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In this article, Brewer analyzes the supposed trap in the dual consolidated loss regulations as they apply to the disregarded revenues of a disregarded entity owned by a domestic corporation, and he discusses whether the trap is myth or reality.

A. Introduction

Because of its magnitude and complexity, U.S. tax law is rife with "traps for the unwary." However unintended a supposed trap may be, once identified by a respected expert (whether at the IRS or in the private sector), a trap can take on a life of its own.[1] But occasionally, these supposed traps are exposed as myth.[2] The purpose of this article is to shine a light on one alleged trap for the unwary that reportedly lies in the minefield known as the dual consolidated loss (DCL) regulations, as those regulations apply to the disregarded revenues of a disregarded entity (DRE) owned by a domestic corporation.

B. The Alleged DCL Trap

The fact pattern is quite common: A domestic corporation operates a foreign business unit through a wholly owned foreign legal entity that elects, for U.S. tax purposes, to be disregarded as an entity separate from the domestic corporation that owns it. If the DRE earns its income from the domestic corporation, that income is disregarded for U.S. tax purposes. As explained in more detail below, for DCL purposes, disregarded items of a DRE are not allowed to be taken into account in computing the net income or DCL of a DRE. As a result, the expenses of the DRE purportedly create a DCL and are thereby rendered nondeductible for U.S. tax purposes, in the absence of a domestic use election or some other exception in the DCL regs. Thus, the operation of the foreign business unit allegedly gives rise to phantom DCLs, *even if the DRE is highly profitable*.[3] Moreover, even with a domestic use election, the phantom DCLs would then be triggered into income if the foreign DRE later elects to be reclassified as a corporation for U.S. tax purposes, *even if there were never any losses for foreign tax purposes*.

Example 1: USP operates a profitable service business. To enable it to better serve global clients, USP sets up an Amsterdam office in which employees perform some of the services forming a valuable part of USP's deliverables to its clients. The Amsterdam office is operated in a wholly owned Dutch BV (BV) that elected to be disregarded as an entity separate from USP for U.S. tax purposes. USP bills its clients and pays BV a service fee equal to its costs, plus a 10 percent profit factor. For its first year, 2015, BV had costs of $10 million, service fee income (received from USP) of $11 million, and net income of $1 million.

If the supposed trap is real, USP must calculate the net income or DCL of BV by eliminating its gross income, which is disregarded for U.S. tax purposes as a result of the sub's check-the-box election. If (as the hoax goes) there is no

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[1]A classic example is the so-called zero-basis theory advanced by the IRS in Rev. Rul. 68-629, 1968-2 C.B. 154, and later adopted by the Tax Court in *Alderman v. Commissioner*, 55 T.C. 662 (1971) (promissory note of a shareholder contributed to his corporation in a section 351 transaction was deemed to have a zero tax basis in the hands of the corporation).

[2]*See, e.g.*, *Lessinger v. Commissioner*, 872 F.2d 519 (2d Cir. 1989), and *Peracchi v. Commissioner*, 143 F.3d 487 (9th Cir. 1998) (both cases rejecting the IRS's zero-basis theory).

[3]This alleged DCL trap was identified by respected DCL experts at least as far back as 2008. *See, e.g.*, Joseph M. Calianno and Kagney Petersen, "An Opportunity and a Possible Trap Under the U.S. Dual Consolidated Loss Regs," *Tax Notes Int'l*, May 12, 2008, p. 499.

provision permitting USP to impute any gross income to BV for purposes of the DCL rules, BV is left with a DCL of $10 million for 2015,[4] even though its operations produced all of the following: a net economic profit; positive net taxable income to USP for U.S. tax purposes; and positive net taxable income to BV for Dutch tax purposes.

Even though USP is deemed to have a DCL as a result of BV's operations, USP is permitted to deduct the DCL on its 2015 return, if it is savvy enough to recognize the alleged trap and make a domestic use election under reg. section 1.1503(d)-6(d). Failure to make the election would, in all likelihood, result in the permanent forfeiture of any U.S. tax deduction for BV's $10 million of business expenses. Also, even if USP makes a domestic use election, it would be forced to recapture the $10 million DCL if it were to elect, effective anytime within the next five years, to convert BV to a corporation for U.S. tax purposes. Recapture would be required *even if there were no gain inherent in the assets of BV*. Thus, the resulting deemed incorporation would require USP to recognize $10 million of phantom (that is, nonexistent) income.

