Because Not There, Neither Here? Examining the ‘Mirror Legislation’ Status of the U.K.’s New Anti-Hybrid Rules

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Effective January 1, and without any grandfathering or other transition mechanism, the United Kingdom became the first country to adopt the anti-hybrid recommendations from action 2 of the OECD’s base erosion and profit-shifting initiative. While this development has been discussed in the tax press on a general level, this article focuses on one specific provision in the new U.K. rules — namely chapter 9 of new Part 6A of the U.K.’s Taxation (International and Other Provisions) Act 2010 (TIOPA) — and that provision’s interaction with an arcane part of the United States tax system’s own pre-BEPS anti-hybrid rules.

In sum, the concurrent applications of the U.S. and U.K. anti-hybrid rules to losses incurred by U.K. check-the-box hybrid subsidiaries that flow into U.S. multinational groups may now result in almost all those entities’ losses being noncurrently deductible for U.S. tax purposes and possibly for U.K. tax purposes. This risk was foreseen at the outset of the BEPS project, and it has come to fruition. The U.S. Treasury and U.K. HM Revenue & Customs should consider coordinating a joint response to this matter, as they did in 2006 to relieve a similar case of overlapping restrictions imposed on losses incurred by U.K. permanent establishments of U.S. corporations. Even absent a bilateral agreement, the U.S. Treasury should consider providing U.S. taxpayers with guidance on the status of this U.K. provision and foreseeably similar BEPS action 2-based legislation from other countries.

Chapter 6 of the BEPS Action 2 Report

To understand the context for this issue, it helps to review the underlying BEPS recommendations that form the basis for the U.K. anti-hybrid rules. Chapter 6 of the action 2 final report recommends that countries enact

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1. OECD, “Neutralising the Effects of Hybrid Mismatch Arrangements” (the action 2 final report). See also Finance Act of 2016, c.24, section 66, sch. 10.  
3. Unless otherwise stated, all section references are to the Internal Revenue Code of 1986 and to the U.S. Treasury regulations promulgated thereunder. Also, for ease of discussion, all amounts discussed herein are simply noted in U.S. dollars or generically.  
legislation to neutralize specific cases of double deduction (DD) arising as a result of the payer’s hybrid status. Two key recommended parameters, recommendations 6.1.(a)-(b), for this legislation are:

- the parent (or investor) jurisdiction should have the primary responsibility and opportunity to deny a tax benefit for DD amounts flowing through from a hybrid subsidiary that is tax resident in another jurisdiction; and
- if the parent jurisdiction does not restrict the investor’s ability to claim a tax benefit for the hybrid subsidiary’s DD payment, then the payer jurisdiction (that is, the tax residence of the hybrid subsidiary) should neutralize the DD outcome by denying a deduction locally for the DD amounts.

Thus, the action 2 final report contemplates a core framework in which the local tax jurisdiction of the hybrid subsidiary should only apply its own rules against the local hybrid subsidiary if the parent jurisdiction has failed to restrict the investor’s deduction for the flow-through loss. A simple example of how these concepts would apply can be illustrated through Example 1.

![Figure 1. Example 1](image)

In this example, Parent, a Country X tax resident, owns all of Sub, a Country Y tax resident. Sub is a hybrid entity with respect to Parent for Country X tax purposes. Sub incurs a $100 loss, which Parent would otherwise be able to deduct for Country X tax purposes because of Sub’s hybrid status. In this example, the action 2 framework recommends that Country X should deny Parent the ability to deduct Sub’s loss for Country X tax purposes (that is, to neutralize the DD result). If Country X does not do so, then Country Y should deny Sub the ability to deduct its $100 loss for purposes of Country Y’s tax laws.³

The action 2 final report does not recommend automatic, permanent disallowance of the DD amount (here, Sub’s $100 loss). Rather, DD amounts should be able to (but only able to) offset, including as a carryover to other tax years, dual inclusion income that is taken into account as ordinary income by both the parent and the hybrid subsidiary in both the parent and payer jurisdictions. To prevent suspended losses from becoming permanently stranded, the report also recommends that the restriction not apply to the extent that the taxpayer can establish that the excess deduction (that is, above dual inclusion income) in the other jurisdiction cannot be offset against the income of any other person that is not dual inclusion income.

Thus, the action 2 final report recommends countries enact anti-DD legislation that ring-fences the loss of a hybrid payer entity to be usable only against dual inclusion income, with the only potential exception being for taxpayers that can affirmatively demonstrate that the DD amounts cannot be used against non-dual inclusion income. The report does not countenance any other scenario in which a DD amount could be offset against other, non-dual inclusion income.

In particular, and in contrast to the U.S. rules discussed infra, the action 2 report specifically does not contemplate that countries might take a wait-and-see approach to determine if a DD outcome actually occurs — for example, by enacting an investor-level rule that permits the DD amount to be offset against the parent’s non-dual inclusion income with the caveat that it must

³For ease of discussion, all pictures and examples herein assume that the entities recognize the same number of items of income and deduction for purposes of both relevant countries’ income tax systems.

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be clawed back if a prohibited offset later occurs in the hybrid subsidiary’s jurisdiction.

