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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR
ASSISTANT DISTRICT COUNSEL CC:WR:SCA:LN
Attn:

FROM: Jasper L. Cummings, Jr.
Associate Chief Counsel (Corporate) CC:CORP

SUBJECT: Carryback of Specified Liability Expenses

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LEGEND

Date 1 =
Date 2 =

X =
Y =

$a =
$b =
$c =
$d =
$e =
$f =
$g =

ISSUES

1) Whether the consolidated group, of which X is the parent (the "X group"), may carry back any portion of its consolidated net operating loss ("CNOL") ten years as a specified liability ("SL") loss, for the tax year ending on Date 1, where X incurred SL expenses during the year and had positive separate taxable income for such year.

2) To what extent may the X group carry back a portion of its CNOL ten years as a SL loss, for the tax year ending on Date 2, where: (a) X incurred SL expenses during the year and had net negative separate income for such year, (b) Y, another member of the group, had net negative separate income, no portion of which was attributable to SL expenses, and (c) the sum of the net negative separate incomes of X and Y is greater than the CNOL of the X group.

CONCLUSIONS

1) It is the position of the Service that no portion of the SL expenses of a member of a group can constitute an SL loss of the group where that member has positive separate taxable income. Therefore, the X group may not carry back any portion of its CNOL ten years as an SL loss, for the tax year ending on Date 1.

2) The Service has not yet established a final position on the portion of the CNOL of the X group, for the tax year ending on Date 2, that can be carried back ten years as an SL loss under the circumstances described above. Establishing such a position by the Field Service Advice procedure is inappropriate. Such position, however, can be established through the Technical Advice procedure. Therefore, you may wish to consider submitting a request for Technical Advice.

FACTS

In its taxable year ending on Date 1, the consolidated net operating loss ("CNOL") of the consolidated group, of which X was the parent (the "X group"), was

approximately $d. In that same year, X's specified liability ("SL") expenses exceeded $d. However, X's separate taxable income (within the meaning of Treas. Reg. § 1.1502-12), even adjusted to include the consolidated items eliminated in the calculation of that separate taxable income (see Treas. Reg. § 1.1502-79A(a)(3)), was positive.

In its taxable year ending on Date 2, the CNOL of the X group was $e. In that same year, X's negative separate taxable income was $c, all of which was attributable to SL expenses. X's separate net operating loss (within the meaning of Treas. Reg. § 1.1502-79A(a)(3)) was $b, which is less than $c. X's portion of the CNOL (within the meaning of Treas. Reg. § 1.1502-79A(a)(3)) was $a, which is less than $b. In addition, Y was a member of the X group. Its negative separate taxable income was $g; its separate net operating loss was $f. None of Y's loss was attributable to SL expenses.

LAW AND ANALYSIS

Year Ending On Date 1

For the tax year ending on Date 1, X had specified liability ("SL") expenses, as defined in I.R.C. § 172(f). Section 172(f)(1), as then in effect, provided that:

> The term "specified liability loss" means the sum of the following amounts to the extent taken into account in computing the net operating loss for the taxable year:
>
> > (A) Any amount allowable as a deduction under section 162 or 165 which is attributable to –
> >
> > > (i) product liability, or
> > >
> > > (ii) expenses incurred in the investigation or settlement of, or opposition to, claims against the taxpayer on account of product liability.

Section 172(f)(2) provides that:

> The amount of the specified liability loss for any taxable year shall not exceed the amount of the net operating loss for such taxable year.

Section 172(b)(1)(C) provides:

> In the case of a taxpayer which has a specified liability loss (as defined in subsection (f)) for a taxable year, such specified liability

> loss shall be a net operating loss carryback to each of the 10 taxable years preceding the taxable year of such loss.

Thus, the X group sought to carry back ten years a portion of its consolidated net operating loss ("CNOL") equal to the amount of X's SL expenses.

The position of the Service is that if a member incurring SL expense had positive separate taxable income ("STI"), then its SL expenses have been absorbed in determining its STI. In that case, there is no SL loss to be carried back as part of the CNOL.

In order for a group to calculate its consolidated taxable income or loss (within the meaning of Treas. Reg. § 1.1502-11) for a taxable year, each member of the group must first calculate its STI. Treas. Reg. § 1.1502-12 expressly provides that STI includes a case in which deductions exceed gross income, i.e., separate taxable loss. The STI of each member of the group is then aggregated as the first step in arriving at the consolidated taxable income or loss of the group. Treas. Reg. §§ 1.1502-11(a)(1) and 1.1502-21A(f).

Under Treas. Reg. § 1.1502-12, STI is computed in accordance with the provisions of the Code covering the determination of taxable income of separate corporations, subject to various modifications. Such modifications include the exclusion of those items specifically listed for determination on a consolidated basis. As such, those items not separately listed for determination on a consolidated basis are computed on a member by member basis. The position of the Service is that SL expenses are not an item specifically listed for determination on a consolidated basis. Thus, SL expenses are deducted in order to arrive at the STI of the member that incurred such expense. Consequently, if the STI of a member is positive, i.e., it does not have a separate taxable loss, then it cannot have an SL loss for that year. Under these circumstances, such a member does not contribute an SL loss to the group's CNOL because those expenses have already been consumed by the current income of that member.