C. Legal Analysis Creating the DCL Trap

The regulations provide two different approaches for determining the DCL of a separate unit: one in reg. section 1.1503(d)-5(c)(2) for a true branch (referred to as a ''foreign branch separate unit''); and a second approach in reg. section 1.1503(d)-5(c)(3) for a foreign legal entity that has elected to be disregarded as an entity for U.S. tax purposes (referred to as a ''hybrid entity separate unit''). In Example 1, BV is a hybrid entity separate unit.

Reg. section 1.1503(d)-5(c)(1)(ii) provides that the computation of a DCL for both types of separate units shall be made using only those existing items of income, gain deduction, and loss of the separate unit's domestic owner as those items are determined for U.S. tax purposes. It further provides that items that are disregarded for U.S. tax purposes shall not be regarded or taken into account for purposes of determining the DCL of either type of separate unit.

For foreign branch separate units, reg. section 1.1503(d)-5(c)(2) requires the attribution of income and deductions of the domestic owner to the foreign branch separate unit, without regard to whether those items are reflected on the separate books of the separate unit. Reg. section 1.1503(d)-5(c)(2) specifically incorporates the principles of section 864 to attribute items of the domestic owner to the separate unit. So in Example 1, if the Dutch operations were conducted through a true branch, rather than a disregarded BV, it would be necessary to attribute some gross income of USP to the Dutch branch to determine the amount (if any) of its DCL.

In contrast, for hybrid entity separate units, reg. section 1.1503(d)-5(c)(3) provides that the domestic owner's items of income and deduction are attributable to the hybrid entity separate unit to the extent that they are reflected on the books and records of the hybrid entity as adjusted to conform to U.S. tax principles. Thus, if one begins with the books and records of the hybrid entity separate unit and eliminates its gross income (because that income is disregarded for U.S. tax purposes), all that is left are its deductions and hence a DCL.

To avoid having a DCL, it would be necessary to either take into account (that is, reinstate) income that reg. section 1.1503(d)-5(c)(1)(ii) specifically requires us to disregard or attribute third-party gross income of the domestic owner to the hybrid entity separate unit.

As for reinstating the disregarded income, an important canon of statutory construction is that when specific and general provisions of the same statute appear to conflict, the specific provisions should govern.[5] Regulations, like statutes, are interpreted according to the same canons of construction.[6] Reinstating the disregarded income would be inconsistent with the requirement of reg. section 1.1503-5(c)(1)(ii) to disregard it.

As for attributing the income of the domestic owner to a hybrid entity separate unit, reg. section 1.1503(d)-5(c)(2) (dealing with DCL computations for foreign branch separate units) appears to present a real obstacle. As explained above, reg. section 1.1503(d)-5(c)(2) specifically requires the attribution of income and deductions of the domestic owner to the foreign branch separate unit, without regard to whether those items are reflected on the books of

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[4]If we assume that the Dutch operations would constitute a foreign branch, as defined in reg. section 1.367(a)-6T(g)(1), then USP actually has two Dutch separate units in Example 1: a hybrid entity separate unit and a foreign branch separate unit, which must be combined under the separate unit combination rule. Thus, the mechanics of calculating the DCL are a bit more complicated than described herein. But the end result is the same. For a detailed explanation of the actual mechanics, see Calianno and Peterson, *id*.

[5]*Mertens Law of Federal Income Taxation*, section 3:11, citing *Edmond v. United States*, 520 U.S. 651 (1997).

[6]*Black & Decker Corp. v. United States*, 436 F.2d 431 (4th Cir. 2006).

the separate unit. In contrast, for hybrid entity separate units, reg. section 1.1503(d)-5(c)(3) does not expressly require, or permit, the attribution of items of the domestic owner to the separate unit and, in that regard, it does not make any reference to section 864 principles.

As a matter of statutory construction, when Congress includes particular language in one section of a statute but omits it in another, it is generally presumed that Congress did so intentionally and purposefully.[7] Therefore, applying this canon of construction to reg. section 1.1503(d)-5(c), it is presumed that the IRS did not intend for any items of the domestic owner that are not already reflected on the books of a hybrid entity separate unit to be attributed to the separate unit under the principles of section 864 or, for that matter, under any other U.S. tax principles.