**U.K. Implements Action 2, Chapter 6**

The U.K. government enacted the Chapter 6 recommendations in Chapter 9 (sections 259I-259IC) of Part 6A TIOPA as part of the 2016 Finance Act legislation. In relevant part, section 259IA TIOPA provides three preconditions to the rules’ applicability:

- there is an amount that it is reasonable to suppose is deductible both by a hybrid entity under its local tax laws and by an investor in the hybrid entity under the investor’s local tax laws;
- either the hybrid entity or the investor are subject to U.K. corporation tax; and
- the hybrid entity and the investor are related or part of a structured arrangement.

Section 259IB TIOPA then sets forth the investor-level rule contemplated by Recommendation 6.1(a) of the action 2 final report, which applies when the parent/investor is a U.K. tax resident. Section 259IC TIOPA contains the payer- or subsidiary-level rule contemplated by Recommendation 6.1(b), which applies when the payer/subsidiary is a U.K. tax resident. There may be many cases in which it is unclear whether one of these conditions is met and the applicability of the rule is questioned. The conditions, however, will often be satisfied easily in the context of U.S. multinational groups’ check-the-box hybrid U.K. limited companies whose net income or loss is directly taken into account in the consolidated U.S. tax return.

A key term of art for these provisions is the “hybrid entity double deduction amount,” or HEDD amount, which corresponds to the DD payment result described in the action 2 final report. The existence of an HEDD amount is a threshold definitional requirement for the U.K. anti-hybrid rules to apply (that is, there must be an HEDD amount for section 259IB or 259IC TIOPA to apply).

The operative restriction in both the section 259IB investor-level rule and the section 259IC subsidiary-level rule is imposed on this HEDD amount. To ensure the primacy of the investor-level rule, a precondition to section 259IC’s application to a particular U.K. hybrid entity is: “It is reasonable to suppose that — (i) no provision under the law of an investor jurisdiction that is equivalent to section 259IB applies” (emphasis added). Thus, if the U.K. corporation is a hybrid entity vis-à-vis an investor and pays an HEDD amount, as a threshold matter, the U.K. subsidiary-level rules will not restrict the U.K. deduction if the parent jurisdiction has enacted legislation equivalent to the U.K.’s investor-level rule, section 259IB TIOPA.

This raises a key question: When is an investor-level anti-double-deduction regime considered equivalent to the U.K.’s investor-level rule in section 259IB TIOPA? Can only legislation modeled on, and enacted after, the October 2015 issuance of the action 2 final report qualify as “equivalent”? Or can older rules, such as the U.S. dual consolidated loss (DCL) rules implemented under section 1503(d), qualify? Section 259BA(2) TIOPA, which provides overall definitions for the U.K. anti-hybrid regime, states that when considering whether another jurisdiction has implemented laws “equivalent to” the U.K. anti-hybrid rules, the reference is to non-U.K. laws that, it is “reasonable to suppose,” are based on the action 2 final report. The draft guidance on the hybrid rules issued by the U.K. government in March 2017 confirms this interpretation, defining “equivalent provisions outside the U.K.” as “any provision of an overseas territory’s law that is based on the [action 2 final report], or any replacement or supplementary publication.”

Apparently, then, the U.S. DCL rules, which were first enacted statutorily in 1986 and substantially modified at the regulatory level in the mid-2000s — and which almost certainly inspired and helped shape the Chapter 6 recommendations but have not been updated to

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7 Section 259IA(2) and (4) TIOPA.

8 Sections 259IB(2) and 259IC(3)-(4) TIOPA.


more specifically track those precise recommendations — do not qualify as “equivalent to” the new U.K. rules. Certainly, it would not be reasonable to suppose that rules issued years before the action 2 final report were based thereon. Further, as discussed more below, the U.S. DCL rules are distinguishable in that they offer a wait-and-see option to allow a hybrid entity’s deductions against non-dual inclusion income. Also, they do not include a subsidiary-level restriction similar to section 259IC TIOPA that denies U.S. tax deductibility of a domestic reverse hybrid corporation’s losses if or when those losses can be claimed by the entity’s investors for non-U.S. tax purposes. Indeed, based on feedback from my U.K. colleagues, I understand HMRC would not consider the application of the U.S. DCL rules to a U.S. investor in a U.K. hybrid entity equivalent to section 259IB TIOPA. Because the DCL rules are not equivalent to section 259IB TIOPA, the “either-or” framework of investor vs. subsidiary level restriction contemplated by the action 2 final report does not apply and, instead, a loss incurred by a U.K. hybrid entity can be concurrently subject to both section 259IC TIOPA and the U.S. DCL rules. Query if the U.S. Treasury expected its BEPS partners to exclude the United States’ pre-existing investor-level restriction (the DCL rules) from that agreed-upon framework.

In assessing whether section 259IC TIOPA applies to U.S.-owned U.K. hybrid entities, also recall that section 259IC requires the existence of an HEDD amount, which in turn requires that “it is reasonable to suppose” the hybrid U.K. tax-resident company’s deductions are claimable by a (U.S.) investor. To the extent that the U.S. DCL rules deny deductibility of the U.K. company’s deduction and loss amounts for U.S. tax purposes, one might wonder if those amounts fall outside the definition of an HEDD amount because (or to the extent that) the deductions are not claimable by the U.S. investor. That is, part of the first precondition for applicability in section 259IA TIOPA (that it is “reasonable to suppose” that the investor may claim the hybrid entity’s losses in the investor’s tax jurisdiction) arguably would not be satisfied. Based on further feedback from U.K. colleagues, I understand that if the U.S. DCL rules actually denied the ability of a U.S. investor to claim its share of a U.K. hybrid entity’s loss, then HMRC would not consider this condition satisfied and section 259IC would not apply.

