent jurisdiction in the DD scenario take the primary response of denying the deduction against its taxable income. But, if the parent jurisdiction were not to do so, the other jurisdiction should take the defensive response of denying the deduction itself. Since the release of BEPS Action 2, many countries (including the United States) have implemented hybrid mismatch rules that follow these recommendations. Most notably, the European Union has adopted Council Directive (EU) 2017/952 (commonly known as ATAD II), which requires EU Member States to implement hybrid mismatch rules no later than the beginning of 2020.

As we noted above, in the Hybrid Regulations, Treasury acknowledged that a foreign hybrid mismatch rule can constitute mirror legislation. Curiously, Treasury did not revise the definition of mirror legislation in Reg. §1.1503(d)-3(e). Thus, from Treasury's perspective, its reference to a foreign hybrid mismatch rule as mirror legislation in a new example under the DCL Regulations may merely clarify what Treasury believes to be apparent on the definition's face. Specifically, in a second set of "alternative facts" in Example 41, Treasury refers to "… provisions of Country Z tax law that constitute mirror legislation … and that are substantially similar to the recommendations in Chapter 6 of [BEPS Action 2] …"[38] As noted above, Chapter 6 of BEPS Action 2 contains recommendations for a "deductible hybrid payments rule" that targets DD scenarios.

In the DCL context, a DD scenario might arise where a DRC, a foreign branch or a hybrid entity makes a payment that is deductible in two jurisdictions.[39] Importantly, in the case of a foreign branch and hybrid entity, the United States would be the parent jurisdiction, tasked under BEPS Action 2 with the primary response of disallowing the deduction. Because the DUL rule generally does function to disallow a deduction against U.S. taxable income in these circumstances, Treasury may have believed that a foreign hybrid mismatch rule would not also disallow a deduction against foreign taxable income, if that rule adhered to BEPS Action 2. However, as more foreign hybrid mismatch rules emerge, this belief may not reflect reality; rather than tailoring a defensive response, these rules may disallow a deduction outright regardless of how the parent jurisdiction (*i.e.*, the United States) treats the deduction. Unfortunately for the taxpayer, the likely result is double taxation.

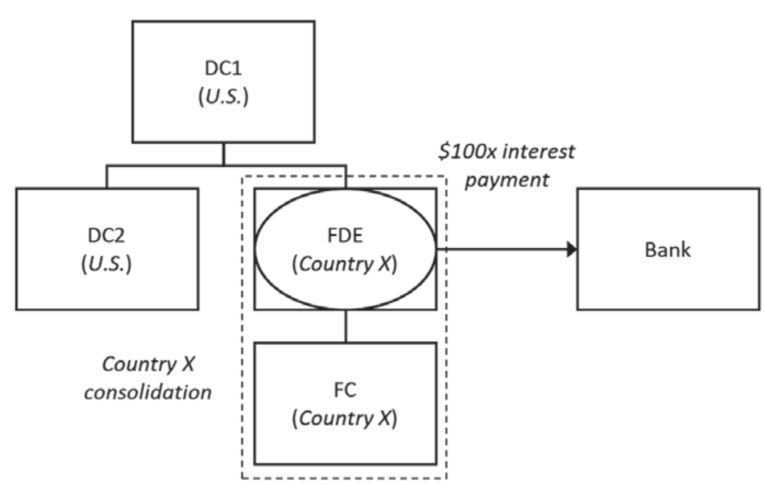
Example 5

Example 5 is intended to show the interaction of a foreign hybrid mismatch rule with the mirror legislation rule.

As in Example 3, DC1 owns an interest in FDE, a hybrid entity, whose deductions or losses may offset income of FC under the Country X consolidation regime. FDE makes a $100x payment of interest to a third-party bank. Country X has enacted hybrid mismatch rules based on BEPS Action 2. The $100x payment is FDE's only item of income, gain, deduction, or loss for Country X purposes. Based on its character, the payment would generally be deductible for Country X purposes. However, the Country X hybrid mismatch rules deny FDE the deduction because DC1, an investor in FDE that is not resident in Country X, is also able to take the deduction. Accordingly, Country X denies FDE a deduction with respect all or a portion of its interest expense on the payment (*see* Example 5).