Also corroborating the existence of this supposed DCL trap, examples 6 and 23 of reg. section 1.1503(d)-7(c) could be interpreted as saying that it is impermissible to attribute the domestic owner's items to a hybrid entity separate unit. In examples 6 and 23, the interest expense of the owner of a hybrid entity separate unit is not permitted to be attributed to the separate unit specifically because it is not reflected on the books and records of the separate unit.

It is relevant to note that the DCL provision that requires some items to be disregarded in computing the taxable income or DCL of a separate unit can cut both ways. As discussed above, the provision can result in a DCL when no loss actually exists (or a larger DCL than the actual loss), which occurs when the disregarded item is an item of revenue. But the same rule can also prevent a DCL from occurring when there is an actual loss (or can result in a smaller DCL than the actual loss). This would be the case when the disregarded item is an item of deductible expense.

D. Easy Way Out for the Wary

Like many traps for the unwary, this one can be avoided by the wary with a little advance planning. The way to escape it (business considerations permitting) is to have the DRE be owned by a different domestic corporation than the one that pays the DRE its revenues. Under that arrangement, the revenues would not be disregarded and therefore would be taken into account in determining the taxable income or DCL of the separate unit. If, in Example 1, USP had held its interest in BV indirectly, through a U.S. subsidiary, the sub would have had taxable income of $1 million, instead of a DCL of $10 million.

E. Legal Analysis Exposing the Trap as a Myth

1. The interpretation supporting the trap is inconsistent with the statute. The legislative purpose for the enactment of the DCL rules in 1986 was to prevent a dual resident corporation from double dipping by using a single economic loss first to offset income that was subject to U.S. tax (but not foreign tax) and then again to offset income subject to foreign tax (but not U.S. tax).[8] In 1988 Congress extended the application of section 1503(d) by adding section 1503(d)(3) to apply the provisions to separate units of domestic corporations. Thus, the authority of the IRS to issue regulations applying the DCL rules to separate business units (including hybrid entity separate units) was granted by Congress in section 1503(d)(3).

Section 1503(d)(3) expressly requires the regulations to apply the DCL rules to a separate unit ''in the same manner as if such unit were a wholly owned subsidiary of such corporation.'' Computing the income or DCL of a hybrid entity separate unit by taking into account only its expenses — and none of the gross income attributable to its activities — would produce a dramatically different result than computing the income or DCL of a wholly owned subsidiary. This interpretation would render the regulation inconsistent with the requirement imposed by Congress and therefore invalid, if it would result in a DCL in circumstances such as those in Example 1.

2. There is a better interpretation based on the conformity requirement in reg. section 1.1503(d)-5(c)(3). Another fundamental rule of statutory interpretation is that a statute, when ambiguous, should *not* be interpreted to produce an absurd or unreasonable result.[9] It is also well established that if a statute has two possible meanings and one violates the Constitution, courts should adopt the other.[10] Similarly, when a regulation lends itself to two possible interpretations — one that produces an absurd result, inconsistent with the authorizing statute, and a second that produces a reasonable result, consistent with the statute — the second interpretation should prevail.

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[7]*Mertens*, *supra* note 5, section 3:49, citing *Sigmon Coal Co. Inc. v. Apfel*, 226 F.3d 291 (4th Cir. 2000).

[8]*See*, *e.g.*, preamble to final DCL regulations. T.D. 9315.

[9]*See*, *e.g.*, *King v. Burwell*, 135 S. Ct. 2480 (2015) (adopting a strained interpretation of the Affordable Care Act to avoid the results of a literal interpretation that the Court deemed to be unintended by Congress).

[10]*NFIB v. Sebelius*, 132 S. Ct. 2566 (2012), citing *Parsons v. Bedford*, 3 Pet. 433, 448-449 (1830) and *Blodgett v. Holden*, 275 U.S. 142, 148 (1927) (concurring opinion).

The argument for the alleged trap fails to give effect to some important language in reg. section 1.1503(d)-5(c)(3) that supports an entirely different interpretation of the provision and produces a result far more consistent with the legislative purpose of section 1503(d) and its grant of regulatory authority.

Under reg. section 1.1503(d)-5(c)(3), the books and records of a hybrid entity separate unit must be ''adjusted to conform to U.S. tax principles.'' The plain and unambiguous meaning of the quoted language requires adjustments for any aspect of the books and records of a hybrid entity separate unit (after eliminating disregarded items) that would otherwise not be in conformity with U.S. tax principles. Otherwise, the books and records of the hybrid entity separate unit would, by definition, *not* conform to U.S. tax principles.