Note, however, that section 259IC TIOPA has two subsections (259IC(8) and (9) TIOPA) that, taken together, more specifically address cases in which the U.K. hybrid entity’s HEDD amount is actually claimed by the hybrid entity’s investor against non-dual inclusion income. This amount is classified as an illegitimate overseas deduction and is permanently forfeited from U.K. tax deductibility — that is, the amount cannot be offset, even against dual inclusion income in other periods. Thus, the actual deduction of an HEDD amount by a U.S. investor in a U.K. hybrid entity would ensure that amount’s forfeiture for U.K. tax purposes.

U.S. Dual Consolidated Loss Rules

The U.S. DCL rules are contained in IRC section 1503(d), and an extensive set of implementing regulations are in Treas. reg. section 1.1503(d)-1 through 8. In BEPS parlance, section 1503(d) authorizes two anti-DD provisions. The first provision restricts “dual resident corporations” (DRCs) from sharing their losses with affiliates, except to the extent that the taxpayer can demonstrate that the DRC’s loss cannot offset income of a non-U.S. corporation. The DRC restriction is generally endorsed in chapter 7 of the action 2 final report. The second restrictive provision is an investor-level primary rule that, as implemented by regulation, restricts

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12 Section 259IC(8)-(9) TIOPA. Technically, this occurs because the provisions treat the illegitimate overseas deduction amount as having already been allowed, thus it is no longer part of the suspended deduction carried over for use against dual inclusion income in other years. See also INTM 557080, “Hybrids: Chapter 9 — Hybrid Entity Double Deduction Mismatches: Counteraction: Hybrid Entity,” at 314 (confirming this interpretation by stating that the amount should be treated as having been deducted at an earlier period).

13 A dual resident corporation is an entity that is treated as a U.S. tax resident corporation for U.S. corporate income tax purposes but is also subject to income tax by a foreign country, either on a residence basis or on its worldwide income. See section 1503(d)(2)(A); and Treas. reg. section 1.1503(d)-1(b)(2). The issues presented by DRCs are similar to the hybrid entity DD case, but DRCs are not discussed herein because they are much less common than check-the-box hybrid entities. Note, however, that Chapter 10 of the U.K. anti-hybrid rules contains provisions similar to the Chapter 9 provisions discussed herein that would apply to either a U.K. PE of a U.S. company or a U.K.-U.S. DRC, with likely the same complications as those presented for U.S.-owned U.K. hybrid entities.
losses incurred by “separate [business] units” of a U.S. corporation in a manner similar to the DRC restriction.  

Thus, the section 1503(d) statutory rules are quite similar to the action 2 final report recommendations. The loss of a DRC or separate unit only is usable against the DRC or separate unit’s own income, but relief should be available if the taxpayer can demonstrate that the loss would be stranded in the foreign jurisdiction, meaning it is not usable by an affiliate in the foreign jurisdiction (similar to the BEPS requirement of proving the loss is not usable against non-dual inclusion income).

In implementing the 1503(d) regime, however, the U.S. Treasury offered taxpayers a middle approach to deducting DCLs incurred by DRCs and separate units. Under this approach, U.S. taxpayers can make a domestic use election to contemporaneously deduct the DCL against income of a domestic affiliate of the separate unit or DRC. In BEPS terms, the domestic use election permits an offset against non-dual inclusion income.

A key requirement for the domestic use election is that the U.S. taxpayer must certify that no foreign use of the DCL has occurred in the year the DCL is incurred and that none will occur in the following five-year certification period. If there is a subsequent foreign use or other triggering event after a domestic use election has been made, then the taxpayer must recapture (or claw back) the DCL amount into gross income and pay an interest charge for any tax benefit derived from the prior deduction of the loss. If no triggering event occurs during the five-year certification period, the domestic use election terminates and no recapture can occur, even if the DCL is later made available for a foreign use and offsets income of another entity in the foreign country. Thus, the DCL rules allow U.S. taxpayers to use a DCL against an affiliates’ non-dual inclusion income as long as they comply with the five-year wait-and-see certification period and recapture regime.

Note that as a means of deducting the DCL against other income, the DCL rules include a “no possibility of foreign use” exception that more closely resembles the stranded loss exception contemplated in the action 2 final report and implemented by the U.K. in section 259IC(6) TIOPA.

Foreign Use — In General

The foreign use rule is what prevents use of a DCL against income that is not also subject to U.S. corporate income tax. A simple example will help explain the foreign use and domestic use election concepts.

Assume that a domestic corporation (USCo) wholly owns a U.K. limited company (U.K. Ltd) that has elected to be treated as a disregarded entity for U.S. tax purposes. USCo’s ownership interest in U.K. Ltd is a hybrid entity separate unit for DCL purposes, so any loss attributable to U.K. Ltd is subject to the restrictions of the DCL regime. Assume further that U.K. Ltd incurs a $100 loss under the computational rules in Treas. reg. section 1.1503(d)-5(c) and that the loss, therefore, is a DCL. Also assume USCo has $300 in other income for the year.

