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US International Tax Alert

Final regulations address disregarded payment loss and dual consolidated loss rules

Overview

On January 14, 2025, the IRS and Treasury Department published final regulations (TD 10026) (the "Final DPL Regulations") to finalize certain provisions of the proposed regulations issued on August 6, 2024 (REG-105128-23, the "Proposed DCL/DPL Regulations"). (Read Deloitte's August 14, 2024 US International Tax alert on the Proposed DCL/DPL Regulations here.) The Final DPL Regulations finalize the rules from the Proposed DCL/DPL Regulations that relate to disregarded payment losses (DPLs), including portions that are also relevant for dual consolidated losses (DCLs), such as the proposed anti-avoidance rule and the exception to a foreign use in Treas. Reg. § 1.1503(d)-3(c)(3). The Final DPL Regulations retain the basic approach and structure of these portions of the Proposed DCL/DPL Regulations, with certain revisions. It is important to note that the Final DPL Regulations do not finalize all provisions of the Proposed DCL/DPL Regulations. With the exception of the proposed rules addressing the application of the DCL rules to the GloBE Model Rules (see below), the following provisions remain outstanding as proposed rules with retroactive effective dates. They may have retroactive effect if and when they are finalized in the future. (For further details, please refer to the tax alert linked above.)

- Rules largely reversing the "inclusions on stock" rule in Treas. Reg. § 1.1503(d)-5(c)(4)(iv)
- Rules addressing the interaction between the intercompany transaction rules in Treas. Reg. § 1.1502-13 and the DCL rules
- Rules addressing the application of the DCL rules to the GloBE Model Rules
- The addition of language in Treas. Reg. § 1.1503(d)-5(c)(4)(iv) to clarify the meaning of the phrase "as adjusted to conform to US tax principles" in the general rule for determining items of income, gain, deduction, and loss of a domestic owner that are attributable to a hybrid entity separate unit
- Changes to the definition of the DCL certification period in Treas. Reg. § 1.1503(d)-1(b)(20), and a corresponding change to Treas. Reg. § 1.1503(d)-6(d)(2), to include years prior to the year in which a DCL is incurred

It is also important to note that most of the Final DPL Regulations have a delayed applicability date, with the exception of the application of the anti-avoidance rule to DCLs. Specifically, the applicability dates of the provisions in the Final DPL Regulations are as follows:

- The disregarded payment loss rules in Treas. Reg. § 1.1503(d)-1(d) (the "DPL Rules") apply to taxable years beginning on or after January 1, 2026. The provisions in the Proposed DCL/DPL Regulations related to consenting to the DPL rules were not adopted by the Final DPL Regulations.
- The anti-avoidance rule in Treas. Reg. § 1.1503(d)-1(f) (the "Anti-Avoidance Rule") applies to DCLs incurred in taxable years ending on or after August 6, 2024, and to DPLs in taxable years beginning on or after January 1, 2026.
- The deemed ordering rule in Treas. Reg. § 1.1503(d)-3(c)(3) (the "Deemed Ordering Rule") applies to DCLs and DPLs incurred in taxable years beginning on or after January 1, 2026.

The Final DPL Regulations provide that when the provisions within the Proposed DCL/DPL Regulations addressing the application of the DCL rules to the GloBE Model Rules are finalized, the applicability date set forth in the Proposed DCL/DPL Regulations will be modified. Such final regulations will provide that the DCL and DPL rules will apply without taking into account QDMTTs or Top-up Taxes collected under an IIR or UTPR incurred in taxable years beginning before August 31, 2025. The Final DPL Regulations note that taxpayers may rely on this transition relief until such final regulations are published.

Disregarded Payment Loss Rules

The Final DPL Regulations finalize the rules from the Proposed DCL/DPL Regulations that relate to DPLs, which address disregarded payments that could give rise to "deduction/no-inclusion" (D/NI) outcomes, with the following revisions.

DPL inclusions and DPL cumulative register: The Final DPL Regulations now provide disregarded payment entity (DPE) owners a deduction to the extent that the DPE derives disregarded payment income (DPI) in a year following the year of a DPL inclusion. Specifically, a suspended deduction of the DPE owner is established at the time of a DPL inclusion, in an amount equal to the DPL inclusion, and may be deductible in a future period to the extent of DPI generated by the underlying DPE. Note that there are additional reporting requirements related to the use of a suspended deduction.

The Final DPL Regulations also clarify that DPLs do not decrease the DPL cumulative register (*i.e.*, DPLs do not create negative balances in the DPL cumulative register), and that the DPL certification period with respect to a DPL terminates in the event of a DPL inclusion.

Disregarded payment entities and minority interests: The Final DPL Regulations revise the definition of a DPE to exclude entities that are not related, within the meaning of section 954(d)(3), to a DPE owner (previously referred to in the Proposed DCL/DPL Regulations as "specified domestic owners"). Where a DPE owner indirectly owns more than a minority interest, but less than all the interests in a DPE, the DPE owner must apply the DPL rules on a proportionate basis; however, the Final DPL Regulations remove the requirement from the Proposed DCL/DPL Regulations that such determination be based solely on value.