Computing the net income or loss of a business unit by reflecting only expenses and no gross income attributable to the activities of that unit would clearly *not* be in conformity with U.S. tax principles for determining the economic net income or loss of a separate business unit. Thus, reg. section 1.1503(d)-5(c)(3) requires the books and records of the hybrid entity separate unit to be adjusted by applying any relevant U.S. tax principles that would properly reflect the portion of the domestic owner's third-party gross income attributable to the activities of the hybrid entity separate unit (such as the principles of section 864 or 482).

3. Explanation for the lack of any reference in reg. section 1.1503(d)-5(c)(3) to section 864 principles. As discussed above, one might question whether reg. section 1.1503(d)-5(c)(3) should be interpreted to permit the application of section 864 in the absence of any specific directive to do so. One might also question whether the drafters of the regulations could realistically have intended to require such opposite approaches regarding the application of U.S. tax principles — with reg. section 1.1503(d)-5(c)(3) requiring adjustments to conform the accounts with every relevant principle of U.S. tax law and reg. section 1.1503(d)-5(c)(2) not permitting adjustments to conform with any U.S. tax principles except those of section 864.

This can be explained by the different starting points the drafters chose in reg. section 1.1503(d)-5(c)(2) and -5(c)(3). For true branches, reg. section 1.1503(d)-5(c)(2) starts with ''the items of income, gain, deduction (other than interest), and loss of [the] domestic owner.'' It then requires the application of section 864 principles to determine the extent to which any of those items of the domestic owner are properly attributable to the branch. It is important to note that the domestic owner's items of income, gain, deduction, and loss are already in conformity with U.S. tax principles. As a U.S. taxpayer, the domestic owner is required to compute *all* of its items in conformity with relevant U.S. tax principles.

In contrast, for hybrid entity separate units, reg. section 1.1503(d)-5(c)(3) starts with the books and records of the hybrid branch to determine which of ''the domestic owner's items of income, gain, deduction, and loss are attributable to'' the separate unit. Thus, instead of employing section 864 principles to attribute the domestic owner's items to the separate unit, reg. section 1.1503(d)-5(c)(3) looks to the books of the hybrid entity to perform the attribution function. This is a perfectly reasonable starting place for a hybrid branch separate unit because the hybrid branch is a separate legal entity that is obligated under the laws of its country to keep separate books and records in conformity with the accounting and tax principles *of that country*.

Also, because a hybrid entity is actually a separate and distinct legal entity, its items of income, gain, deduction, and loss are generally not reflected on the books of the domestic owner, as they would be in the case of a true branch. Thus, it would not be a workable approach to employ section 864 principles as the starting point to attribute a domestic owner's items to a hybrid branch separate unit.

A true branch may or may not be required by foreign law to keep separate books and records. Often, the books of a true branch will simply reflect those items that flowed through its bank accounts, with no attempt to account for third-party revenues collected directly by the home office or for expenses incurred by the home office that directly benefit the business conducted by the branch. As explained in the preamble to the 2005 proposed DCL regulations, those items are accounted for on the books of the entity of which the branch is a part and are typically required by foreign tax law to be attributed to a branch or permanent establishment of a U.S. corporation in the foreign country, similar to the way the section 864 rules apply to a U.S. branch of a foreign corporation.

In contrast, by starting with the books and records of the hybrid entity, reg. section 1.1503(d)-5(c)(3) begins with something that is likely to differ in many respects from U.S. tax principles. Therefore, to accomplish the underlying purpose of the DCL rules (that is, to determine the net operating loss, computed under U.S. tax principles, that is made available to offset other foreign income), within the construct chosen by Congress for determining the DCL of a separate unit (that is, as if the unit were a wholly owned subsidiary of the domestic owner), it is necessary to conform that starting point to all relevant U.S. tax principles. However, because foreign accounting and tax principles would already require the books and records of the hybrid entity to include items properly attributable to that entity, the one set of U.S. tax principles that would not be necessary to apply as a general rule would be those in section 864.

But to say that the principles of section 864 are not applicable *as a general rule* does not mean that those principles cannot be applied when appropriate. When the books and records of the hybrid entity (after eliminating disregarded transactions) reflect results that are substantially out of conformity with U.S. tax principles, because gross income received from the domestic owner is disregarded, the literal language of reg. section 1.1503(d)-5(c)(3) requires an adjustment to reflect an appropriate amount of the gross income reflected on the domestic owner's books. In that case, an appropriate result could at least arguably be accomplished by employing the principles of section 864.