Section 1503(d)(3). A separate unit includes a U.S. corporation’s interest in a hybrid entity, meaning an entity that is subject to income tax on a residence or worldwide basis in a non-U.S. country, and also a foreign branch separate unit, which generally corresponds to a PE presence in the other country. Treas. reg. section 1.1503(d)-1(b)(4). The non-applicability of the U.S. DCL rules to hybrid entities owned directly or indirectly by U.S. individuals versus U.S. corporations is an important scoping point, but not relevant to this discussion. Note that the section 1503(d) rules do not contain a secondary payer-level restriction that, like section 259IC TIOPA, would restrict the deductions of a U.S. corporation when it is treated as a hybrid or pass-through by its foreign investors. This lack of scope was explicitly acknowledged by the U.S. Treasury in the preamble to the 2007 final regulations. See 72 Fed. Reg. at 12094 (discussing the conclusion that the section 1503(d) rules could not apply, as a definitional matter, to a domestic reverse hybrid entity (an entity classified as a U.S. corporation for U.S. tax purposes, but as a pass-through for the owner(s) for non-U.S. tax purposes), because the entity was neither a DRC nor a separate unit of a domestic corporation, notwithstanding the fact that the double deduction of losses presented policy considerations very similar to those that led to section 1503(d)’s enactment).

Treas. reg. section 1.1503(d)-1(b)(20).

Treas. reg. section 1.1503(d)-6(e)(1); and Treas. reg. section 1.1503(d)-6(b). Taxpayers can avoid the recapture if they can demonstrate that no foreign use could arise after the triggering event (Treas. reg. section 1.1503(d)-6(e)(2)) and can reduce the amount recaptured if the DCL could have been absorbed as a ring-fenced carryover against the DRC or separate unit’s own income (Treas. reg. section 1.1503(d)-6(h)(2)).

Treas. reg. section 1.1503(d)-6(e)(1) (requiring recapture (only) when a triggering event occurs during the certification period).

Treas. reg. section 1.1503(d)-6(c).
Absent the DCL rules, because of U.K. Ltd’s status as a branch or division of USCo under the U.S. check-the-box rules, USCo would take into account U.K. Ltd’s $100 loss automatically as part of USCo’s overall taxable income computation, reporting a net income of $200 ($300-$100). Because U.K. Ltd’s loss is a DCL, however, USCo must make a domestic use election to offset the $100 against USCo’s other $300 of income.

USCo cannot make a domestic use election if there is a foreign use of the DCL in the year it is incurred. A foreign use occurs when any portion of the items of deduction or loss taken into account in computing the loss is made available under foreign (U.K.) law to offset income that the U.S. tax system views as attributable to a foreign corporation or foreign owner of a hybrid entity.

This offset most often occurs when there is tax consolidation between the DRC or separate unit and an entity treated as a foreign corporation for U.S. tax purposes. In Example 2, however, when USCo and U.K. Ltd have no other affiliates through which this could occur, generally there could be no foreign use of the $100 loss in that year and, therefore, USCo may file a domestic use election for that loss.

This calculus changes, however, if USCo has another U.K. subsidiary or affiliate that is treated as a foreign corporation for U.S. tax purposes. For example, assume further that USCo owns another U.K. subsidiary that is treated as a controlled foreign corporation under section 957 for U.S. tax purposes (U.K. CFC, a sister entity to U.K. Ltd). U.K. CFC earns $100 of income in the same year. Under the U.K. Group Relief rules, U.K. CFC can claim U.K. Ltd’s loss and use that loss to offset U.K. CFC’s income.

This group relief claim would produce a foreign use (in BEPS parlance, an offset against non-dual inclusion income) because U.K. Ltd’s loss is being used for U.K. corporate income tax purposes to offset income of U.K. CFC and U.K. CFC is treated as a foreign corporation for U.S. corporate income tax purposes.

As a final point on this example, note that because U.K. Ltd’s sharing of its loss with U.K. CFC (or any other qualifying affiliate) is predicated upon an affirmative claim by the affiliate, U.K. Ltd’s loss only is considered “made available” for a foreign use if the affirmative claim

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19 See Treas. reg. section 1.1503(d)-6(d)(2) and -6(e)(1)(i).
20 See Treas. reg. section 1.1503(d)-3(a)(1).
21 See, e.g., Treas. reg. section 1.1503(d)-7(c), Example 5.
22 In accordance with Treas. reg. section 1.1503(d)-6(a)(2), the lack of a foreign affiliate does not alone constitute an exception to the general DCL restrictions.
23 See generally Part 5 of the U.K.’s Corporation Tax Act 2010 (CTA). The example assumes that USCo would be recognized as a corporation for purposes of the relevant U.K. grouping rules.
for group relief is made. This conclusion is specifically authorized by an exception, set forth in Treas. reg. section 1.1503(d)-3(c)(2) (the election exception), which provides a helpful limitation to the otherwise plain meaning of “made available” in this arena. As applied to the entities in Figure 3, if U.K. Ltd did not surrender its loss to U.K. CFC for U.K. tax purposes, then USCo would be entitled to file a domestic use election and use U.K. Ltd’s loss for U.S. tax purposes.

Mirror Legislation Rule — Overview

Beyond the general foreign use concept set forth above, the U.S. DCL rules also provide that a foreign use is deemed to occur if the DRC or separate unit is subject to a foreign country’s DCL-type provision (the mirror legislation rule). The mirror legislation rule has been a feature of the DCL regulations since the original 1989 temporary rules, and it addresses Congress’s concern that foreign jurisdictions (particularly the U.K.) might capture the revenue gain associated with section 1503(d)’s passage by enacting their own anti-double-deduction provisions (mirror legislation). If a foreign country were to do so, the DRCs and separate units in that jurisdiction would only be able to deduct their losses against their affiliates’ U.S. taxable income. This would partially negate the intended benefit of section 1503(d)’s restrictions by forcing the U.S. fisc to bear the entire cost of such losses instead of allowing some taxpayers to choose to forgo their U.S. deductions and keep their foreign deductions. In this case, Congress intended that the losses would presumptively not be eligible for U.S. tax relief; instead, the U.S. Treasury would negotiate with the foreign country to adopt a bilateral agreement permitting the DCL to be used in either jurisdiction but not both.

