Office of Chief Counsel
Internal Revenue Service

memorandum

CC:LM:FS:MAN:3:POSTF-157618-01
RLPeacock

date:

to: Henry Singleton, Territory Manager
Large and Mid-Size Business Division (Financial Services & Healthcare)
Attn: Richard Bosch, Revenue Agent

from: Area Counsel (Financial Services)(Area 1: Manhattan)

subject: [redacted] (EIN [redacted])

UIL Nos. 172.02-00
172.06-00
1502.21-00
1502.79-00

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INTRODUCTION

This memorandum is in response to your request for advice in the above-captioned matter. Specifically, you have asked our office to examine the effect of the Supreme Court's decision in United Dominion Indus., Inc. v. United States, 121 S. Ct. 1934 (2001), on the specified liability ("SL") losses available to [redacted] ("[redacted]") for the taxable years ending [redacted], [redacted], [redacted], [redacted], [redacted], and [redacted].

ISSUES

1. What effect does United Dominion have on the SL expenses arising from members of [redacted] that filed separate tax returns for the carryback years?

2. Is the SL loss limitation argument adopted by the Tax Court in Norwest Corp. v. Commissioner, 111 T.C. 105 (1998), still valid after United Dominion?

BACKGROUND

This opinion is based upon the facts set forth herein. It might change if the facts are determined to be incorrect. If the facts are determined to be incorrect, this opinion should not be relied upon. You should be aware that, under routing procedures which have been established for opinions of this type, we have referred this memorandum to the Office of Chief Counsel for review. That review might result in modifications to the conclusions herein. We will inform you of the result of the review as soon as we hear from that office, which should be in approximately 10 days. In the meantime, the conclusions reached in this opinion should be considered to be only preliminary.

On [redacted], [redacted], a United Kingdom corporation ("[redacted]"), created [redacted] ("[redacted]") for the purpose of acquiring [redacted] ("[redacted]") and its subsidiaries ("[redacted]"). In [redacted], [redacted] changed its name to [redacted] ("[redacted]").

Prior to its acquisition by [redacted], [redacted] was the parent of the following subsidiaries: [redacted], [redacted], [redacted], [redacted], [redacted], [redacted], [redacted], [redacted], [redacted], [redacted], and [redacted]. Of these subsidiaries, [redacted], [redacted], [redacted], [redacted], [redacted], [redacted], and [redacted] (the "SRLY companies") filed income tax returns

separately from [redacted] during [redacted] and [redacted] (the "carry back years").

In [redacted], [redacted] acquired [redacted] ("[redacted]") and its subsidiaries.

[redacted] filed consolidated income tax returns for the taxable years ending [redacted], [redacted], [redacted], [redacted], [redacted], and [redacted]. [redacted] included the [redacted] on its consolidated tax returns during each of the years at issue.

For the period ending [redacted], [redacted] and [redacted] filed separate consolidated tax returns. [redacted] included [redacted] on its consolidated tax return for the short period ending [redacted], and for the remaining taxable years at issue.

On [redacted], [redacted] changed its name to [redacted] Group Holdings.

[redacted] claimed the following SL loss carry back amounts, pursuant to I.R.C. § 172(f)[1]/, for the taxable years ending [redacted], [redacted] and [redacted]:

Company	[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]	[redacted]
Total Claimed SL Loss Carry back	[redacted]	[redacted]	[redacted]

*The statute of this separate return loss year was not protected. Therefore, this carry back is barred by statute.

[redacted] claimed the following SL expenses, pursuant to I.R.C. § 172(f), for the taxable years ending [redacted], [redacted], and [redacted]:

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[1]/ For purposes of this memorandum, our office has assumed that the expenses claimed by the taxpayer qualify as SL expenses for each of the taxable years at issue.

Company			
[redacted]	[redacted]	[redacted]	[redacted]
Total Claimed SL Loss Carry back	[redacted]	[redacted]	[redacted]

**The amount claimed by [redacted] for [redacted] includes penalties of $[redacted] that are not allowable.

[redacted]'s total SL losses for the taxable years ending [redacted] through [redacted] were $[redacted].