Assume that in Year 1, DC1 has a net loss attributable to its interest in FDE. The loss is treated as a DCL and is subject to the DUL rule. Further, because FDE cannot deduct the $100x payment for Country X purposes, there is no foreign deduction to offset income of FC or any other Country X affiliate of FDE. Nonetheless, because the Country X hybrid mismatch rule constitutes mirror legislation, there is a deemed foreign use of the DCL. Thus, DC1 cannot satisfy the "no possibility of foreign use" exception or DUE

EXAMPLE 5.



exception, and the DC1 U.S. consolidated group cannot use the DCL to reduce consolidated income.

Exceptions to the Mirror Legislation Rule

There are two exceptions to the mirror legislation rule: (1) the stand-alone exception; and (2) the DCC exception.

The stand-alone exception applies if, in the absence of the mirror legislation rule, the DRC or separate unit could not otherwise put the DCL to a foreign use in the taxable year in which the DCL is incurred.[40] Thus, for example, the stand-alone exception ought to apply when the DRC or separate unit has no foreign affiliate that can use the loss in that taxable year—*e.g.*, in a fact pattern along the lines of Example 4 above. Thus, in general, the stand-alone exception does *not* apply if the DRC or separate unit can share its loss with another entity in the same country, such as under a consolidation or loss-sharing regime. This result follows even if the foreign country requires an election to consolidate, and no such election is made.[41] Thus, where the mirror legislation rule applies, the taxpayer loses its optionality to choose a domestic use or a foreign use.

The second exception—the DCC exception—applies only where a DCC that is a DRC incurs the DCL.[42] In expanding the definition of DRC to include certain DCCs, the Hybrid Regulations also provided simply that the mirror legislation rule does not cause a deemed foreign use of a DCL that a DCC that is a DRC incurs. In the preamble to proposed regulations, which the Hybrid Regulations largely finalized, Treasury asserted that the DCC exception minimizes the number of cases in which a DCL could be "stranded," meaning the DCL cannot offset/reduce U.S. or foreign taxable income.[43] The basis for this assertion ostensibly is that the DCC, if treated as a DRC, is a flow-through for purposes of its parent's jurisdiction; therefore, BEPS Action 2 principles should cause the DCC's parent to deny a deduction against taxable income in that jurisdiction. However, the DCC exception does not apply in the case of a separate unit because, Treasury believes, in such a DD scenario the United States would be the parent jurisdiction and the DCL Regulations "should neutralize the double-deduction outcome" in accordance with BEPS Action 2.[44] As explained above, Treasury's belief apparently reflects its assumption that any foreign hybrid mismatch rule would not automatically deny a deduction against foreign taxable income because the United States, as the parent jurisdiction in the parlance of BEPS Action 2, would first deny the deduction (because of the DUL rule).[45] That might be true if the foreign hybrid mismatch rule strictly follows Chapter 6 of BEPS Action 2. However, if the foreign hybrid mismatch rule denies the deduction outright, the mirror legislation rule could indeed present a problem.

Mitigating the Mirror Legislation Rule

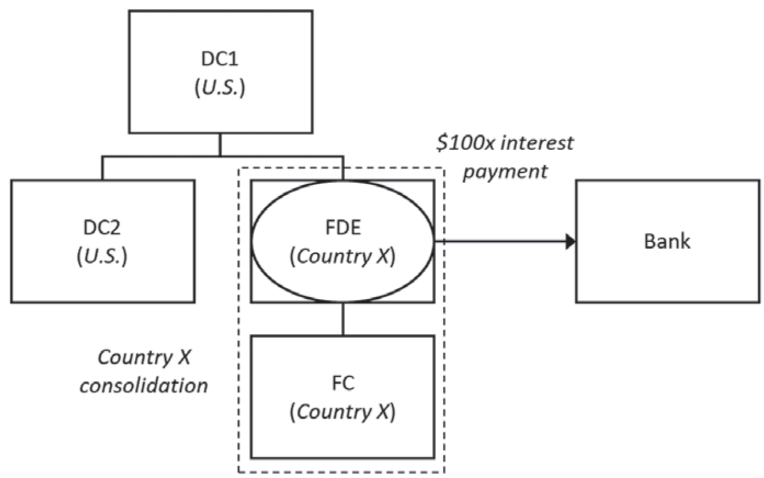
In this final section, we discuss facts and approaches that may mitigate the impact of the mirror legislation rule.

There is no mirror legislation because the foreign hybrid mismatch rule does not automatically deny a deduction.