Under the current version of the mirror legislation rule, a foreign use is deemed to occur when the foreign mirror legislation would deny any opportunity for a foreign use of the DCL (such as the foreign country denying the entity’s ability to share the loss with an affiliate resident elsewhere by restricting the ability to claim the loss at all or by restricting the local tax consolidation mechanism to limit sharing of the loss) in the year the DCL is incurred, for any of the following reasons:

- the DRC or separate unit that incurred the loss is subject to income taxation by another country (including the United States) on its worldwide income or on a residence basis;
- the loss may be available to offset income (other than income of the DRC or separate unit) under the laws of another country (including the United States); or
- the deductibility of any portion of a deduction or loss taken into account in computing the dual consolidated loss depends on whether the amount is deductible under the laws of another country (including the United States).

Note that the use of “foreign” and “another” is context-specific. The United States’ mirror legislation rule refers to a foreign (to the U.S.) country restricting the use of a loss or deduction for purposes of its tax system because of the tax treatment in the other country that is, to that other jurisdiction, foreign (thus, including the U.S.).

The three reasons focus, respectively, on whether the foreign country’s laws target:

- the foreign entity’s status as a dual resident;
- the ability of a tax resident in a different country to deduct the foreign entity’s loss; and
- whether any of the foreign entity’s items are double deductions available to offset income both locally and in another country.
The DCL regulations contain three examples illustrating the mirror regulation rule. The first example describes a Country X mirror legislation provision that prevents a dual resident corporation, but not a hybrid entity, from using the Country X form of tax consolidation. The second example describes a Country X mirror legislation provision that prevents Country X branches and PEs of non-Country X owners from sharing their losses with Country X affiliates if the loss can also be used in another country. In an alternative set of facts for the second example, however, the Country X law permits the taxpayer to choose to use the loss in Country X or in the other country, but not in both countries (similar to the U.S. DCL rules). Under this alternative, the elective Country X law is interpreted to not deny the potential for a foreign use because it offers the choice for a foreign use instead of a flat denial. Therefore, it does not trigger a deemed foreign use under the mirror legislation rule.

The third example describes Country X mirror legislation that prevents a Country X branch, PE, or a Country X hybrid entity from sharing its losses with Country X affiliates if the loss may be used in another taxing jurisdiction as well (including the United States).

Apart from these examples, there is no formal guidance about what types of non-U.S. tax laws constitute foreign mirror legislation or any further illustration of the mirror legislation rule’s application. In reading the plain language of the provision, however, it is notable that a foreign law must only deny the opportunity for foreign use, meaning the ability to use the DCL in whole or in part against income other than that of the separate unit or dual resident corporation. It does not depend on a full disallowance by the foreign law. Thus, rules like section 259IC TIOPA — which effectively deny loss-sharing for HEDD amounts but permit the U.K. hybrid entity’s loss to be used in other years against dual inclusion income (for example, the U.K. hybrid entity’s own income) or upon a showing that the loss would be stranded (which roughly corresponds to there being no potential for a foreign use) — seem to fall within the scope of mirror legislation.

For DCLs that are subject to the mirror legislation rule and therefore presumptively non-U.S. deductible because of the deemed foreign use, the DCL regime contains two potential relief options. The first is a generally applicable stand-alone exception to the deemed foreign use result. This exception permits taxpayers to make domestic use elections for DCLs that nominally would be disallowed because the DRC or separate unit is subject to mirror legislation but for which a foreign use could not contemporaneously occur (for example, when there is no prohibited foreign affiliate with which the DCL could be shared).

Consider again the case from Example 2 above, when U.K. CFC does not exist and U.K. Ltd has no other U.K. affiliates. If a provision of U.K. tax law rendered U.K. Ltd’s $100 loss nondeductible in the U.K. for one of the three enumerated reasons (for example, because it is also deductible in the United States by USCo), USCo nevertheless could file a domestic use election for the DCL under the stand-alone exception, because U.K. Ltd’s loss in the U.K. could not have been put to a foreign use absent the application of the mirror legislation rule. It is worth emphasizing that the stand-alone language in the stand-alone exception does not literally mean that there can be only one legal entity in foreign jurisdiction. A combined DCL attributable to multiple hybrid entities or foreign branches that form a combined separate unit can also qualify for a stand-alone exception as long as there is no entity treated as a foreign corporation for U.S. tax purposes with which any of the foreign tax benefit could be shared.