4. Section 482 principles provide an alternative means to achieve the appropriate result. As an alternative to section 864, an appropriate result in Example 1 could be accomplished by employing the principles of section 482. But as explained above, it is unlikely that section 482 principles should be applied to simply reinstate the "disregarded" income received by the separate unit from the domestic owner. This application would arguably be inconsistent with the requirement of reg. section 1.1503(d)-5(c)(1)(ii), which provides that items that are disregarded for U.S. tax purposes shall not be taken into account for purposes of determining the DCL of either type of separate unit.

It is important to note that section 482 is not limited to the imputation of a payment between the two controlled entities in question (in this case, between the domestic owner and its hybrid entity separate unit). Section 482 principles can be applied to allocate a portion of the third-party, "regarded" gross income of the domestic owner to the hybrid entity separate unit in order to clearly reflect the net income or loss of the separate unit.

Section 482 reads, in relevant part, as follows:

> In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to . . . clearly reflect the income of any of such organizations, trades, or businesses.

It would seem likely that a U.S. corporation and its hybrid entity separate unit should be viewed as representing two organizations (assuming they each conduct real activities). Further, if the U.S. corporation and its hybrid entity separate unit are each engaged in activities that, when viewed separately, constitute integral business units, it would seem likely that those separate business units should be viewed as constituting two trades or businesses. Thus, there would not appear to be any doubt that section 482 would permit the allocation of an item of gross income from a U.S. corporation to its hybrid entity separate unit (or to the separate business of that unit) if necessary to clearly reflect the income of the separate unit.

An interpretation of reg. section 1.1503(d)-5(c)(3) that fails to permit the attribution of third-party income in Example 1 would produce an absurd result, inconsistent with the clear and unambiguous language of section 1503(d)(3). However, an interpretation that permits the attribution of an appropriate share of the domestic owner's third-party gross income to its hybrid entity separate unit (whether under section 482 principles or under section 864 principles) produces a reasonable result that is consistent with legislative intent and that preserves the ability of the regulations to prohibit double dipping.

5. The entity classification regulations require an interpretation of the DCL regulations that produces the same results for both types of separate units. An election under reg. section 301.7701-3 to disregard an entity requires that the entity's activities be treated for all federal tax purposes (except as specifically provided in reg. section 301.7701-2(c)(2)(iv) and (v), or in reg. section 301.7701-2T(c)) "in the same manner as a sole proprietorship, branch, or division of the owner."[11]

> **Example 2:** The facts are identical to those in Example 1, except that the Amsterdam office is conducted as a true branch, with no separate legal entity set up to house its activities.
>
> Under these circumstances, reg. section 1.1503(d)-5(c)(2) clearly requires the attribution of an appropriate amount of USP's third-party gross income in determining the net income or DCL of its Amsterdam branch. Thus, as a true branch, the Amsterdam office does not produce a DCL.

Another relevant canon of statutory construction is that all parts of the statute should be read together, and the courts should therefore avoid interpretations of one provision to render another

[11]Reg. section 301.7701-2(a).

inoperative or superfluous.[12] Applying that canon to the tax regulations would require that reg. section 1.1503(d)-5(c)(3) be interpreted, if possible, to produce results consistent with those required by reg. section 301.7701-2(a). Thus, the result in the case of the disregarded entity in Example 1 should be the same as the result for the true branch in Example 2, given that the language of reg. section 1.1503(d)-5(c)(3) lends itself to that possibility.

There is no guidance suggesting that the drafters intended substantially different results from the application of reg. section 1.1503(d)-5(c)(2) and -5(c)(3), or that they intended reg. section 1.1503(d)-5(c)(3) to be applied in a manner that ignores its literal language and produces results inconsistent with the stated requirement of section 1503(d)(3).

That reg. section 1.1503(d)-5(c)(2) and -5(c)(3) are intended to produce similar results is supported by the fact that both of those provisions are contained within a broader set of rules in paragraph (c) that apply to both types of separate units: foreign branch separate units and hybrid branch separate units. Reg. section 1.1503(d)-5(c)(1) sets forth some basic rules applicable to the determination of the income or DCL for both types. With section 1503(d)(3) as a guide, reg. section 1.1503(d)-5(c)(1) should be interpreted as determining whether a wholly owned subsidiary would have had an NOL as computed under U.S. tax principles. The provision states that "the computation shall be made as if the separate unit . . . were a domestic corporation, using items that are attributable to the separate unit."