A foreign hybrid mismatch rule that offers an election to use the DCL in the foreign country may not necessarily constitute mirror legislation. As noted above, the definition of mirror legislation requires the foreign tax law to "deny *any* opportunity" for the foreign use of the DCL.[46] In effect, the mirror legislation rule only becomes relevant if the rule applies to the specific DCL at issue. Consider a foreign hybrid mismatch rule that allows a deduction against foreign taxable income, provided that, *e.g.*, U.S. tax law denies any deduction for the same payment against U.S. taxable income. In that case, the foreign hybrid mismatch rule does not appear to constitute mirror legislation because there is an opportunity for foreign use. This result is consistent with the optionality built into the definition of "foreign use," which we discuss above. Namely, the fact that foreign law allows a taxpayer to elect to use a deduction/loss does not mean that the DCL Regulations treat the taxpayer as having elected to use that deduction/loss. Presumably, a foreign hybrid mismatch rule that also preserves this optionality presents no threat to the U.S. fisc that would justify applying the mirror legislation rule because the foreign jurisdiction allows the taxpayer to erode the foreign tax base by using the loss in the foreign jurisdiction.

This result most likely arises in a DD scenario where the foreign country is the payer jurisdiction because, per BEPS Action 2, the parent jurisdiction, rather than the payer jurisdiction, should deny a deduction against taxable income in the parent jurisdiction. The payer jurisdiction, in contrast, should deny a deduction against taxable income in its jurisdiction only if the parent jurisdiction fails to do what BEPS Action 2 recommends. Thus, the payer jurisdiction's hybrid

EXAMPLE 6.



mismatch rule may not deny the taxpayer a deduction as a matter of strict liability.

Example 6

As in Example 5, DC1 owns FDE, a hybrid entity that is part of a Country X consolidated group. Further, FDE makes the same $100x payment of interest, except that in this Example 6 the Country X hybrid mismatch rule does not automatically disallow a deduction for the $100x payment. Instead, the Country X hybrid mismatch rule only disallows the deduction if DC1, the investor in FDE under the Country X mismatch rule, is allowed a deduction under U.S. tax law (*see* Example 6).

The Country X hybrid mismatch rule likely does not constitute mirror legislation to the extent that the Country X hybrid mismatch rule does not "deny any opportunity" for a foreign use of the $100x deduction (or any portion of that $100x). Because the application of the Country X hybrid mismatch rule turns on the U.S. tax response, Country X tax law may be sufficiently flexible to turn off the strict liability result under the mirror legislation rule.

There is no DCL because of subpart F or GILTI inclusions attributable to the DRC or separate unit.

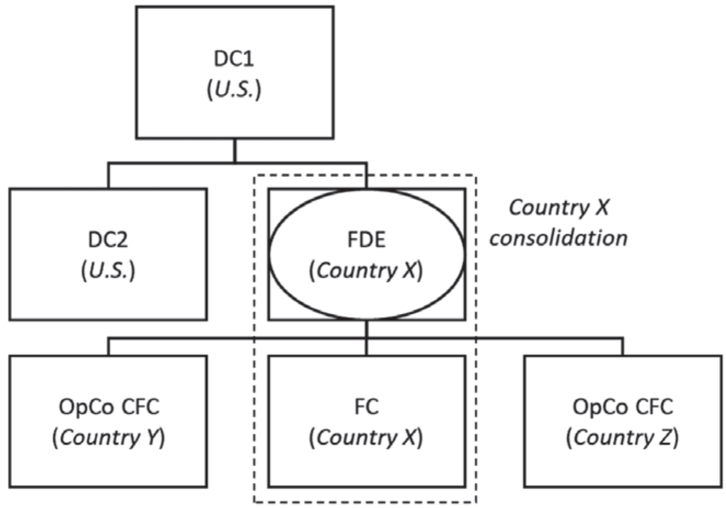
Significant subpart F or GILTI inclusions may also mitigate a DCL issue by increasing the U.S. taxable income of the DRC or income attributable to the separate unit, effectively wiping out any DCL. Under the DCL Regulations, a DRC generally computes its income or DCL under ordinary U.S. tax rules, taking into account only items of income, gain, deduction or loss for the relevant taxable year.[47] A DRC excludes certain items from this computation: any net capital loss of the DRC, any carry-forward or carry-back losses, and any items of a separate unit or an interest in a transparent entity.[48] Subpart F and GILTI inclusions, on the other hand, ought to generally factor into the DRC's income, making a DCL less likely.

The attribution rules for a separate unit generally provide a similar result if a U.S. corporation that owns the separate unit has a subpart F or GILTI inclusion in respect of CFCs that the separate unit directly owns.[49] These rules attribute to the separate unit amounts the U.S. corporation includes in income under subpart F/GILTI.[50] Thus, where a U.S. corporation has significant subpart F or GILTI inclusions from first-tier CFCs that it owns through the separate unit, these inclusions may reduce, and possibly eliminate, any DCL that would otherwise be attributable to the separate unit.[51]

Example 7

As in prior examples, DC1 owns FDE, a hybrid entity, which forms part of a Country X consolidated group with FC. In this Example 7, DC1 owns two additional CFCs through FDE, which are located in Country Y and Country Z, respectively. Each CFC earns significant operating income with respect to which DC1 has a GILTI inclusion in a given taxable year (*see* Example 7).

EXAMPLE 7.



Here, there may be no DCL attributable to DC1's interest in FDE, a hybrid entity separate unit, to the extent that DC1's GILTI inclusion from its first-tier CFCs exceeds any net loss that would otherwise be attributable to FDE. Thus, even if Country X has enacted a regime that constitutes mirror legislation under Reg. §1.1503(d)-3(e), by effecting GILTI/subpart F inclusions in respect of the first tier CFCs that DC1 holds through its interest in FDE in the illustration above, DC1 is able to effectively use FDE's net loss to offset consolidated taxable income. By contrast, if DC2 were to hold the two CFCs, the mirror legislation rule likely would apply to deny the DC1 U.S. consolidated group the ability to use any DCL to offset the GILTI/subpart F income attributable to the CFCs. As foreign hybrid mismatch rules enter into force, in particular as a result of ATAD II, companies may want to consider structuring into arrangements that put them in a position to fall on the more favorable side of what we view as an arbitrary distinction.

The stand-alone exception applies because there is no foreign consolidated group.

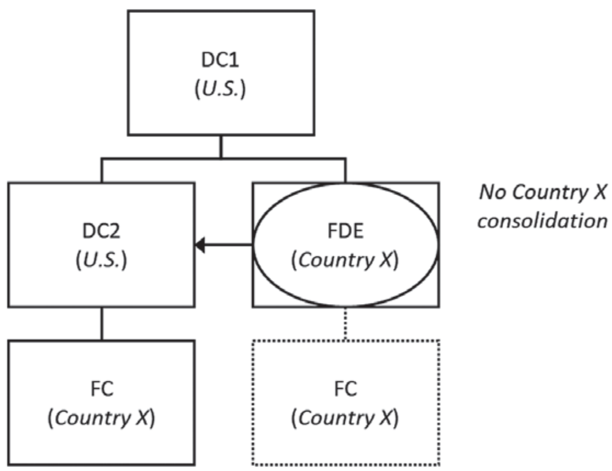
A break in the chain of ownership of the foreign entities (*i.e.*, deconsolidation) could also mitigate a DCL issue that the mirror legislation rule creates. For example, an intra-group transfer could cause the foreign consolidated group to dissolve by breaking the requisite common ownership threshold upon which the foreign consolidation rules rely. This event could effectively revitalize the stand-alone exception to the extent that it prevents the taxpayer's foreign affiliates from using the DCL to offset foreign taxable income under a foreign consolidation regime.

Unfortunately, breaking consolidation is likely not a permanent solution to an ongoing DCL issue. For example, in the fact pattern above, a subsequent event might cause the taxpayer's foreign affiliates to again satisfy the threshold requirements for the foreign consolidation regime. In that case, the stand-alone exception might no longer apply, even where the foreign consolidation regime requires an election to consolidate.[52] At that point, the U.S. group cannot file the DUE certification because it cannot represent that there is no foreign use of the DCL. As a result, the U.S. group may be required to give back five years' worth of DCLs because, absent the DUE exception, the DUL rule would deny any domestic use of these DCLs during the entire certification period.

Example 8

As in prior examples, DC1 owns FDE, a hybrid entity, which forms part of a Country X consolidated group with FC. In this Example 8, DC1, through FDE, transfers FC to DC2. Following the transfer, the Country X consolidation rules no longer apply, and FC cannot use losses/deductions attributable to FDE (*see* Example 8).

EXAMPLE 8.