Note that in contrast to the general foreign use rule, the stand-alone exception expressly does not

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29 Id. at 1.1503(d)-7(c), examples 17-19.
30 Id. at Example 17.
31 Id. at Example 18.
32 Id. at Example 18(iii).
33 Id. at Example 19.
34 Treas. reg. section 1.1503(d)-3(e)(2).
35 See Treas. reg. sections 1.1503(d)-3(e)(2) (providing for stand-alone exception) and Treas. reg. section 1.1503(d)-7(c), Example 18 (illustrating application of stand-alone exception).
take into account whether the foreign use availability is “limited by election (or other similar procedure).” Therefore, in the context of the mirror legislation rule, a DCL is available for a foreign use even absent an affirmative group relief or other tax consolidation election. As applied to the case presented in Example 3, U.K. Ltd’s $100 DCL would not be eligible for a stand-alone exception domestic use election, even if U.K. Ltd would or could not surrender its loss to U.K. CFC. This might result in double nondeductibility of U.K. Ltd’s $100 loss in both the U.S. and in the U.K., as shown in Example 4.

The second potential avenue for relief for DCLs subject to the mirror legislation rule is a bilateral agreement between the U.S. and the foreign country, as envisioned by Congress in the wake of section 1503(d)’s enactment. To date, however, the U.S. Treasury has negotiated only one such agreement, a competent authority agreement with the U.K. government (the 2006 CAA). The 2006 CAA is not plenary and does not cover all U.S. and U.K. anti-double-deduction rules. Rather, it only applies to losses of U.S. corporations’ U.K. PEs. Absent the 2006 CAA, the intersecting application of the U.S. DCL mirror legislation rule with former section 403D of the United Kingdom’s Income and Corporation Tax Act (ICTA), now section 107 of the Corporation Tax Act (CTA), would have rendered a U.K. PE’s loss nondeductible for both U.S. and U.K. tax purposes. Under the 2006 CAA, however, a U.K. PE loss can be either deducted in the U.S. using a modified domestic use election under Treas. reg. section 1.1503(d)-6(b) or surrendered via group relief in the U.K. It cannot be used in both jurisdictions against other income of affiliates.

Also note that the mirror legislation rule expressly requires the taxpayer to assume that the foreign jurisdiction recognized the DRC or separate unit entity as incurring a loss in that year even if it factually did not. This can lead to surprising and arguably inequitable results in the context of the mandatory separate unit combination rule.

Over the prior 30 years, there have not been many foreign law provisions that constituted mirror legislation, and U.S. taxpayers have not been subject to widespread application of the mirror legislation rule’s deemed foreign use result. For example, the IRS’s Internal Revenue Manual indicates that only the U.K., Germany, Australia, and New Zealand may have some form of mirror legislation. Perhaps reflective of this

36 See Treas. reg. section 1.1503(d)-6(b) (authorizing exception to DCL limitation in the case of a bilateral agreement).
38 In particular, the relief offered by the 2006 CAA only applies to losses incurred by U.K. foreign branch separate units and not to section 2991C restricted losses incurred by U.K. hybrid entities. In this regard, see Treas. reg. section 1.1503(d)-7(c), Example 19(iii) (when Country X mirror legislation applied to losses incurred both by Country X hybrid entities as well as Country X PEs but the Treas. reg. section 1.1503(d)-6(b) “mirror agreement” only offered relief to the losses incurred by PEs, the mirror legislation rule applied to restrict a loss incurred by a Country X hybrid entity and furthermore to a combined separate unit, including a Country X hybrid entity, even if the Country X hybrid entity did not itself incur a loss on a stand-alone basis and thus the Country X mirror legislation would not have applied to the Country X hybrid entity for that particular year).
40 See Treas. reg. section 1.1503(d)-3(e)(1).
41 See Treas. reg. section 1.1503(d)-1(b)(4)(ii) (all foreign branch and hybrid entity separate units within taxing jurisdiction of a foreign country treated as a single combined separate unit). See also note 30, infra.
42 IRM section 4.61.13.2.4.1.1.
limited scope, as noted above, the U.S. Treasury has entered into only one of the bilateral agreements contemplated by Congress (the 2006 CAA).

As a final point, the mirror legislation rule is also noteworthy in that its validity was expressly upheld in the only DCL controversy matter to be litigated in court between a taxpayer and the IRS.43

U.K. Mirror Legislation Rules

Section 259IC TIOPA restricts the availability of a U.K. deduction against non-dual inclusion income for HEDD amounts, meaning amounts it is reasonable to suppose are also deductible by the U.K. hybrid entity’s investor. Thus, in the U.K., deductibility of a U.K. hybrid entity separate unit’s (for example, U.K. Ltd’s) items of deduction and loss is restricted when those items may be deductible under the laws of another country (for example, by USCo in the United States).

In mirror legislation terms, section 259IC prevents a U.K. hybrid entity from putting its loss toward a foreign use because the provision restricts the hybrid entity’s HEDD amount(s), only allowing them to be used against dual inclusion income. Thus, the provision renders those deductions generally unavailable to offset income of other affiliates through U.K. group relief. Section 259IC appears to fall within the third category of the mirror legislation definition: The law denies the possibility for foreign use (for example, via group relief to an affiliate) of the U.K. hybrid entity’s loss by making the U.K. deductibility of an item of the U.K. hybrid entity contingent upon whether the item can be deducted by a non-U.K. (for example, U.S.) investor in the U.K. company. Because section 259IC does not offer the affected entities a choice of where to claim the deduction, the provision also does not align with the alternative facts in Example 18 of the DCL regulations that concluded the mirror legislation rule did not apply.

Furthermore, because the U.K. government does not consider the U.S. DCL rules to be “equivalent to” section 259IB TIOPA for purposes of the U.K. anti-hybrid rules,44 the existence of the U.S. DCL rules does not “call off” the application of section 259IC to a U.S.-owned U.K. hybrid entity. Thus, the key questions are whether or when the mirror legislation rule and deemed foreign use result actually apply to a U.S.-owned U.K. hybrid entity and how that treatment affects U.K. taxation.

Based on the foregoing, if a U.S. taxpayer attempted to file a domestic use election for a loss incurred by a U.K. hybrid entity (a DCL), it would seem “reasonable to suppose” that the loss had been deducted outside the U.K. and that section 259IC TIOPA would apply to the loss. Indeed, the loss amount would presumably be classified as an “illegitimate overseas deduction” that could never be used in the U.K., even against dual inclusion income. That denial of the loss for U.K. tax purposes seems, in turn, to trigger the application of the mirror legislation rule, creating a deemed foreign use for U.S. DCL purposes. While somewhat circular, and muddled by the different tax return due-date timelines for U.S. versus U.K. tax purposes, it nevertheless seems clear that the result of all this is that the mirror legislation rule now precludes U.S. taxpayers from making regular domestic use elections for a loss incurred by a U.K. hybrid entity.

When the mirror legislation rule deems a foreign use and denies U.S. deductibility, it also no longer seems reasonable to suppose that the U.K. hybrid entity’s losses would be deductible in both the U.K. and the United States. Thus, the “as-applied” or “factual” imposition of the U.S. DCL rules might call off the application of section 259IC TIOPA for U.K. tax purposes and reopen the possibility of the U.K. hybrid entity’s loss

43See British Car Auctions v. United States, 35 Fed. Cl. 123 (1996), aff’d without published opinion, 113 F.3d 1497 (1997) (upholding a predecessor version of the mirror legislation rule against a U.K. tax-resident domestic corporation that continued its DRC status in the years following section 1503(d)’s enactment).

44See HMRC draft guidance, supra note 9.
being deductible in the U.K.\textsuperscript{45} Query if the U.K. government appreciated that the net effect of all this interaction could be that U.K. law forces the nonequivalent, investor-level U.S. rule to apply while not restricting the U.K. deductions of U.S.-owned U.K. hybrid entities.

Wide-Ranging Effect of Mirror Legislation

Before the U.K.'s enactment of its new anti-hybrid rules, U.S. taxpayers had to contend with two pieces of U.K. mirror legislation: a restriction on some losses incurred by certain dual resident companies\textsuperscript{46} and the restriction against sharing the losses of U.K. PEs that was addressed by the 2006 CAA.\textsuperscript{47} These mirror legislation provisions did not apply to losses incurred by check-the-box U.K. hybrid entities. The DCL regulations expressly make clear that the mere existence of these other types of mirror legislation did not pose a mirror-legislation-rule-deemed foreign use risk to DCLs of U.K. hybrid entities.\textsuperscript{48} Also, the election exception to the general foreign use rule often made the DCL analysis for U.K. hybrid entities straightforward: As long as a U.K. hybrid entity that incurred a DCL did not surrender its loss via group relief to an affiliate outside the U.S. tax group (for example, U.K. CFC), the U.S. investor could file a domestic use election for the U.K. hybrid entity separate unit's DCL. Indeed, in my experience, many U.S. companies have individual U.K. hybrid entity separate units or U.K. combined separate units including hybrid entities, and they routinely file domestic use elections for DCLs incurred by those separate units over the years.

Effective for losses starting in 2017, however, it appears U.S. corporations \textit{can no longer file domestic use elections} for DCLs incurred by U.K. separate units that are or include hybrid entities. The mirror legislation status of section 259IC creates an automatic foreign use of any DCL incurred by a U.K. hybrid entity, rendering the regular domestic use election unavailable.

Moreover, under the IRS's interpretation of the mirror legislation rule in the context of a combined separate unit, the \textit{mere existence} of a U.K. hybrid entity that is subject to section 259IC within a U.K. combined separate unit creates a pollutive deemed foreign use of the \textit{entire} combined separate unit's DCL, \textit{even if} the U.K. hybrid entity has net income attributable to it and the loss is actually attributable to a U.K. PE that might be covered by the 2006 CAA.

This result is illustrated in Example 5. The combined separate unit of U.K. PE and U.K. Ltd incurs a net $100 DCL (the sum of U.K. PE's $200 loss and U.K. Ltd's $100 income). Technically, the loss is attributable to U.K. PE, whose losses are covered\textsuperscript{49} by the 2006 CAA, and not U.K. Ltd,

\textsuperscript{45} Note that the asymmetry between the classes of income against which the ring-fenced loss may be used under the two regimes presents further uncertainty. Under the DCL rules, a DCL subject to the domestic use limitation can be used against the DRC or separate unit's own income in other years as a deemed carryback or carryover (see Treas. reg. section 1.1503(d)-4(c), and the amount of income for this purpose is determined \textit{solely under U.S. tax principles} with the foreign tax treatment irrelevant. See Treas. reg. section 1.1503(d)-5(d). The net loss incurred by the hybrid entity is also a DCL, and thus income is effectively allowed to be absorbed against the hybrid entity's deductions to the extent thereof, with only the net loss amount subject to restriction.

The U.K. rules, however, focus on the HEDD amount and do not allow automatic offsetting against income. Rather, the U.K. definition of dual inclusion income requires it to be ordinary income of the U.K. entity for U.K. corporate tax purposes \textit{and also} ordinary income for the investor under the laws of the investor's tax residence before the income can be offset by the HEDD amounts. See section 259IC(10) TIOPA.

