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DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR
DISTRICT COUNSEL CC:

FROM: DEBORAH A. BUTLER
ASSISTANT CHIEF COUNSEL (FIELD SERVICE)
CC:DOM:FS

SUBJECT: Carryback of Specified Liability Loss by a Consolidated Group

This Field Service Advice responds to your memorandum dated December 2, 1998. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND:

P =
S =

Year 1 =
Year 2 =
Year 3 =
Year 4 =
Year 5 =

Date 1 =
Date 2 =

ISSUES:

1) Whether the P consolidated group is entitled to carry back specified liability ("SL") losses incurred by a member of the group if that member had positive separate taxable income in that year.

2) To what extent may the P group carry back SL losses incurred by a member of the group if that member had negative separate taxable income in that year.

CONCLUSIONS:

1) The P group is not entitled to carry back SL losses incurred by a member of the group if that member had positive separate taxable income in that year.

2) The P group may carry back SL losses incurred by a member of the group if that member had negative separate taxable income in that year only to the extent described herein.

FACTS:

For the tax years Year 1 to Year 5, P was the common parent of an affiliated group of corporations filing a consolidated Federal income tax return. One of P's subsidiaries is S. You have indicated that S was in existence in Year 1 but that some of S's subsidiaries were not in existence prior to Year 3.

The P group claimed a consolidated net operating loss ("CNOL") for each of Year 4 through Year 5. However, you do not have any information as to the separate taxable income or loss of each member of the group for each of these years.

On Date 1, P filed several Forms 1120X for Years 1 through Year 5. P claims that it may carry back certain deductions 10 years as SL losses. On Date 2, P amended these Forms 1120X to carry back additional deductions as SL losses.

We understand that CC:DOM:FS:IT&A has issued a memo addressing whether these deductions qualify as SL losses. Assuming for this purpose that they do, our office addresses in this memo whether and to what extent, under the consolidated return regulations, the P group may carry such items back ten years. As explained in more detail below, we do not have enough information to answer the question. However, we will explain what information we need and provide general guidance.

LAW AND ANALYSIS

Background

If a corporation has a "net operating loss" ("NOL"), then, under I.R.C. § 172(a) and (c) and the regulations thereunder, that corporation may carry this NOL back to its prior tax years. A corporation has an NOL if the total of all of its deductions exceeds all of its income items in the current year.

Generally, a corporation may carry its NOL back three years under I.R.C. § 172(b)(1)(A). However, if this NOL includes SL losses, as defined in I.R.C. § 172(f)(1), then that corporation may carry that portion of its NOL back ten years under I.R.C. § 172(b)(1)(C).[1]

If a corporation is a member of a consolidated group, then the group determines its CNOL under Treas. Reg. § 1.1502-21(f). Under that section, a consolidated group determines its CNOL through a two-step process. First, it computes each member's separate taxable income or loss under Treas. Reg. § 1.1502-12. Second, it aggregates all the individual members' separately computed incomes or losses along with the consolidated computed items.

If the net amount of these separately and consolidated computed incomes and losses is negative, this net negative amount constitutes a CNOL of the group. The group may then carry this CNOL back to its prior consolidated return years under Treas. Reg. § 1.1502-21(b)(1). If the corporation incurring a portion of the CNOL was a member of the group immediately after its formation, then such losses may be carried back to the equivalent consolidated return year of the group under Treas. Reg. § 1.1502-79(a)(2). In other words, Treas. Reg. § 1.1502-79(a)(2) treats that corporation as if it were a member of the group in the carryback year.

The number of years the group may carry back the CNOL is determined by I.R.C. § 172(b). Thus, as noted above, the group may generally carry its CNOL back

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[1] Sections 172(b)(1)(C) and 172(f)(1) apply to NOL's described therein for tax years beginning after December 31, 1990. For NOL's arising in tax years beginning prior to that date, sections 172(b)(1)(I) and 172(j)(1) applied to product liability losses, and sections 172(b)(1) (J) and 172(k)(1) applied to deferred statutory or tort liability losses . In this case, some of the applicable NOL's of the members of the P group are product liability amounts, some are deferred statutory or tort liability amounts and some are specified liability amounts. In this memo, we will describe all applicable NOL's of the members of the P group as "SL" amounts.

three years. However, if any portion of the group's CNOL includes SL losses, then the group may carry such portion back ten years.

Issue One - Member Has Separately Computed Taxable Income

If the member has positive separate taxable income in the year in which it incurred the SL expense, we believe that the Service has two arguments for denying a ten-year carryback of such loss as part of the CNOL. These arguments are presented separately below.