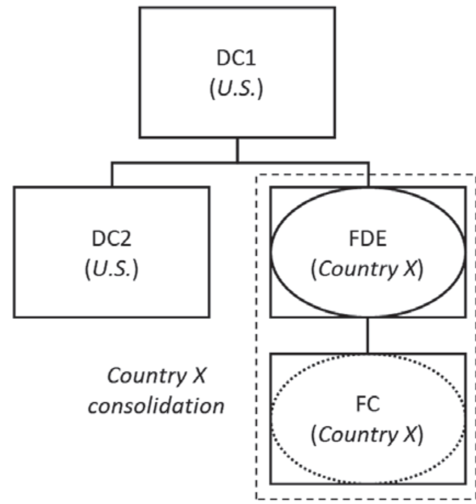


Here, the DUE exception may be available to the DC1 U.S. consolidated group because FDE cannot share any deduction or loss with FC. Thus, there is no foreign use of any DCL attributable to DC1's interest in FDE to the extent that there is no change in circumstances. To satisfy the DUE exception, the DC1 U.S. consolidated group must also make annual certifications that there is no foreign use of the DCL during the certification period of five years.

The stand-alone exception applies because there is no other foreign corporation or hybrid entity separate unit.

The final potential mitigating factor arises where, *for U.S. tax purposes*, there is no other foreign corporation (or hybrid entity of a foreign corporation) in the foreign consolidated group. Importantly, a foreign consolidated group could still exist in this scenario. The solution in this context might involve simply filing a check-the-box election to treat another foreign corporation, located in the same country as the separate unit, as a DRE. For example, if the same domestic corporation owns the foreign DRE and the separate unit, the separate unit combination rule ought to generally treat these two separate units as a combined separate unit.[53] Thus, there might be no DCL in the first place, if the newly-checked DRE has enough income to offset the net loss attributable to the loss-making DRE.[54] Alternatively, if the combined separate unit has a DCL, there ought not to be a foreign use of a DCL absent a change in circumstances because, according to U.S. tax rules, there is no other foreign corporation (or hybrid entity of a foreign corporation) with which the combined separate unit could share the DCL.

EXAMPLE 9.



Again, the approach set forth above may not represent a permanent solution to a persistent DCL issue. As we noted in the discussion surrounding Example 8, the subsequent creation, acquisition or intra-group transfer of a foreign corporation or hybrid entity could make a DCL available for a foreign use, which could cause a claw-back of any DCL during the certification period.

Example 9

As in prior examples, DC1 owns FDE, a hybrid entity, which forms part of a Country X consolidated group with FC. In this Example 9, FC files a check-the-box election to be treated as a DRE for U.S. tax purposes. Following the election, FDE and FC are treated as a combined separate unit for purposes of the DCL Regulations because both FDE and FC are tax resident in the same foreign country (Country X). DC1 owns no other Country X entities (corporate or pass-through) directly or indirectly (*see* Example 9).

Here, the DUE exception may be available because, after the combination rule treats FDE and FC as a combined separate unit, there is no other foreign corporation or hybrid entity that a foreign corporation owns with which FDE can share the DCL. To satisfy the DUE exception, the DC1 U.S. consolidated group must also make annual certifications that there is no foreign use of the DCL during the certification period of five years.

Conclusion

The rapid proliferation of foreign hybrid mismatch rules seems likely to make the mirror legislation rule much more significant than it has been in the past. The combination of the mirror legislation rule and a foreign hybrid mismatch rule could leave a taxpayer without a deduction in the United States or the relevant foreign country. While there are at least a few strategies that taxpayers can employ to mitigate the draconian results of this combination, when we take into account the complexities of the U.S. foreign tax credit regime, the fact remains that at least some taxpayers are likely to suffer double taxation. Although we understand the policy rationale that motivated the mirror legislation rule, if the United States wishes to retain the rule in its current form, we believe the only equitable approach is for the United States to actively pursue additional mutual agreements with jurisdictions that adopt mirror legislation, along the lines of the agreement between the United States and the United Kingdom. These agreements will at least offer the promise of mitigating the risk of double taxation that the combination of the mirror legislation rule and a foreign hybrid mismatch rule creates.

ENDNOTES

* The views expressed in this article are those of the authors and do not necessarily reflect the views of Ernst & Young LLP or other members of the global EY organization.

[1] *See* T.D. 9896, "Rules Regarding Certain Hybrid Arrangements," 85 FR 19802 (April 8, 2020).

[2] *See* T.D. 9896, 85 FR 19802.

[3] Reg. §1.1503(d)-7(c)(41).

[4] Reg. §1.1503(d)-7(c)(41)(iv).