Therefore, the U.S. DCL rules could permit a U.K. hybrid entity's DCL to be used against income that the U.S. attributes to the U.K. entity, but the same income \textit{might not} (for example, because of a base difference) be considered dual inclusion income of the U.K. hybrid entity under section 259IC(10) TIOPA. This actual offset would appear to taint the deducted amount in the U.K. as an illegitimate overseas deduction that cannot be deducted thereafter for U.K. tax purposes, even against dual inclusion income. Similarly, the U.S. DCL rules may attribute deduction items to a U.K. entity that are not recognized for U.K. tax purposes (for example, section 197 amortization) and subject those U.S.-only deductions to the DCL restriction.

\textsuperscript{46} See Treas. reg. section 1.1503(d)-7(c), ex. 17(iii) (foreign country's mirror legislation applied to losses incurred by DRCs but not to losses of hybrid entities, and therefore there was no deemed foreign use of a DCL incurred by a hybrid entity separate unit in that country).

\textsuperscript{47} Or, perhaps more accurately, “were covered.” The status of the U.K. PE's losses under chapter 10 of the U.K. anti-hybrid rules, and the potential interaction with the 2006 CAA, is beyond the scope of this hybrid-entity-focused article. Note for now that U.K. PE's losses appear to be restricted “dual territory deductions” under section 259JD TIOPA while section 107 CTA is still in effect, which suggests that the anti-hybrid rules may have superseded the relief offered to U.K. PE through the CAA.
whose losses are subject to section 259IC TIOPA. Nevertheless, because there is an incurable deemed foreign use under the mirror legislation rule for one portion of the combined separate unit (U.K. Ltd), the entire combined DCL is tainted.\textsuperscript{50} Because of the interaction of the laws, USCo cannot deduct the $100 DCL for U.S. tax purposes through any type of domestic use election. This scenario may be very relevant for U.S. financial and other groups that operate in the U.K. through both true (U.K. PE) and hybrid (U.K. Ltd) branches.

Conclusion

Without an available domestic use election, and without the existence of a bilateral agreement under Treas. reg. section 1.1503(d)-6(b) that addresses section 259IC TIOPA, from 2017 forward, a U.S. multinational’s only options to deduct a U.K. DCL involving a U.K. hybrid entity separate unit are:

\begin{itemize}
  \item a stand-alone domestic use agreement, an option that is not available if the U.S. group has any U.K. affiliates treated as foreign corporations (for example, CFCs) for U.S. tax purposes;
  \item a “no possibility of foreign use” statement, which is subject to a legal standard that is exceedingly difficult to meet and is, in almost every case, unavailable as a practical matter; or
  \item against net income earned in other years by the U.K. separate unit under the Treas. reg. section 1.1503(d)-4(c) separate return limitation year rules, which will also typically be unavailable as a practical matter.
\end{itemize}

Absent one of the foregoing (narrow) exceptions, U.K. DCLs involving U.K. hybrid entities are, starting in 2017, generally nondeductible for U.S. tax purposes.\textsuperscript{51}

At the risk of sounding hyperbolic, this is a watershed change for affected U.S. multinationals. It has an immediate effect on the tax provision computations for any 2017 U.K. hybrid entity passthrough losses these multinationals have projected to benefit on their 2017 U.S. tax returns.

Consistent with the 2006 CAA and the unequivocal intent expressed in the 1986

\textsuperscript{50}See Treas. reg. section 1.1503(d)-7(c), Example 19(iii).

\textsuperscript{51}Because the new U.K. rules took effect January 1, 2017, it appears they deny domestic use elections for DCLs incurred in taxable years beginning on or otherwise including that date, but they should not implicate calendar-year U.S. taxpayers’ 2016 U.K. DCLs.
Bluebook,\textsuperscript{52} the U.S. Treasury Department should consider ameliorating this problem by negotiating a new bilateral agreement with the U.K. government that would permit losses of U.K. hybrid entities to be used either in the U.S. (through a modified domestic use election) or in the U.K. (against non-dual inclusion income), but not both.

More broadly, the U.S. Treasury also should consider, as a matter of sound tax policy, and especially given Treasury’s extensive participation in the BEPS initiative, offering education and guidance to U.S. taxpayers about the foreseeable U.S. tax implications of foreign laws that are enacted in accordance with the BEPS initiative. Precedent exists for timely guidance on new foreign tax matters when the application of the foreign law is a key factor in how to apply U.S. international tax rules — for example, the notices addressing whether specified new foreign tax levies qualify as income taxes for purposes of section 901.\textsuperscript{53}

In particular, it would be very helpful for the U.S. Treasury to confirm (or reject) the reasons set forth above as to why section 259IC TIOPA does or does not constitute mirror legislation that triggers a deemed foreign use for U.S. DCL purposes. Many other European countries may enact similar legislation under the European Union’s recent second anti-tax-avoidance directive, which (in relevant part) directs EU member states to adopt the BEPS action 2 anti-double-deduction recommendations into their domestic laws by January 1, 2020.\textsuperscript{54} If those countries follow the U.K.’s path in only acknowledging other countries’ legislation that is based on the BEPS action 2 report when analyzing the interaction between the investor-level primary and subsidiary-level secondary rules, a much broader range of U.S. taxpayers will be adversely affected absent relief and guidance from the U.S. Treasury.

\textsuperscript{52} Supra note 25.