Prior to the Supreme Court's decision in United Dominion Indus. Inc. v. United States, 121 S.Ct. 1934 (2001), the revenue agent examining [redacted]'s consolidated returns computed the allowable amount of [redacted]'s SL losses using the "separate entity" approach advocated by the Service. This resulted in the following adjustments to [redacted]'s SL expenses:

Company			
[redacted]	[redacted]	[redacted]	[redacted]
Total Allowed SL Expenses	[redacted]	[redacted]	[redacted]
TOTAL DISALLOWANCE	[redacted]	[redacted]	[redacted]

Company	[redacted]	[redacted]	[redacted]
Total Allowed SL Expenses	[redacted]	[redacted]	[redacted]
TOTAL DISALLOWANCE	[redacted]	[redacted]	[redacted]

The revenue agent took an alternative position with respect to the members of [redacted] who filed separate income tax returns during the carry back years (i.e., the SRLY companies). For these companies, the revenue agent compared each company's SL expenses to the amount of the CNOL allocated to it pursuant to Treas. Reg. 1.1502-79(a)(3). As set forth in the three charts below, the revenue agent then limited the amount of the SL loss carry back available to the SRLY companies based on each SRLY company's NOL.

1. Amount of SL expenses claimed by SRLY Companies

Company	[redacted]	[redacted]	[redacted]
Total SL Expenses	[redacted]	[redacted]*	[redacted]

*The statute of this separate return loss year was not protected. Therefore, this carry back is barred by statute.

Company	[redacted]	[redacted]	[redacted]
Total SL Expenses	[redacted]	[redacted]	[redacted]

2. Allocated NOL of [redacted]

Company			
[redacted]	[redacted]	[redacted]	[redacted]
Total NOL Limitation	[redacted]	[redacted]	[redacted]
Company			
[redacted]	[redacted]	[redacted]	[redacted]
Total NOL Limitation	[redacted]	[redacted]	[redacted]

3. SL Carry back Limited to SRLY NOL

Company			
[redacted]	[redacted]	[redacted]	[redacted]
Carry back Allowable	[redacted]	[redacted]	[redacted]
Company			
[redacted]	[redacted]	[redacted]	[redacted]
Carry back Allowable	[redacted]	[redacted]	[redacted]

After the Supreme Court rendered its decision in United Dominion, the agent re-calculated the amount of the SL loss available to [redacted] using the "single entity" approach for each of the years at issue. The revenue agent concluded, however, that the NOL limitation for the SRLY companies was not affected by United Dominion. His revised computation of the SL loss available to [redacted] and the SRLY companies is as follows:

1. [redacted]

Member	SLL Expense per claim	Allocated NOL (SRLY)	NOL Limit.	SLL not Apport. to SRLY	SLL Avail. to group	SLL Avail. to SRLY
[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
Total	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]

2. [redacted]

Member	SLL Expense per claim	Allocated NOL (SRLY)	NOL Limit.	SLL not Apport. to SRLY	SLL Avail. to group	SLL Avail. to SRLY
[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
Total	[redacted]	[redacted]	[redacted]	[redacted]	(942,864)	[redacted]

3. [redacted]

Member	SLL Expense per claim	Allocated NOL (SRLY)	NOL Limit.	SLL not Apport. to SRLY	SLL Avail. to group	SLL Avail. to SRLY
[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
Total	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]

4. [redacted]

Member	SLL Expense per claim	Allocated NOL (SRLY)	NOL Limit.	SLL not Apport. to SRLY	SLL Avail. to group	SLL Avail. to SRLY
[redacted]	[redacted]	[redacted]	[redacted]	[redacted] **	[redacted]	[redacted]
Total	[redacted]		[redacted]	[redacted]	[redacted]	[redacted]

5. [redacted]

Member	SLL Expense per claim	Allocated NOL (SRLY)	NOL Limit.	SLL not Apport. to SRLY	SLL Avail. to group	SLL Avail. to SRLY
[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
Total	[redacted]		[redacted]		[redacted]	

6. [redacted]

Member	SLL Expense per claim	Allocated NOL (SRLY)	NOL Limit.	SLL not Apport. to SRLY	SLL Avail. to group	SLL Avail. to SRLY
[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
Total	[redacted]		[redacted]	[redacted]	[redacted]	[redacted]

* Barred by statute
** This amount represents the [redacted] NOL limitation less a penalty claimed by [redacted] in the amount of $[redacted].

Based on the foregoing charts, the revenue agent determined that the total SL loss available to [redacted] for all of the years at issue was $[redacted], and the total SL loss available to the SRLY companies for all of the years at issue was $[redacted]. The total amount of SL losses available for both [redacted] and the SRLY companies was $[redacted].

DISCUSSION

Our office must examine whether the revenue agent properly determined the SL losses available to [redacted] and the SRLY companies subsequent to the Supreme Court's decision in United Dominion Indus. Inc. v. United States, 121 S. Ct. 1934 (2001). Our office must also evaluate whether the government has any remaining SL loss limitation arguments remaining after United Dominion.

The Net Operating Loss Rules

A corporation that has a net operating loss ("NOL") may generally carry back the NOL three years prior to the year of the loss, or may carry over the NOL fifteen years after the year of the loss, pursuant to I.R.C. § 172(b)[2]/. A corporation has an NOL if its total deductions exceed its taxable income for the taxable year. I.R.C. § 172(c).

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[2]/ In 1997, Congress amended I.R.C. § 172(b) to allow a general 2 year carry back period and a 20 year carry over period. Pub. L. No. 105-34, Taxpayer Relief Act of 1997, § 1082(a), (b), 111 Stat. 788. This amendment is effective for taxable years beginning after January 7, 1997. Id. at § 1082(c).

A corporation that has an SL loss, however, may carry back the SL loss ten years prior to the year of the loss, but not prior to 1984. I.R.C. § 172(c); Pub. L. No. 101-508, Omnibus Budget Reconciliation Act of 1990, § 11811(b)(2)(B), 104 Stat. 1388 (1990).

For the taxable years at issue, an SL loss was defined as the sum of amounts associated with product liability claims, liabilities arising under State or Federal law, or liabilities arising out of any tort of the taxpayer which occurred at least three years prior to the taxable year, to the extent these amounts were used to compute the NOL for the taxable year. I.R.C. § 172(f)(1)(1997).

A corporation's SL loss is limited, however, to the amount of the corporation's NOL for the taxable year at issue ("the NOL limitation"). I.R.C. § 172(f)(2).

The Consolidated Return Regulations

I.R.C. § 1501 allows an affiliated group of corporations to file a consolidated income tax return instead of filing numerous separate income tax returns. Under the authority of I.R.C. § 1502, the Secretary has promulgated regulations governing the procedures for filing consolidated returns. See Treas. Reg. §§ 1.1502-1 through 1.1502-81.

Treas. Reg. §§ 1.1502-11, 1.1502-12, and 1.1502-21 govern an affiliated group's calculation of separate income ("STI"), consolidated taxable income ("CTI") and consolidated net operating loss ("CNOL").

Treas. Reg. § 1.1502-11 provides the procedures for computing a group's CTI. A group's CTI is the sum of the STI of each group member (as determined pursuant to Treas. Reg. § 1.1502-12), plus the following consolidated items: 1) any CNOL deduction (as determined pursuant to Treas. Reg. § 1.1502-21 or § 1.1502-21A); 2) any consolidated net capital gain; 3) any consolidated loss under I.R.C. § 1231; 4) any consolidated charitable contributions deduction; 5) any consolidated deduction under I.R.C. § 922; 6) any consolidated dividends received deduction; and 7) any consolidated deduction under I.R.C. § 247. Treas. Reg. § 1.1502-11(a)(as amended in 1997).

Treas. Reg. § 1.1502-12(a)(as amended in 1996) provides that a group member's STI is computed as if each member was filing a separate income tax return, subject to certain modifications. Among other things, these modifications exclude the consolidated

items included in the calculation of the group's CTI, pursuant to Treas. Reg. § 1.1502-11(a). Treas. Reg. § 1.1502-12(h)-(n).

Treas. Reg. § 1.1502-21A (applicable for taxable years prior to January 1, 1997) provides that a group's CNOL deduction is the aggregate CNOL carry overs and carry backs to the taxable year. CNOL is calculated similarly to CTI, by taking into account: 1) the STI of each member; 2) any consolidated net capital gain; 3) any consolidated net loss under I.R.C. § 1231; 4) any consolidated charitable contributions deduction; 5) any consolidated dividends received deduction; and 6) any consolidated deduction under I.R.C. § 247. Treas. Reg. § 1.1502-21A(f).

Treas. Reg. § 1.1502-79A(a)(applicable for taxable years prior to January 1, 1997) addresses how to allocate CNOL to a member of the consolidated group if the member elects to carry over or carry back a loss to a "separate return year," i.e., a year when the member was not a member of the consolidated group. The regulation provides, in part, that the amount of CNOL allocated to the member is calculated by multiplying the CNOL of the group "by a fraction, the numerator of which is the separate net operating loss of such corporation, and the denominator of which is the sum of the separate net operating losses of all members of the group in such year having such losses." Treas. Reg. § 1.1502-79A(a)(3).

The consolidated return regulations do not specifically address the application of the SL loss carry back to consolidated groups. The regulations do, however, provide that, "[t]he Internal Revenue Code, or other law, shall be applicable to the group to the extent the regulations do not exclude its application." Treas. Reg. § 1.1502-80(a)(as amended in 1997).

The United Dominion Opinion

In United Dominion Indus., Inc. v. United States, 121 S.Ct. 1934 (2001), the Supreme Court analyzed whether the NOL limitation on product liability ("PL") losses[3]/ should be determined on a company-by-company basis (i.e., the separate entity approach) or on a consolidated basis (i.e., the single

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[3]/ PL losses were the statutory predecessor to SL losses. In 1990, Congress grouped PL losses with other similar expenses, treating the expenses collectively as SL losses. Pub. L. No. 101-508, Omnibus Budget Reconciliation Act of 1990, § 11811(b)(1), 104 Stat. 1388-532 (1990).

entity approach) for an affiliated group of corporations filing a consolidated income tax return.

In United Dominion, the taxpayer was the successor to AMCA International Corporation ("AMCA"), the parent of a consolidated group that filed consolidated income tax returns for the taxable years 1983 through 1986. United Dominion, 121 S.Ct. at 1937. For each of the taxable years, AMCA computed its CNOL, and compared this amount to the aggregate of its member's PL expenses. Id. AMCA then carried back the amount of the PL expenses which equaled its CNOL as its PL loss for the ten year carry back period allowed by I.R.C. § 172(b)(1)(C). Id. Five of AMCA's members that generated the PL expenses had positive taxable income for the years at issue. Id. at 1938.

The taxpayer argued that the Court should adopt the single entity approach when interpreting the NOL limitation of I.R.C. § 172(f)(2). Id. Under this approach, when the group's CNOL exceeds the aggregate of all of the members' PL expenses, the group can carry back the total amount of the PL expenses as its PL loss. Id.

Conversely, the government argued that the Court should adopt the separate entity approach when interpreting the NOL limitation of I.R.C. § 172(f)(2). Id. Under this approach, the government determined each member's income or loss separately, and compared this amount to the PL expenses generated by each member to determine if each member generated its own PL loss. Id. If so, the member could contribute its separate PL loss to the group. Id. If, however, the member has positive taxable income, it has no separate PL loss to contribute to the group, and its PL expenses would not be available to the group for the ten year carry back period of I.R.C. § 172(b)(1)(C). Id. This approach prohibited the inclusion of the PL expenses from the members of AMCA who had positive taxable income in the computation of the PL loss available to AMCA.

The Supreme Court adopted the single entity approach advocated by the taxpayer, noting that this approach was "straightforward," and "(relatively) easy to understand and apply." Id. at 1939, 1940. The Court reasoned that, because the regulations do not define "separate NOL" for the member of a consolidated group (except where separate return years are involved), the NOL limitation of I.R.C. § 172(f)(2) must apply at the group level, i.e., to the CNOL. Id. The Court explained that, "there is no NOL below the consolidated level and hence nothing for comparison with PLEs to produce PLL at any stage before the CNOL calculation." Id. at 1940.

In rejecting the government's separate entity approach, the Court discounted the government's theory that the Court should compare each member's STI, as computed pursuant to Treas. Reg. § 1.1502-12, to its PL expenses, because STI is analogous to "separate NOL." Id. The government reasoned that this comparison, "places the group member closest to the position it would have occupied if it had filed a separate return." Id. The Court disagreed, explaining that the computation of a member's STI under Treas. Reg. § 1.1502-12 excludes several consolidated items which a taxpayer filing a separate tax return would normally consider. Id.

The Fourth Circuit rejected the STI theory advanced by the government, but adopted the government's separate entity approach based on the definition of "separate net operating loss" used in Treas. Reg. § 1.1502-79. Id. The Supreme Court rejected this reasoning as well, explaining,

> Section 1.1502-79(a)(3) unbakes the cake for only one reason, and that reason has no application here. The definition on which the Court of Appeals relied applies, by its terms, only "for purposes of" § 1.1502-79(a)(3), and context makes clear that the purpose is to provide a way to allocate CNOL to an affiliate member that seeks to carry back a loss to a "separate return year," that is, to a year in which the member was not part of the consolidated group. ... No separate return years are at issue before us; all NOL carry backs relevant here apply to years in which the five corporations were affiliated in the group.

United Dominion, 121 S.Ct. at 1941 (internal citations omitted) (emphasis added).

Issue 1:

The first issue is what effect, if any, does United Dominion have on the SL expenses arising from members of [redacted] that filed separate income tax returns during the carry back years.

The following members of [redacted] generated SL expenses during the taxable years at issue, but were not members of the group during the carry back years:

Year	Company	SLEs
[redacted]	[redacted]	[redacted]

The issue of how to compute SL loss where separate return years are involved was addressed in Amtel, Inc. v. United States, 31 Fed. Cl. 598 (Ct. Cl. 1994), aff'd without published opinion, 59 F.3d 181 (Fed. Cir. 1995). During 1975, Amtel filed a consolidated income tax return as the parent of an affiliated group whose members included Litwin and Litwin Panamanian. Amtel, 31 Fed. Cl. at 599. In 1977, AMCA purchased Amtel and its consolidated group, and thereafter included Amtel and its group on its own consolidated income tax returns. Id. In 1985, Amtel, Litwin and Litwin Panamanian generated separate taxable income, but incurred PL expenses. Id. Amtel then sought to carry back the share of the PL loss attributable to Litwin, Litwin Panamanian and itself from 1985 to 1975, a separate return year. Id.

The Court of Claims, relying on Treas. Reg. 1.1502-79, held that Amtel was not permitted to carry back a PL loss from 1985 to 1975, since Amtel did not have an NOL during 1985. Id. at 600. Treas. Reg. § 1.1502-79(a) provides the method for allocating CNOL to individual members of the group where the group members may carry back CNOL to a separate return year. The Amtel Court explained,

> [C]ontrary 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. In that context, the Service treats the members as separate by apportioning the consolidated net operating loss.

Id. (citing Treas. Reg. § 1.1502-79(a)).

The Court of Claims determined that the separate return approach advocated by the government was the appropriate method of calculating whether any PL loss (or SL loss) was available for members of an affiliated group to carry back to separate return years. The Court held, therefore, that Amtel's available PL loss carry back for 1975, a separate return year, was limited to its 1985 NOL as determined under Treas. Reg. § 1.1502-79(a) - zero. Id. at 601.

The holding of Amtel was left undisturbed by the Supreme Court in United Dominion. As discussed above, United Dominion specifically excluded situations where separate return years are involved from its holding that the single entity approach is the appropriate method to use when determining the PL loss available to a consolidated group. United Dominion, 121 S.Ct. at 1941.

Based on the foregoing, the members of [redacted] who seek to carry back a portion of the SL loss for each of the taxable years at issue to their separate return years are limited to carrying back the lesser of their SL expenses or their allocated NOL based on Treas. Reg. § 1.1502-79. The revenue agent properly applied the NOL limitation to the SRLY Companies as follows:

1. [redacted]

Member	SLL Expense per claim	Allocated NOL (SRLY)	NOL Limit.	SLL Avail. to SRLY
[redacted]	[redacted]	[redacted]	[redacted]	[redacted]

2. [redacted]

Member	SLL Expense per claim	Allocated NOL (SRLY)	NOL Limit.	SLL Avail. to SRLY
[redacted]	[redacted]	[redacted]	[redacted]	[redacted]

3. [redacted]

Member	SLL Expense per claim	Allocated NOL (SRLY)	NOL Limit.	SLL Avail. to SRLY
[redacted]	[redacted]	[redacted]	[redacted]	[redacted]

Several of [redacted] members have unused SL expenses, since the amount of their SL expenses exceeded the amount of CNOL allocated to them pursuant to Treas. Reg. § 1.1502-79. During the taxable year ending [redacted], [redacted] had unused SL expenses of $[redacted]. During the taxable

year ending [redacted], [redacted] and [redacted] had unused SL expenses of $[redacted] and $[redacted], respectively. Finally, during the taxable year ending [redacted], [redacted], [redacted], [redacted] and [redacted] had unused SL expenses of $[redacted], $[redacted], $[redacted], and $[redacted], respectively.

The remaining issue, therefore, is whether [redacted] may carry back these excess SL expenses to its own prior consolidated returns, even if the members generating the SL expenses were not members of the group during the carry back years. Based on the Supreme Court's decision in United Dominion, the location of the SL expenses is irrelevant. One simply compares the amount of the CNOL with the aggregate amount of the SL expenses. The lower amount can be carried back ten years as an SL loss, and the remainder can be carried back two (or three) years as an NOL. Thus, [redacted] may carry back the excess SL expenses of the members not carried back to the separate return years to its own prior consolidated returns, even if the amounts are carried back to years in which the members generating the excess SL expenses were not members of the group.

Based on the foregoing, our office agrees that the revenue agent properly re-computed the SL loss available to [redacted] and the SRLY companies for the taxable years at issue, based on the holdings of United Dominion and Amtel.

Issue 2:

The second issue is whether the SL loss limitation argument adopted by the Tax Court in Norwest Corp. v. Commissioner, 111 T.C. 105 (1998), is still valid after United Dominion.

In Norwest, the Tax Court addressed the application of the NOL limitation of former section 172(b)(1)(L) (analogous to the NOL limitation in current section 172(f)(2)), to a consolidated group consisting of members who sought to carry back bank bad debt losses for a ten-year carry back period. Like United Dominion, the taxpayer asserted that the NOL limitation applied at the group level. Norwest, 111 T.C. at 130.

The Tax Court, in adopting the separate entity theory advanced by the government, explained,

> Although the consolidated return regulations do speak in terms of a "consolidated net operating loss," it is quite clear that the consolidated net operating loss is to be determined by taking into account the "separate" taxable income, including the

> separate NOL, of each member of the group. ... The separately determined losses of each member of the affiliated group do not lose their distinct character ... upon consolidation.

Norwest, 111 T.C. at 130-31 (citation omitted).

In United Dominion, the Supreme Court specifically rejected the notion of a "separate" NOL for each group member. United Dominion, therefore, definitively disposed of use of the separate member approach previously advocated by the government, and adopted by the Tax Court, in Norwest.

Should you have any questions regarding this matter, please contact Robin L. Peacock at (212) 436-1335.

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ROLAND BARRAL
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