[5] *See, e.g.,* Senate Report No. 99-313, 99th Cong., 2d Sess. 419, 420 (1986). *See also British Car Auctions*, FedCl, 96-1 USTC ¶50,187, 35 FedCl 123, 125 (citing the 1986 Senate Report in relevant part). *See also* General Explanation of the Tax Reform Act of 1986, Joint Committee on Taxation (May 4, 1987) ("1986 JCT Explanation"). In describing the purpose of Code Sec. 1503(d), the 1986 JCT Explanation explains that "[l]osses (however derived) that a corporation uses to offset foreign tax on income that the United States does not subject to current tax should not also be used to reduce any other corporation's U.S. tax." 1986 JCT Explanation, at 1064.

[6] Reg. §1.1503(d)-4(b). *See* Reg. §1.1503(d)-2 (providing that "domestic use" of a DCL is deemed to occur where the DCL is "made available" to offset the income of a domestic affiliate).

[7] Reg. §1.1503(d)-4(a), by reference to Reg. §1.1503(d)-2.

[8] *See* Reg. §1.1503(d)-6(c); *see also* Reg. §1.1503(d)-3(a)(1) (defining "foreign use" of a DCL to include a situation where "any portion of a deduction or loss taken into account in computing the dual consolidated loss *is made available* under the income tax laws of a foreign country to offset or reduce, directly or indirectly, any item that is recognized as income or gain under such laws and that is, or would be, considered under U.S. tax principles") (emphasis added); Reg. §1.1503(d)-3(d) (defining "available for use" as encompassing a DCL, "regardless of whether it actually offsets or reduces any items of income or gain under the income tax laws of the foreign country in such year, and regardless of whether any of the items that may be so offset or reduced are regarded as income under U.S. tax principles").

[9] Reg. §1.1503(d)-6(d).

[10] Reg. §1.1503(d)-1(b)(2).

[11] Reg. §301.7701-3(c)(3).

[12] Reg. §1.1503(d)-1(b)(2)(iii); *see also* Reg. §1.1503(d)-1(c)(1)(i).

[13] Reg. §1.1503(d)-1(b)(4)(i). Under the DCL Regulations, the term "hybrid entity" means specifically an entity that is *not* taxable as a corporation for U.S. tax purposes but is subject to tax in a foreign country as a corporation either as a resident or on its worldwide income—*e.g.*, a foreign disregarded entity. Reg. §1.1503(d)-1(b)(3).

[14] Reg. §1.1503(d)-1(b)(4)(ii).

[15] Reg. §1.1503(d)-1(b)(5)(i).

[16] Reg. §1.1503(d)-1(b)(5)(ii).

[17] Reg. §1.1503(d)-2.

[18] Reg. §1.1503(d)-6.

[19] Reg. §1.1503(d)-6(b).

[20] *See, e.g.,* "United Kingdom/United States Dual Consolidated Loss Competent Authority Agreement" (2006), entered into pursuant to the mutual agreement article, Article 26(3), of the U.K.–U.S. income tax treaty. *See* Announcement 2006-86, 2006-45 IRB 842 (Nov. 6, 2006) (the "U.K.–U.S. DCL Mutual Agreement"). As the United States and the United Kingdom entered into this agreement in 2006, the agreement predates BEPS Action 2 and, similarly, the U.K.'s hybrid mismatch rules. Thus, the U.K.–U.S. DCL Mutual Agreement may require a refresh to permit taxpayers to elect to use a mutually-allowable deduction in the United Kingdom or United States (but not both) in light of these developments.

[21] Reg. §1.1503(d)-3(a)(1). *See also* "Dual Consolidated Loss Regulations," 70 FR 29868, 29872 (May 24, 2005) ("2005 Proposed DCL Regulations") (issuing a notice of proposed rulemaking that includes a definition of "foreign use" that is substantially similar to the current DCL Regulations, in relevant part). The preamble to the 2005 Proposed DCL Regulations indicates that, by using the term "available," Treasury expanded the "actual use" standard to cover circumstances where the DCL *could* offset income because, *e.g.*, the foreign consolidated group has a loss for foreign tax purposes in a given taxable year, but that loss creates a loss carryover for the group, and the loss carryover includes the DCL. Treasury explained that this "available" standard would reduce the administrative complexity that would occur if the taxpayer had to identify and track a DCL that forms part of a loss carry-forward or carry-back until the DCL *actually* offsets foreign taxable income.

[22] Reg. §1.1503(d)-3(a)(1). *See also* 2005 Proposed DCL Regulations, at 29872.

