# An Unwelcome Surprise in Already Unwelcome DCL Final Regulations: A New Deemed Priority Rule

*By Brian Jenn*



By their usual standards, the Treasury Department ("Treasury") and the Internal Revenue Service ("IRS") moved at breakneck speed to finalize the controversial proposed dual consolidated loss ("DCL")[1], published on August 7, 2024 (the "2024 Proposed Regulations") by the end of the Biden Administration. The final regulations,[2] which were published on January 14, 2025 (the "2025 Final Regulations") less than a week before the second inauguration of President Trump, include an entirely new and much criticized "disregarded payment loss" ("DPL") regime under which a U.S. corporation must include income *disregarded* interest and royalty payments it receives from a foreign disregarded entity it owns.

While taxpayers were no doubt surprised to see the DPL regime in final regulations in January 2025, the DPL regime itself is not the focus of this column. Rather, as a public service, this column highlights a supposedly conforming change to a priority rule in the DCL regulations[3] governing when a foreign use of a DCL is considered to occur (the "Deemed Priority Rule").[4] In a change to how the Deemed Priority Rule previously operated, under the 2025 Final Regulations, a domestic corporation may find itself unable to make a "domestic use election"[5] ("DUE") in a common fact pattern involving a foreign disregarded entity ("FDE") that provides services to its regarded U.S. corporate owner. Such an FDE may have a DCL because it has regarded (related party or third party) expenses but only has income that is disregarded, since a DCL is calculated only by reference to regarded income and deduction items under the regulations.[6] This fact pattern will be familiar especially to U.S. taxpayers that needed to elect to disregard entities formerly treated as controlled foreign corporations ("CFCs") in order to avoid payments to such entities being treated as base erosion payments under Code Sec. 59A (the "BEAT").

Although there is a reasonable likelihood that at least the DPL rules, and possibly the entire January 2025 final regulations package, will be suspended and revised or revoked by the new team at Treasury (perhaps even by the time this

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column is published), there are no guarantees, particularly about the fate of the change to the Deemed Priority Rule. In addition to being mindful of any potential impact of the change to the Deemed Priority Rule in their own structures, taxpayers may consider highlighting this perverse (if not unintended) impact to Treasury and the IRS in the context of their review of regulations issued in the twilight of the Biden Administration.

## Foreign Use and the Deemed Priority Rule Under the Prior Final Regulations

Under the DCL regulations,[7] a domestic corporation generally may not use a U.S. net loss in computing U.S. taxable income if the loss is attributable to a disregarded entity or dual resident corporation (among others) that is subject to foreign tax in addition to U.S. tax. A taxpayer may, however, make a DUE and use the loss (referred to as a DCL) in computing taxable income under certain conditions. A key condition of making a DUE is that there has not been, and will not be during a five-year certification period, a foreign use of the DCL.[8]

*Although there may be many taxpayers hopefully awaiting the revocation of the DPL regime, taxpayers with disregarded service providers will do well to be mindful of the impact of the Deemed Ordering Rule on their structures, as well, and consider highlighting to Treasury and the IRS the inappropriate outcomes under that rule.*

For purposes of determining the availability of a DUE, a foreign use "occurs when any portion of a deduction or loss taken into account in computing the DCL is made available under the income tax laws of a foreign country to offset or reduce, directly or indirectly, any items that is recognized as income or gain under such laws and that is, or would be, considered under U.S. tax principles to be an item of a foreign corporation" or an owner of a hybrid entity.[9] An item composing a DCL may be "made available" to a foreign corporation by way of a consolidation or loss sharing regime or under the "jurisdictional blending" regime of the Global Anti-Base Erosion ("GloBE") Model Rules, whereby Top-Up Tax for a jurisdiction is computed taking into account GloBE income all of the constituent entities of an MNE Group that are tax residents of that jurisdiction.[10]

Under the Deemed Priority Rule in the prior final regulations, if (i) the losses or deductions composing a DCL are made available under foreign law both to offset income that would constitute a foreign use and income that would not constitute a foreign use, and (ii) the laws of the foreign country do not provide rules for determining which income is offset, then the losses or deductions are deemed to offset the income that does not constitute a foreign use, to the extent of that income, before offsetting income that gives rise to a foreign use. Importantly, the Deemed Priority Rule under the prior final regulations did not distinguish between foreign income that is regarded for U.S. purposes and foreign income that is disregarded for U.S. purposes.

Under the prior final regulations, the Deemed Priority Rule sensibly prevented a deemed foreign use of a DCL in the case discussed above: a foreign service provider that is a disregarded entity of a U.S. corporation and earns disregarded services payments from its owner but has regarded expenses that give rise to a DCL. In particular, because such a disregarded foreign service provider typically would have positive taxable income for foreign purposes, the deduction items composing the DCL would be treated as offsetting the same entity's income under relevant foreign income tax law, which happens to be disregarded for U.S. federal income tax purposes. Nothing in the prior final regulations suggests that only income that is "recognized as income or gain" under foreign income tax laws *and* regarded for U.S. federal income tax purposes can be offset under the Deemed Priority Rule.