The Final DPL Regulations clarify that a foreign branch owned by a domestic corporation through one or more partnerships may constitute a DPE, such that a domestic corporate partner's proportionate share of a deduction related to payments between a partnership and a disregarded entity of such partnership may give rise to a DPL. The Final DPL Regulations also provide that an entity that is treated as a partnership for US tax purposes, but that is a foreign tax resident, may constitute a DPE.

Determination of DPL items: The Final DPL Regulations provide a *de minimis* exception to the DPL Rules (the "*De Minimis* Exception"). Pursuant to the *De Minimis* Exception, a DPL with respect to a DPE in a foreign taxable year is deemed to be zero if (a) it is incurred in connection with the conduct of an active trade or business, and (b) the amount of the DPL is less than the lesser of (1) $3 million, or (2) 10% of the aggregate amount of all items of the DPE that are deductible under a foreign tax law (regardless of whether such items are regarded or disregarded for US federal income tax purposes).

The Final DPL Regulations also exclude royalties paid or accrued pursuant to a license agreement entered into before August 6, 2024 from the computation of a DPE's DPL or DPI. This exclusion does not apply if there is a significant modification of any terms of the license agreement.

Additionally, the Final DPL Regulations clarify that items incurred or derived in the portion of a foreign taxable year in which an entity or foreign branch is not a DPE are not taken into account for purposes of calculating DPI or DPL.

Foreign use -- mirror legislation: The Final DPL Regulations narrow the definition of a foreign use for DPL purposes by excluding the deemed foreign use that may occur under the mirror legislation rule in Treas. Reg. § 1.1503(d)-3(e).

Anti-Avoidance Rule

The Final DCL Regulations adopt the anti-avoidance rule introduced in the Proposed DCL/DPL Regulations, with some modifications. Similar to the rule provided in the Proposed DCL/DPL Regulations, the Anti-Avoidance Rule applies "if a transaction, series of transactions, plan, or arrangement is engaged in with a view to avoid the purposes of" the DCL or DPL rules. The Anti-Avoidance rule empowers the IRS to make "appropriate adjustments," such as disregarding a transaction or modifying the items that are taken into account for purposes of determining a DCL of a DRC or separate unit.

The Final DPL Regulations clarify that the Anti-Avoidance Rule is meant to apply to transactions only if they result in a double deduction or similar outcome. As a result, instances in which a taxpayer restructures their arrangements to avoid the application of the DPL rules or the DCL rules, such as by converting disregarded payments into regarded payments or terminating agreements that give rise to disregarded payments, are not meant to be captured by the Anti-Avoidance Rule so long as the restructured arrangement does not give rise to the potential for two deductions (*i.e.*, a deduction for foreign tax purposes, and a deduction for US tax purposes).

The Final DPL Regulations also provide exceptions to the Anti-Avoidance Rule. The Anti-Avoidance Rule does not apply to a reduction or elimination of a DCL

solely by reason of intercompany transactions as described in Treas. Reg. § 1.1502-13, items of income arising from the ownership of stock and taken into account pursuant to Treas. Reg. § 1.1503(d)-5(c)(4)(iv), or the attribution of items to a hybrid entity separate unit of items that have not and will not be reflected on the entity's books and records. Additionally, the Anti-Avoidance Rule does not apply with respect to the application of the DCL rules to the GloBE Model Rules, or to cause a foreign use of a DCL to occur solely in a period before the taxable year in which such loss was incurred.

In addition to adopting the example provided in the Proposed DCL/DPL Regulations, the Final DPL Regulations provide additional examples to illustrate the scope of the Anti-Avoidance Rule. In Treas. Reg. § 1.1503(d)-7(c)(44), Example 44 ("Example 44"), the parent of a US consolidated group transfers cash to a DPE of one of its domestic subsidiaries (the DPE owner) in exchange for an interest-bearing note. The taxpayer takes the position that the related interest expense deductions are disallowed under section 163(l), and that interest income on the loan is treated as tax-exempt income under the intercompany transaction rules in Treas. Reg. § 1.1502-13. An interest expense deduction is allowed or foreign tax purposes, which is used to offset income of a foreign corporation. The analysis in Example 44 provides that this structure results in a double deduction or similar outcome, because there is a foreign use of the interest expense deduction and no corresponding income inclusion for US tax purposes. As a result, the Anti-Avoidance Rule applies, and adjustments are made to treat the foreign interest deduction as a DPL. As a result of the foreign use of that DPL, the DPE owner has a DPL inclusion and establishes a suspended deduction.

Deemed Ordering Rule

The Final DPL Regulations modify the exception to foreign use in Treas. Reg. § 1.1503(d)-3(c)(3), which is now referred to as the Deemed Ordering Rule. The Final DPL Regulations clarify that the application of the Deemed Ordering Rule for DCL purposes should only take into account items that would be taken into account in the determination of a DCL (*i.e.*, items that are regarded for US federal income tax purposes). When applying the Deemed Ordering Rule in the DPL context, items of income or gain are taken into account only to the extent such items would be considered in the determination of a DPL (*i.e.*, only items that are disregarded for US federal income tax purposes and would be considered in the determination of DPI are considered). The Final DPL Regulations also remove the condition that the Deemed Ordering Rule applies only if the laws of the foreign country do not provide applicable rules for determining which income is offset by the losses or deductions.

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