[23] *See* 2005 Proposed DCL Regulations, 70 FR 29872.

[24] *See supra*, Endnote 21 for further discussion.

[25] *See* Reg. §1.1503(d)-3(a)(1). *See also* Endnote 21.

[26] Reg. §1.1503(d)-3(c)(2).

[27] *Id*.

[28] *See* Reg. §1.1503(d)-6(c).

[29] *See* Reg. §1.1503(d)-6(d). *See also* Reg. §1.1503(d)-6(d)(1)(i) through (vii) for a list of items of information that the taxpayer must include in the domestic use agreement.

[30] *See* Reg. §1.1503(d)-6(d)(1)(v), -6(g).

[31] Reg. §1.1503(d)-3(e)(1).

[32] *See* T.D. 9315; "Dual Consolidated Loss Regulations," 72 FR 12902, 12906-07 (Mar. 19, 2007) ("2007 Final DCL Regulations"). In the preamble to the 2007 Final DCL Regulations, Treasury cites the Joint Committee on Taxation "Blue Book" for the 1986 Tax Reform Act for their statement that "the mirror legislation rule was designed to prevent the revenue gain resulting from the disallowance of a double dip from inuring solely to the foreign country." 2007 Final DCL Regulations, at 12906–12907 (citing Staff of the Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1986, at 1065–1066 (J. Comm. Print 1987), *see* §601.601(d)(2)(ii)(b); *British*

Car Auctions, Inc., FedCl, 96-1 USTC ¶50,187, 35 FedCl 123 (1996), *aff'd without op.*, CA-FC, 116 F3d 1497).

33 *See* 2007 Final DCL Regulations, at 12906–12907.

34 *See* 2007 Final DCL Regulations, at 12906 (stating, "[t]he effect of the mirror legislation rule is that a dual consolidated loss may be disallowed in the United States and in the foreign country.").

35 The earliest example of mirror legislation, and apparently the impetus for the mirror legislation rule, was U.K. domestic legislation that generally resembled the DCL Regulations. *See, e.g., British Car Auctions, Inc.*, 35 FedCl 126–127 (stating that shortly after Congress enacted Code Sec. 1503(d), the United Kingdom enacted legislation denying the use of a DRC's losses by any U.K. affiliates, and that Congress had identified the "deleterious effects" that the "no possibility of foreign use" and DUE exceptions would have if not back-stopped by the mirror legislation rule). In the interim between the 2005 Proposed DCL Regulations and the 2007 Final DCL Regulations, the U.S. Competent Authority entered into a mutual agreement with its U.K. counterpart by which the Competent Authorities agreed to certain ground rules for the use of a DCL in either the United States or the United Kingdom (but not both), including at the election of the taxpayer.

36 OECD, *Neutralising the Effects of Hybrid Mismatch Arrangements*, Action 2—2015 Final Report, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, 2015, Paris, *https://doi.org/10.1787/9789264241138-en*. Drawing inspiration from Paris, Congress and the Treasury appear to have enacted Code Secs. 245A(e) and 267A, and issued the Hybrid Regulations, respectively, based in large part on the recommendations in BEPS Action 2.

37 The recommendations in BEPS Action 2 also targeted a second broad scenario where the payer jurisdiction allows a deduction, and the payee jurisdiction does not require an income inclusion—a "deduction/no-inclusion," or "D/NI" scenario. In a D/NI scenario, the payer jurisdiction should take the primary response to deny the deduction, with the payee jurisdiction taking the defensive response to require an income inclusion only if the payer jurisdiction fails to take the primary response.

38 Reg. §1.1503(d)-7(c)(41)(iv) ("Example 41"). Overall, Example 41 has little to do with the mirror legislation rule, and focuses instead on the addition of DCCs to the definition of a DRC. Hence, we do not discuss Example 41 in detail in this column. The pertinent sentence, summarized in the text accompanying this note, provides: "The facts are the same as in paragraph (c)(41)(i) of this section, except that, under provisions of Country Z tax law that constitute mirror legislation under §1.1503(d)-3(e)(1) and that are substantially similar to the recommendations in Chapter 6 of OECD/G–20, *Neutralising the Effects of Hybrid Mismatch Arrangements, Action 2: 2015 Final Report* (October 2015), Country Z tax law prohibits the $100x loss attributable to DCC from offsetting FSZ1's income that is not also subject to U.S. tax." With respect to these alternative facts, Example 41 concludes that there is no deemed foreign use on account of the exception under Reg. §1.1503(d)-3(e)(3), *i.e.*, the "DCC exception."