This provides a clear indication that for both reg. section 1.1503(d)-5(c)(2) and -5(c)(3), it is necessary to apply all relevant U.S. tax principles — their purpose is to determine whether the separate unit has an NOL computed under U.S. tax principles as though the separate unit were a domestic corporation. There is no question that if the Amsterdam office in examples 1 and 2 were operated in a wholly owned subsidiary, it would not have had an NOL. Thus, no DCL should result in Example 1 or Example 2.

6. The regulations should be interpreted to produce the same results regardless of which entity invoices the client.

> **Example 3:** The facts are the same as in Example 1, except that BV invoices the clients for its services and receives its $11 million of gross income directly from the clients.
>
> Under these circumstances, BV's gross income would not be disregarded; hence, there would be no DCL.

Aside from the possible application of the DCL rules, the U.S. and Dutch tax consequences in examples 1 and 3 are identical. There is no indication that Congress, or the IRS, intended for the DCL results in those two examples to be dramatically different. To interpret the DCL regulations to produce a $10 million DCL in Example 1 creates a result that is not only absurd and inconsistent with the guidance provided by section 1503(d)(3) but one that is also dramatically different from that in Example 3, in which the economic and tax results (absent the DCL regulations) are identical.

7. The regulations should be interpreted to produce the same results regardless of which entity owns the DRE.

> **Example 4:** The facts are the same as in Example 1, except that BV is wholly owned by USsub, a domestic corporation wholly owned by USP.
>
> Under these circumstances, BV's gross income from USP would not be disregarded; hence, there would be no DCL.

Again, aside from the possible application of the DCL rules, the U.S. and Dutch tax consequences in examples 1 and 4 are identical. There is no indication that the two examples should produce quite different results, for the same reasons discussed in Example 3.

8. Examples 6 and 23 in the DCL regulation are distinguishable. As explained above, in examples 6 and 23 of reg. section 1.1503(d)-7(c), the interest expense of the owner of a hybrid entity separate unit is not permitted to be attributed to the separate unit specifically because the interest expense is not reflected on the books and records of the separate unit.[13] The fact that Example 23 does not attribute the domestic owner's third-party interest expense to the hybrid entity separate unit should not be interpreted to indicate that a domestic owner's third-party revenues should not be attributed to a hybrid entity separate unit when the hybrid entity's activities gave rise to those revenues.

Interest expense is accorded unique treatment under U.S. tax law. If a parent company is capitalized in part with interest-bearing debt and its wholly owned subsidiary is capitalized entirely with equity, there is nothing in section 482, 864, or any other U.S. tax provision that causes a portion of the parent's interest expense to be reallocated to the subsidiary, even if the funding for expenditures by the subsidiary can be directly traced to the parent's borrowing. In contrast, when a parent company

[12] *Mertens*, *supra* note 5, section 3:48, citing *United States v. Commonwealth Energy System*, 235 F.3d 11 (1st Cir. 2000).

[13] This is what creates the "opportunity" identified by Calianno and Petersen, *supra* note 3.

collects revenues that were earned by the subsidiary or pays the subsidiary's expenses, those items of income and expense are required to be attributed to the subsidiary. Thus, the way that Congress and the IRS may have chosen to attribute interest expense to different entities and business units does not provide any meaningful inference regarding the treatment of any other item of income or expense.

9. Example 25 supports adjustments for items not reflected on the books of a hybrid branch. The thesis that reg. section 1.1503(d)-5(c)(3) permits the recognition of items not reflected on the separate books and records of the hybrid entity is corroborated by Example 25, which explains that adjustments should be made to the books and records of the hybrid branch separate unit for the following items described in that example as being treated differently under the tax laws of the foreign country, as compared with those of the United States:

- the amount of straight-line depreciation expense reflected on the hybrid entity's books was required to be adjusted to reflect the amount of depreciation allowable for U.S. tax purposes;
- a political contribution reflected on the books of the hybrid entity was not taken into account in determining the income or DCL of the hybrid branch separate unit because political contributions are not deductible for U.S. tax purposes; and
- repair and maintenance expenses that were deducted in the year paid on the books of the hybrid entity separate unit were required to be capitalized and amortized over five years, to conform to U.S. tax principles.