The Separate Taxable Income Approach

As noted above, each member of the group computes its separate taxable income or loss. In making that computation, the member takes into account its SL amount. Thus, if the member has a positive separate taxable income, then that member's SL deductions are absorbed in determining the separate taxable income of that member. Consequently, there are no SL deductions to be carried back, as part of the group's CNOL, to any prior consolidated return years of the group.

This position was recently adopted by the Tax Court in the case of *Intermet Corporation and Subsidiaries v. Commissioner*, 111 T.C. #16 (12/08/98). In *Intermet*, a consolidated group with a CNOL sought to carry back a portion of it ten years as an SL loss. However, the member incurring the putative SL expense[2] had positive separate taxable income. The court held that such expense had been absorbed by that member in determining its separate taxable income. Consequently, such expense could not be carried back by the group.

In addition, as also noted above, under Treas. Reg. § 1.1502-21(f), a CNOL is composed of the separate taxable incomes (or losses) of each member. Treas. Reg. § 1.1502-12 requires each member's separate taxable income to be computed in the manner in which a separate corporation ordinarily computes its income or loss under the Internal Revenue Code, except for certain enumerated items that are calculated on a consolidated basis. SL expenses are not one of those enumerated items. *Intermet* at 12 (slip opinion), *citing Amtel v. United States*, 31 Fed. Cl. 598, 602 (1994), aff'd without published opinion 59 F.3d 181 (Fed. Cir. 1995), discussed below.

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[2] The Service also argued that such expense was not an SL expense within the meaning of I.R.C. § 172(f). However, the court did not address this issue since it held that such expense could not in any event be carried back.

Thus, if a member's separate taxable income, computed as a separate corporation, has more current income items than its current deduction items, then that member's deductions, including any SL deductions, necessarily offset its income items currently. Therefore, this member, which has positive taxable income, does not contribute towards the CNOL of the group. In other words, that member does not contribute any SL loss to the CNOL of the group.

After the calculation described above, the group may still have a CNOL to carry back to prior years. If that is the case, it is only because other members, after netting their deductions against their income items, have separately computed net losses. If those other members' deductions do not include SL deductions, the resulting consolidated loss does not include a SL loss. Such loss is, however, not disallowed. Rather, it may only be carried back three years, under the normal rule of I.R.C. § 172(b)(1)(A), not ten years under the special provisions of I.R.C. § 172(b)(1)(C).

The NOL Limitation Approach

Code Section 172(f)(1) limits the SL loss to a taxpayer's NOL. Thus, this NOL limitation should be applied on a member-by-member basis. While an individual member's NOL is not specifically recognized under the consolidated return regulations, Treas. Reg. § 1.1502-12 states that the separate taxable income of a member is determined as if it were a stand alone entity. Moreover, each member is a separate taxable entity. *Wegman's Properties, Inc. v. Commissioner*, 78 T.C. 786, 789 (1982). Further, other Code sections (such as I.R.C. § 172) apply separately to each member unless the consolidated return regulations provide otherwise. Treas. Reg. § 1.1502-80(a). Thus, each member's separate NOL (arguably the portion of the CNOL attributable to such member) should be used in applying the NOL limitation. A recently issued Tax Court decision supports this argument. *Norwest Corporation and Subsidiaries v. Commissioner*, 111 T.C. No. 5 (August 10, 1998).

In *Norwest*, the taxpayers consisted of bank members and nonbank members of a consolidated group. The group had a CNOL. Some of the banks with separately computed losses under Treas. Reg. § 1.1502-12 had bad debt deductions.

Code section 172(b)(1)(L), in effect for the years at issue, permitted a bank to carry back ten years the portion of its NOL that is attributable to its bad debt deductions. In other words, that section provides an NOL limitation like the NOL limitation of I.R.C. § 172(f) at issue here.

The taxpayer in *Norwest* argued that to meet the requirements for a ten-year carryback treatment, the group only had to show: (1) bad debt deductions incurred by any member of the group and (2) a CNOL. The taxpayer argued that the NOL limitation applied at the group level. *Norwest* at 93-94 (slip opinion).

The Service argued, and the Tax Court agreed, that the bad debt NOL limitation was determined on a separate member basis. In applying this separate entity approach, the Norwest court viewed each member as having some form of a separate NOL. Each such separate NOL contributed to the CNOL. A member having separate taxable income (presumably without any loss items computed on a consolidated basis) effectively had a zero separate NOL. Consequently, that member could contribute no amount of deductions to the CNOL.