39 *See* BEPS Action 2, at 67–76.

40 Reg. §1.1503(d)-3(e)(2). *See also* Final 2007 DCL Regulations, at 12907.

41 *Id*. Notably, however, the stand-alone exception does not treat an item of deduction or loss as available for foreign use solely because foreign tax law would enable a foreign use through a sale, merger or similar transaction, provided that such a transaction does not actually occur. *See* Reg. §1.1503(d)-3(e)(2)(i).

42 Reg. §1.1503(d)-3(e)(3).

43 "Rules Regarding Certain Hybrid Arrangements," 83 FR 67612, 67623-24 (December 28, 2018) (issuing a notice of proposed rulemaking including proposed rules that the Hybrid Regulations later finalized without significant change, particularly under the DCL Regulations).

44 *Id*. In a later section, we discuss how an element of contingency or optionality in the foreign hybrid mismatch rule could mitigate a DCL issue.

45 Under the deductible hybrid payments rule of Chapter 6 of BEPS Action 2, the parent jurisdiction bears responsibility for the "primary response" of denying a deduction against its taxable income. The payer jurisdiction, by contrast, should deny a deduction against its own taxable income only if the parent jurisdiction fails to take the primary response (called the "defensive rule").

46 Reg. §1.1503(d)-3(e)(1) (emphasis added).

47 Reg. §1.1503(d)-5(b)(1).

48 Reg. §1.1503(d)-5(b)(2). As we explain in the next paragraph, an item of a separate unit may also include subpart F or GILTI inclusions under the attribution rules for separate units.

49 Reg. §1.1503(d)-5(c)(3)(i) provides the general attribution rule for a hybrid entity separate unit. That rule states that a domestic corporation's items of income, gain, deduction, and loss are generally attributable to the separate unit if such items are reflected on the books and records of the separate unit, as adjusted to conform to U.S. tax principles. *See also* Reg. §1.989(a)-1(d) for the meaning of "books and records," as adopted for purposes of the hybrid entity attribution rule.

50 *See* Reg. §1.1503(d)-5(c)(4)(iv), -7(c)(24) ("Example 24"). The DCL Regulations state that this rule applies to income arising "for example, under Code Secs. 78, 951 or 986(c)." Of course, the rule, which Treasury promulgated in 2007, does not mention Code Sec. 951A or GILTI. However, it *see*ms consistent with the DRC attribution rules, as well as the statutory framework of GILTI, if a GILTI inclusion were treated in the same manner as a subpart F inclusion for purposes of Reg. §1.1503(d)-5(c)(4)(iv). *See, e.g.,* Code Sec. 951A(f)(1)(A) and Reg. §1.951A-1(d)(1), incorporating Code Sec. 951(a) for purposes of determining a U.S. shareholder's *pro rata* share of GILTI tested items.

51 For these purposes, we note that the subpart F or GILTI inclusion generally must be associated with a first-tier CFC, meaning that the stock of the CFC with respect to which an actual dividend is paid could not be owned by another corporation (particularly, another CFC). Also, Example 24 *see*ms to indicate that, if the domestic corporation owns the CFC stock through multiple hybrid entity separate units, the subpart F or GILTI inclusion is attributable only to the lowest-tier separate unit (that, presumably, is the legal owner of the CFC's stock). This result would *see*m consistent with the general books and records approach to attributing income to a hybrid entity separate unit, as an actual dividend from the CFC would presumably be reflected only on this lowest-tier hybrid entity separate unit's books and records.

52 *See* Reg. §§1.1503(d)-3(e)(2); 1.1503(d)-6(e)(1)(ix). *See also* Reg. §1.1503(d)-3(e)(2)(i) (stating that, for the stand-alone exception, the determination of whether an item of deduction or loss is available for foreign use in the absence of the mirror legislation should be "made without regard to whether such availability is limited by election (or other similar procedure)").

53 Reg. §1.1503(d)-1(b)(4)(ii).

54 Reg. §1.1503(d)-5(c)(4)(ii). *See also* Reg. §1.1503(d)-7(c)(25),(26) (providing Example 25 and Example 26, respectively, which each illustrate the attribution of items of income, gain, deduction, and loss to a combined separate unit by first attributing these items to the individual separate units before the combined separate unit takes into account the items of the individual separate units).