The third item was not reflected on the books and records of the hybrid branch in years 2 through 5 because the amounts were fully expensed for foreign tax purposes in year 1. Nonetheless, in computing the net income or DCL for years 2 through 5, Example 25 requires adjustments to include amortization deductions that are not reflected on the entity's books for those years.

One might challenge this interpretation of Example 25, based on the fact that the repair and maintenance costs in question were actually reflected on the books of the hybrid entity, just not for all of the years in question. Thus, it might be argued that all Example 25 means is that adjustments may be made for an item that is not on the books of the hybrid entity for the year in question, as long as it was, or will be, reflected on the books of the hybrid entity for at least one tax year. But even if one accepts that limit to Example 25's meaning, nothing in that example (or any other example) supports the position that U.S. tax principles cannot be applied, when appropriate, to attribute items of the domestic owner to a hybrid entity separate unit.

Further, it should be noted that the books and records of the hybrid entity in Example 1 did, in fact, include gross service fee income of $11 million. True, reg. section 1.1503(d)-5(c)(1)(ii) requires that amount to be disregarded. But it is not correct to say that by attributing a portion of the domestic owner's gross service fee income to the hybrid entity in Example 1, we would be making an adjustment for an item that was not reflected on the books of the hybrid entity.

It might also be argued that this supposed limit on the meaning of Example 25 should be rejected as inconsistent with the U.S. tax principle regarding the integrity of the tax year. This supposed meaning of Example 25 would expand the analysis required by reg. section 1.1503(d)-5(c)(3) to compute the income or DCL of a hybrid entity separate unit to include all prior years and any future years for which it could be demonstrated that an item will eventually be reflected on the entity's books.

10. The better interpretation also cuts both ways. As noted above, the DCL provision that produces the alleged trap for the unwary in the case of disregarded revenues can also produce an unintended taxpayer benefit in the case of disregarded deductions. The interpretation advocated herein to avoid the supposed trap by allocating revenues of the single member to a hybrid entity separate unit may also apply to prevent an unintended taxpayer windfall by allocating deductions of the single member to a hybrid entity separate unit.

F. Concluding Remarks

For the odd reader who might now be convinced that the DCL trap is actually a myth, it is important to note that there may still be some highly respected experts who believe that it is real (some of whom may work for the IRS). Certainly, in a situation involving this issue, one should not hesitate to take the position that this alleged trap is actually a myth. But when contemplating whether to plan in to something like this, it is always prudent to think back to the scene in *Dirty Harry* in which Clint Eastwood points his .44 Magnum[14] at a perpetrator's head and says, "You've got to ask yourself one question: 'Do I feel lucky?' Well, do you, punk?"

The hazards of litigation on an issue like the DCL hoax are not unlike the risk facing the punk — that is, does Dirty Harry have any bullets left in his gun? Even if one feels he has properly accounted for all of

[14]Reported to be the most powerful handgun in the world.

the IRS's bullets, until the agency formally announces it will not attempt to pull the trigger[15] or until a few courts shoot down any such attempts by the IRS, the safer bet would be to plan around this issue, when business considerations so permit.[16]

[15]A clarification in the regulations would be welcome.

[16]That planning strategy is explained above under Section D.

IN THE WORKS

A look ahead to planned commentary and analysis.

Was landing General Electric really a win for Massachusetts? (*State Tax Notes*)

Robert Tannenwald analyzes whether the tax deal sending General Electric Co. from Connecticut to Boston was really as great as backers claim by reviewing the data from both states to determine what, if any, short-term and long-term benefits are present.

San Francisco taxpayers behind the eight ball on gross receipts tax (*State Tax Notes*)

Michael Cataldo examines the numerous challenges facing taxpayers attempting to avoid being whipsawed by San Francisco's gross receipts tax.

Abusive parents, rebellious subsidiaries: Hot topics in intragroup tax disputes (*Tax Notes*)

Vadim Mahmoudov discusses what the Great Recession and its corresponding increase in consolidated group members fighting over tax attributes and refunds can teach us about structuring intercompany tax-sharing agreements.

Clarifying the tax classification of workers (*Tax Notes*)

Donald Williamson suggests a bright-line test to determine whether workers are classified as employees or independent contractors.

Seconded employment and PEs (*Tax Notes International*)

Adam G. Province reviews the potential creation of a permanent establishment resulting from seconding employees to a foreign host subsidiary.

St. Lucia investment program (*Tax Notes International*)

Bruce Zagaris discusses St. Lucia's new citizenship by investment program and the related tax advantages for potential investors.