In reaching its conclusion, the Norwest court cited to an analogous case, Amtel v. United States, 31 Fed.Cl. 598 (1994), aff'd, 59 F.3d 181 (1995) . In Amtel, the Court of Federal Claims held that a separate entity approach applied in determining whether the section 172 product liability deductions of a member having separate taxable income that was not a member of the group in the carryback years (a separate return limitation year ("SRLY") of such member) could be carried back as an SL loss. In so holding, the Amtel court reasoned that each member of a consolidated group had a separate NOL with independent significance for tax purposes. The Norwest court, citing to Amtel, stated that "the separately determined losses of each member. . . do not lose their distinct character (to the extent that such distinct character is important) upon consolidation." Furthermore, the Norwest court applied a separate entity approach for determining each loss carryback at issue, even for that portion of the CNOL attributable to members of the group in the consolidated return carryback years, i.e., years to which the SRLY provisions did not apply.

In Norwest, the taxpayer had argued that the section 172 ten-year carryback rule should have been applied by essentially treating all group members as a single taxpayer ("single entity approach"). Under a single entity approach, each group member's deductions would have been treated as contributing to a CNOL, regardless of the amount of income items incurred by that member. The Norwest court clearly indicated that the section 172 ten-year carryback rule, under which a single corporation's use of SL losses is maximized, is not to be construed as providing that an entire consolidated group is treated as a single corporation in order to maximize the composition of the group's CNOL as bank bad debt losses. To the contrary, the court applied a separate entity approach and viewed any application of a single entity approach to determine the group's bank bad debt losses as abusive. Although the Norwest decision involved section 172(l) bank bad debt losses, the Norwest court's reasoning is equally applicable to section 172(f)

SL losses. Both the section 172(l) bank bad debt losses and the section 172(f) SL losses are subject to the same section 172 ten-year carryback rule, which maximizes the carryback of special losses for a single corporation and limits the amount of the loss entitled to the ten-year carryback period to the taxpayer's NOL.

As noted above, the Court of Federal Claims also adopted an NOL limitation on a separate member basis for product liability ("PL") losses (which is what such losses were called prior to being redesignated as SL losses).[3] *Amtel v. United States*, 31 Fed. Cl. 598 (1994), *aff'd*, 59 F. 3d 181 (1995. The *Amtel* Court acknowledged that "[t]he term 'net operating loss' in the context of a consolidated income tax return generally means the net operating loss of the consolidated group as a whole, and not the separate net operating loss of a member." *Id.* at 600. The Court went on to say, however, that

> contrary to Amtel's assertion, a member of an affiliated group may have a separate net operating loss with independent significance for income tax purposes. The IRS does not apply the single entity approach when a taxpayer seeks to carry back a net operating loss from a consolidated return year to a separate return year.

Id.

The *Amtel* Court concluded that it "must apply the allocation formula of Treasury Regulation § 1.1502-79(a)(3) to determine Amtel's separate net operating loss, as that term is used in I.R.C. § 172(j)(1), because Amtel seeks to offset income from a separate return year." *Id.* at 601. The Court found that the plaintiff had no separate NOL under that formula, resulting in a limiting amount of zero. Similarly, to the extent that a member of the Ogden group had positive separate taxable income in a year in which it incurred SL expenses, such member had no separate NOL, thus limiting that member's SL losses to a zero amount.

In addition, the *Amtel* Court pointed out that the consolidated return regulations (i.e., Treas. Reg. §§ 1.1502-11(a)(2) through (a)(8)) specifically list those items that are treated on a consolidated return basis. The Court emphasized that the regulations do not use the term "consolidated product liability loss" or incorporate such a concept. *Id.* at 602 (citations omitted). But see *United Dominion Industries, Inc. v. United States*, 98-2 USTC ¶ 50,527 (W.D.N.C. 1998), *appeal docketed*, No. 98-2380 (4th Cir. Sept. 14, 1998). Therefore, the *Amtel* Court rejected Amtel's claim.

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[3] See footnote 1.

In this case, we would need to know the separate taxable income or loss of each member of the group for each year it incurred an SL expense. As noted above, the group would not be able to carry back the SL expense of any member that had positive separate taxable income in such year.

Issue Two - Member has Separately Computed Loss

As noted above, if a member, after netting current deductions and current income items, has negative separate taxable income (i.e., a loss), that member contributes its loss, including its SL loss, to the CNOL of the group. The question then becomes to what extent may the group carry the SL portion of the loss back ten years to prior consolidated return years of the group (in which the member was a member of the group or a member immediately after its formation, see Treas. Reg. § 1.1502-79A(a)(2)).[4] This was also an issue addressed in *Norwest*, discussed above.

The *Norwest* court addressed this issue with a simple example (pp. 94-96 of the slip opinion), which is explained below. Assume that a consolidated group consists of Member A, Member B and Member C. Member A has $100 separate taxable income, Member B has a separate NOL of ($80) and Member C has a separate NOL of ($30). Thus, the group has a CNOL of ($10) ($100 - $30 - $80).