## The Deemed Priority Rule Under the 2025 Final Regulations

The 2024 Proposed Regulations provided the principles of the Deemed Ordering Rule apply for purposes of determining when there is a foreign use of a DPL but did not change/modify the Deemed Ordering Rule as it applies to foreign use of a DCL. Comments requested clarification that a DPL could be treated as offsetting disregarded income other than disregarded interest and royalties before offsetting income that could constitute a foreign use. Treasury and the IRS disagreed with the comment but did not confine themselves in the 2025 Final Regulations to rejecting the comment. Rather, the 2025 Final Regulations changed how the Deemed Ordering Rule applies in the context of both DCLs and DPLs.

In particular, under the 2025 Final Regulations, the Deemed Ordering Rule is modified to add a limitation. Under that limitation in Reg. §1.1503(d)-3(c)(3)(ii), items of income or gain are taken into account only to the extent such items are or would be taken into account in determining the amounts of income or dual consolidated loss under Reg. §1.1503(d)-5(b) or (c). The 2025 Regulations further provide, by way of example, that the Deemed Ordering Rule does not apply with respect to items that are otherwise disregarded for U.S. tax purposes.

As modified by the 2025 Final Regulations, the Deemed Ordering Rule may lead to a foreign use of a DCL of the disregarded service provider considered in this column where a foreign use would not have occurred under the prior final regulations. In particular, as noted above, a foreign disregarded entity of a domestic corporation may have a DCL because it has regarded expenses but disregarded income. If the domestic corporation also controls a CFC in the same jurisdiction of the CFC, the FDE's DCL could be deemed to be shared with the CFC under a consolidation or loss-sharing regime, resulting in a foreign use of the DCL. Going forward, even if there were not a foreign consolidation or loss-sharing regime in place, jurisdictional blending under the GloBE regime also could result in a foreign use of the DCL. In such cases, the domestic corporation would be unable to make a DUE and consequently would be unable to deduct the FDE's DCL in computing U.S. taxable income.

## DPL Tail Wags DCL Dog

As a matter of policy, the inability of a disregarded service provider to use its DCL under the Deemed Priority Rule in the 2025 Final Regulations is a perverse outcome. In reality, there is no possibility of any portion of the DCL being used to offset the income of a foreign corporation where the FDE itself has positive foreign income that the deductions and losses composing the DCL will directly offset in the computation of foreign taxable income. Furthermore, there is no reason to deem a foreign use of a DCL, as the 2025 Final Regulations do, where there is no actual possibility of one. The DCL regime is concerned with a U.S. deduction or loss offsetting a foreign corporation's foreign taxable income. That does not occur in the case where the FDE with expenses has foreign taxable income to offset and will in fact pay positive foreign tax.

In the preamble to the 2025 Final Regulations, Treasury and the IRS justify the changes to the Deemed Ordering Rule mainly as a matter of "promoting coordinated outcomes" between the DCL and DPL rules and avoidance of double counting. This explanation does not satisfactorily address why, even if one accepted that the DPL rules are an appropriate and valid exercise of regulatory authority (a questionable proposition), a DCL could not be accepted as offsetting disregarded income other than royalties and interest. The preamble further points to the fact that the DCL and the DCL cumulative register are calculated only taking into account regarded income as relevant to the change in the Deemed Priority Rule, but this observation seems inconsequential where the DCL is actually offsetting foreign income on which the FDE that generates the DCL is paying foreign tax.

Although there may be many taxpayers hopefully awaiting the revocation of the DPL regime, taxpayers with disregarded service providers will do well to be mindful of the impact of the Deemed Ordering Rule on their structures, as well, and consider highlighting to Treasury and the IRS the inappropriate outcomes under that rule.



### ENDNOTES

1 REG-105128-23.

2 T.D. 10026 (Note that the T.D. series has now reached five digits.).

3 Reg. §1.1503(d)-3(c)(3).

4 The change to the Deemed Priority Rule applies to DCLs arising in tax years beginning on or after January 1, 2026.

5 Reg. §1.1503(d)-6(d).

6 Reg. §1.1503(d)-5(c)(1)(ii).

7 Reg. §§1.1503(d)-1–8.

8 Reg. §1.1503(d).

9 Reg. §1.1503(d)-3(a)(1).

10 *See*, generally, Global Anti-Base Erosion Model Rules, OECD, Articles 5.1 and 5.2. Note, however, that the final regulations provide a transitional exemption the application of the DCL rules with respect to IIRs, QDMTTs, and UTPRs incurred for tax years beginning before August 31, 2025.