In its taxable year ending on Date 1, X has positive separate taxable income (within the meaning of Treas. Reg. § 1.1502-12). Thus, the position of the Service is that such expenses were not available to be carried back as part of the CNOL of the X group. See Intermet Corporation v. Commissioner, 111 T.C. 294 (1998). See also United Dominion Industries, Inc. v. United States, 208 F.3d 452 (4th Cir. 2000).

We note that the Sixth Circuit reversed the Tax Court in the case of Intermet Corporation v. Commissioner, 209 F.3d 901 (6th Cir. 2000). The Sixth Circuit held that SL expenses are calculated on a consolidated basis. Under that rationale, it is irrelevant that a member incurring SL expenses had positive separate taxable income. However, X is not located in a state under the jurisdiction of the Sixth

Circuit. Therefore, the Sixth Circuit's decision is not controlling with respect to X and we are not required to follow it.

Year Ending on Date 2

In its taxable year ending on Date 2, X had negative separate taxable income (within the meaning of Treas. Reg. § 1.1502-12) of $c, a separate net operating loss (within the meaning of Treas. Reg. § 1.1502-79A(a)(3)) of $b, and its portion of the CNOL was $a (within the meaning of Treas. Reg. § 1.1502-79A(a)(3)). Under Treas. Reg. § 1.1502-79A(a)(3), a member determines its separate net operating loss by increasing or decreasing its separate taxable income or loss (within the meaning of Treas. Reg. § 1.1502-12) by the portion of the consolidated items attributable to it. To determine its portion of the CNOL, a member multiplies the CNOL by a fraction. The numerator of the fraction is the separate net operating loss of that member and the denominator is the sum of the separate net operating losses of all members having such losses.

In this case, X's SL expenses exceeded its negative separate taxable income, which exceeded its separate net operating loss, which exceeded its portion of the CNOL. In addition, Y had a loss, computed on a separate basis. Y's loss was not attributable to SL expenses. You have asked us the appropriate method for calculating the amount of SL expenses incurred by X in the tax year ending on Date 2 that the X group may carry back as part of its CNOL. The Service has not formally developed a position on this issue. Therefore, you may wish to consider submitting a request for Technical Advice.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

As noted above, the Service has not established a position on the issue of whether to use negative separate taxable income, separate net operating loss, or some other amount, such as portion of the CNOL, of a member to determine the amount of the SL expenses of that member that may be carried back. We note, however, that in United Dominion Industries, Inc. v. United States, 208 F.3d 452 (4th Cir. 2000), the 4th Circuit appears to have adopted the separate net operating loss of a member as the I.R.C. § 172(f) NOL limitation amount. [redacted]

In TAM 9715002, the Service arguably took the position that the NOL limitation under I.R.C. § 172(f)(2) is the portion of the CNOL attributable to that member. Under this approach, X's NOL limitation would be $a. We understand that your position is that the X group may only carry this portion of its CNOL back ten years as an SL loss.

However, the facts of the TAM were that the member with SL expenses had positive separate taxable income. In other words, it did not specifically address a fact pattern in which (a) the member incurring the SL expenses had a net negative separate income (b) there was another member of the group with a net negative separate income but no SL expenses and (c) the sum of the net negative separate incomes was greater than the CNOL. Thus, notwithstanding the broad language of the TAM, we do not believe that it addresses the fact pattern at issue here.

As also noted above, the Service has not established a position on the issue of allocating the CNOL between a member, having a loss, with SL expenses and a member, having a loss, without SL expenses where the sum of such expenses exceeds the CNOL. We note, however, that the Tax Court, adopted an allocation formula in an analogous situation in Norwest Corporation v. Commissioner, 111 T.C. 105 (1998). The Norwest court addressed the carryback of bank bad debt losses in a consolidated group with some bank members and other members that were not banks. Like SL expenses, bank bad debt losses can be carried back ten years. Section 172(b)(1)(D). In the case of Norwest, there were members with bank bad debt losses and some members (including banks) with losses other than bank bad debt losses.

In determining the portion of the CNOL that was attributable to bank bad debt losses (and thus could be carried back ten years), the Tax Court applied an allocation formula like the one described in Treas. Reg. § 1.1502-79A. Under this approach, the Tax Court determined the portion of the CNOL to be allocated to a member with bank bad debt losses. The Tax Court held that the group should not be allowed a ten-year NOL carryback for the bad debt of a bank to the extent that bad debt loss exceeds the portion of the CNOL attributable to that member.

We recognize that the Norwest case would provide support for a similar allocation approach in this case.

Please call if you have any further questions.

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