Member C is the only member of the group that is a bank. However, only ($20) of its separate NOL of ($30) is a bank bad debt loss eligible to be carried back ten years. Thus, the question is what portion of the CNOL of ($10) may be carried back ten years as a bank bad debt.

If the entire amount of the separate NOL of both B and C had been bank bad debt, it is clear that all ($10) of the CNOL could have been carried back ten years. Since it was not, the question was whether only a portion of the loss could be so carried.

Norwest essentially argued that, since the CNOL (of ($10)) was less than the total of all the members bank bad debt (of ($20)), the entire ($10) of CNOL should be considered bank bad debt. However, the Service argued, and the court agreed,

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[4] Thus, it irrelevant that some of S's subsidiaries were not in existence until Year 3 if they were members of the P group immediately after their formation. Therefore, if losses of such subsidiaries qualify as SL losses and may be properly carried back ten years, such losses could be carried back to the P group's Year 1 and Year 2 tax years, even though such members were not members of the group in those carryback years.

that, under these facts, only a portion of the CNOL could be carried back. The portion was determined as follows.

First, the Service determined the portion of the CNOL allocable to C, which was ($2.73) of loss ($10 x $30/$110, the sum of the separate member losses).[5] Second, the Service determined the portion of this amount allocable to bad debt as $1.82 ($20 x ($10/$110)).[6] Thus, of the total CNOL of ($10), only ($1.82) could be carried back ten years. Thus, if a member of the P group has a separate NOL and a portion of such NOL constitutes an SL loss, you should use the allocation method described above to determine the portion of such NOL that can be carried back ten years. In other words, you need to determine the portion of such NOL that is allocable to SL losses and the portion allocable to other losses (which are not subject to a special ten-year carryback rule) and then apply the formula described above.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

The Government has lost this issue in one case: *United Dominion Industries, Inc. v. United States*, 98-2 USTC ¶ 50,527 (W.D.N.C. 1998), *appeal docketed*, No. 98-2380 (4th Cir. Sept. 14, 1998). In that case, the court treated an SL expense of a member of the group as a consolidated item, thus allowing the group to carry such item back ten years, even though that member had positive separate taxable income. The Government continues to adhere to its position that an SL expense of a member of the group is taken into account in determining the separate taxable income or loss of that member.

With respect to the allocation method described in *Norwest*, the only unresolved issue in applying this method is that the court did not explain what it meant by "separate NOL." There are three different amounts the court could have meant. First, the court could have been referring to negative separate taxable income after applying Treas. Reg. § 1.1502-12. Second, the court could have been referring to the portion of the CNOL allocable to that member under Treas. Reg. § 1.1502-79A(a)(3). Finally, the court could have been referring to the member's separate NOL, determined as if it were a stand alone corporation. This method is employed by Treas. Reg. § 1.1502-79A(a)(3) in computing an apportionment fraction for use in determining the portion of the CNOL attributable to a member (which is described

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[5] In the court's example, it rounded $2.73 down to $2.70. However, the example cannot be completely explained unless the correct numbers are used.

[6] Another way to arrive at this figure is to multiply $2.73 x ($20/$30). However, if the court's figure of $2.70 is used, the numbers do not match.

above as the second method). It is possible that the separate NOL of a member would be different, depending on the method used, which would effect the amount of SL losses that could be carried back.

In TAM 9715002 (04/11/97), the Service took the position that the second method (i.e., the allocation of the CNOL to the loss members of the group, as determined under Treas. Reg. § 1.1502-79A(a)(3)), is the proper method.

In response to the taxpayer's argument that that regulation is used only for purposes of determining the portion of the CNOL to be carried back to a member's separate return year, the TAM contends that that regulation is not limited by its own terms. The regulation specifies that "separate net operating loss" is one variable in determining "the portion of a consolidated net operating loss attributable to a member." However, it does not specify that "the portion of a consolidated net operating loss attributable to a member" is calculated only for purposes of determining a carryover to a separate return year.

Moreover, the TAM notes that at least one court has utilized that regulation where the loss was carried to a consolidated return year, as in the instant case. *Allied Corp. v. United States*, 231 Ct.Cl. 283, 291-93 (1982), involved the Western Hemisphere Trading Corporation ("WHTC") deduction, which under I.R.C. § 922 and Treas. Reg. § 1.1502-25 equaled a percentage of the WHTC's portion of the consolidated group's consolidated taxable income. One of the members of the group had losses that were carried over to other years for purposes of determining the WHTC's portion of the group's consolidated taxable income attributable to the WHTC in those other years. The court determined that the amount of loss to be carried over for that purpose was not the member's entire separate loss but the WHTC's portion of the group's loss, and that Treas. Reg. § 1.1502-79A(a) provided an appropriate formula for making that computation.

Please call if you have any further questions.

By: _____
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cc: