Office of Chief Counsel
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memorandum

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subject: **Intersection of CNOL apportionment rules and CERT rules**

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ISSUES

(1) Under the facts described above, how is it determined which specific portion of the P group's Year 5 CNOL should be treated as CERT-tainted?

(2) Under the facts described above, which rule is applied first: the CNOL apportionment rule of §1.1502-21(b)(2)(iv), or the CERT rule of §172(b)(1)(E) and (h)?

CONCLUSIONS

(1) The CERT taint should be applied pro rata among the portions of the CNOL apportioned to members for carryback to separate return years and the remaining portion available for carryback to consolidated return years.

(2) To the extent that conclusion (1) is followed, the order of application is irrelevant. However, in any case where separate return carryback years exist, the CERT-tainted loss must be apportioned among members of the group for carryback to such separate return years, rather than being treated as a generic consolidated NOL carryover.

FACTS

Parent (P) is the common parent of a consolidated group that includes wholly-owned subsidiary S. In Year 5, S acquired all of the stock of T in a debt-financed transaction. The debt financing of the transaction was entered into directly by S.

In Year 5, the P group incurred a CNOL. On a separate entity basis, S generated income in Year 5, but T generated a loss (for the portion of Year 5 includible in the P group). On a separate entity basis, various other members of the P group also generated losses in Year 5. During carryback years, the P group and T each have taxable income.

LAW

Section 172(b)(1)(E)(i) provides, in pertinent part, that, if there is a corporate equity reduction transaction (CERT) and an applicable corporation has a corporate equity reduction interest loss for any loss limitation year[1] ending after August 12, 1989, then the corporate equity reduction interest loss shall be an NOL carryback and carryover, except that such loss shall not be carried back to a taxable year preceding the taxable year in which the CERT occurs. A CERT includes a "major stock acquisition", which is generally the acquisition by a corporation of more than 50 percent of the stock (vote or value) in another corporation. §172(h)(3)(B). An "applicable corporation" includes a C corporation that acquires stock, or the stock of which is acquired in a major stock acquisition. §172(b)(1)(E)(iii)(I).

Section 172(h)(1) provides that the term "corporate equity reduction interest loss" means, for any loss limitation year, the excess (if any) of –

(A) the NOL for such taxable year, over

(B) the NOL for such taxable year determined without regard to any allocable interest deductions otherwise taken into account in computing such loss.

"Allocable interest deductions" are deductions allowed under chapter 1 of the Code for interest on the portion of any indebtedness allocable to a CERT. §172(h)(2)(A). Interest is allocated to the CERT in the manner prescribed in §263A(f)(2)(A)(ii) (not tracing interest directly related to any transaction actually related to the CERT; rather, the interest cost of engaging in the CERT is determined using the taxpayer's weighted average cost of borrowing). See §172(h)(2)(B).

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[1]Section 172(b)(1)(E)(ii) defines a "loss limitation year" with respect to any CERT as the taxable year in which the CERT occurs and each of the 2 succeeding taxable years.

Section 172(h)(4)(B)(i) provides that, for purposes of §172(b)(2) (dealing with the amount of carrybacks and carryovers), a corporate equity reduction interest loss shall be treated in a manner similar to the manner in which a specified liability loss (SLL) is treated. Section 172(f)(5) provides that, for purposes of applying §172(b)(2), an SLL for any taxable year shall be treated as a separate NOL for such taxable year to be taken into account after the remaining portion of the NOL for such taxable year.

Section 172(h)(4)(C) provides that all members of an affiliated group filing a consolidated return under section 1502 shall be treated as one taxpayer for purposes of §172(b)(1)(E) and (h).

Section 1.1502-11 provides rules for determining the consolidated taxable income (CTI) of a group. Under these rules, all separate and consolidated items of the members of the group are combined. Section 1.1502-21(e) defines the consolidated net operating loss (CNOL) of a group as any excess of deductions over gross income, as determined under §1.1502-11(a) (without regard to any CNOL deduction). Section 1.1502-21A(f) provides parallel rules for years beginning before January 1, 1997.

Section 1.1502-21(b) provides rules for apportioning the CNOL determined under §§1.1502-11 and 1.1502-21(e) for carryback and carryover to other consolidated and separate return years. Section 1.1502-21(b)(2)(i) states:

> If any CNOL that is attributable to a member of a group may be carried to a separate return year of the member, the amount of the CNOL that is attributable to the member is apportioned to the member (apportioned loss) and carried to the separate return year. If carried back to a separate return year, the apportioned loss may not be carried back to an equivalent, or earlier, consolidated return year of the group. * * *

Section 1.1502-21(b)(2)(iv) provides the following apportionment formula:

> The amount of a CNOL that is attributable to a member is determined by a fraction the numerator of which is the separate net operating loss of the member for the year of the loss and the denominator of which is the sum of the separate net operating losses for that year of all members having such losses. * * *

Sections 1.1502-79A(a)(1)(i) and (a)(3), and 1.1502-21A(b)(1) provide substantively identical rules for the apportionment of pre-1997 losses to separate carryback and carryover years.

ANALYSIS

In General

A consolidated group's CNOL for any year is the equivalent of negative taxable income for that year. The CNOL is computed by combining all of the members' separate and consolidated items for the year, but excluding any CNOL deduction[2] (carried over or carried back from any other year). See §1.1502-21(e); §1.1502-21A(f). Following the computation of the CNOL for any year, such CNOL is apportioned to members for carryover or carryback to separate return years (if any) by application of §1.1502-21(b)(2)(iv). Any amount that has been apportioned to a member for carryback to a separate return year cannot be carried back to an equivalent or earlier consolidated return year. §1.1502-21(b)(2)(i).

Section 172(b)(1)(E) and (h) limit the use in certain carryback years of NOLs that are incurred as a result of corporate equity reductions transactions (CERTs). Under the facts described above, the P group has engaged in a CERT, the acquisition of T by S. The P group (rather than S) is treated as engaging in the transaction, because, under §172(h)(4)(C), all members of an affiliated group filing a consolidated return under section 1501 are treated as one taxpayer for purposes of §172(b)(1)(E) and (h), i.e., for purposes of the CERT rules.

Further, because the entire group is treated as a single taxpayer, the amount of the corporate equity reduction interest loss ("CERT-tainted loss") will be equal to (A) the CNOL for the taxable year, over (B) the CNOL for the taxable year, determined without regard to any allocable interest deductions otherwise taken into account in computing such loss. §172(h)(1). Allocable interest deductions are determined in the manner prescribed in §263A(f)(2)(A)(ii). See §172(h)(2)(B). The legislative history describes this allocation as follows:

> [A] corporation's indebtedness is allocable to a CERT to the extent that the corporation's indebtedness could have been reduced if the CERT had not occurred, in the manner prescribed under section 263A(f)(2)(A)(ii) (without regard to clause (i) thereof). The interest expense associated with such indebtedness is equal to a pro rata portion of the corporation's total interest expense. [H.R. Rep. No. 247, 101st Cong., 1st Sess. 1251 (1989), *reprinted in* 1989 U.S.C.C.A.N. 1906, 2721 (emphasis added).]

Therefore, the allocable interest deductions are computed by determining the amount of borrowing necessitated by participation in the CERT (regardless of whether the borrowing was incurred specifically in relation to the CERT). That borrowing then is

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[2]A group's CNOL deduction for any year for any consolidated return year is the aggregate of the NOL carryovers and carrybacks to that year from consolidated return years and separate return years. See §1.1502-21(a); §1.1502-21A(a).

deemed to produce interest expense at the taxpayer's weighted-average cost of borrowing.[3]

As stated above, the CERT-tainted loss is determined by factoring the allocable interest deductions into the formula contained in §172(h)(1). Thereunder, to the extent that the allocable interest deductions increased the group's CNOL, a portion of the CNOL is a CERT-tainted loss. Such loss may not be carried back to years prior to the CERT. §172(b)(1)(E)(i).

Issue 1: Which specific portion of the CNOL is CERT-tainted?

Applying the law to the facts above, a portion of the CNOL of the P group is CERT-tainted. The dollar value of that portion is determined under §172(h)(1). Once that dollar value is established, the first question presented above is how to determine which specific portion of the CNOL should be treated as CERT-tainted. This issue arises because a part of the CNOL for Year 5 (the year of the CERT) must be apportioned to a member (T) for carryback to separate return years. The remainder will be available to be applied by the P group in its consolidated carryback years.

As discussed above, under §172(h)(4)(C) (mandating treatment of a consolidated group as a single corporation for purposes of the CERT rules), the existence of a CERT-tainted loss is determined on a consolidated group basis, and that loss is part of the CNOL. See also United Dominion Ind., Inc. v. United States, 532 U.S. 822, 834 (2001) (determining the existence of a product liability loss (the precursor of a specified liability loss) under single entity principles).

Section 1.1502-21(b) provides the only method for apportioning a CNOL for carryback to separate return years (see §1.1502-79A(a) for years prior to 1997). Under these regulations, a CNOL is apportioned among all group members that contributed separate NOLs to the group for the taxable year (and excluding any members that did not produce separate NOLs). The formula apportions the CNOL pro rata, according to the relative sizes of the separate NOLs of the members. See §§1.1502-21(b)(2)(iv) and 1.1502-79A(a)(3). This is the exclusive method provided for apportioning CNOLs for carryback to separate return years. See United Dominion Ind., Inc. v. United States,

[3]Because the consolidated group is treated as a single taxpayer, the §263A weighted-average computation must be done on a group-wide basis.

532 U.S. 822, 833 (2001).[4] Because CERT-tainted losses are part of the CNOL of the group, such losses must be apportioned pro rata, under the formula in §1.1502-21(b).

An argument might be raised that the CERT-taint should attach to the part of the CNOL apportioned to the specific member of the group which incurred the interest expense directly related to the CERT. Indeed, before a CERT-taint affixes to a loss, an "applicable corporation" must have a "corporate equity reduction interest loss". §172(b)(1)(E)(i)(II). Further, it might be argued that, under the facts presented, the only "applicable corporations" in this transaction are the acquiring corporation (S) and the target (T). See §172(b)(1)(E)(iii)(I).

The preceding argument ignores the existence of §172(h)(4)(C), which mandates treatment of the entire group as a single taxpayer for purposes of the CERT rules. Thus, single-entity treatment would cause the entire group to qualify as an "applicable corporation." Further, under the facts presented, S (the member who actually incurred the acquisition interest expense) did not generate a separate NOL during Year 5. Thus, no part of the CERT-tainted loss can be apportioned to S. See §§1.1502-21(b)(2)(iv) and 1.1502-79A(a)(3). In addition, under the facts, T did not actually incur the allocable interest expense. Therefore, even under this alternative line of reasoning, there would be no reason to allocate disproportionate CERT-tainted loss to T.

In conclusion, the exclusive method for apportioning a CNOL for carryback is contained in §§1.1502-21(b)(2)(iv) and 1.1502-79A(a)(3), and this is the method that must be used to allocate CERT-tainted losses.

Issue 2: Which rule is applied first: the CNOL apportionment rule of §1.1502-21(b)(2)(iv), or the CERT rule of §172(b)(1)(E)?

Because, as determined above, the CERT-tainted loss must be apportioned on a pro rata basis under §§1.1502-21(b)(2)(iv) or 1.1502-79A(a)(3), the order of the application of the CNOL apportionment rule and the CERT rule is irrelevant. If the CNOL apportionment rule were applied first, the entire CNOL would be apportioned under §1.1502-21(b), and then a set percentage of the apportioned amount would be treated as CERT-tainted.[5] If the CERT rule were applied first, the dollar-value of the

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[4] Section [1.1502-21(b)(2)(iv) or 1.1502-79A(a)(3)] unbakes the cake for only one reason * * *. [C]ontext makes clear that the purpose is to provide a way to allocate CNOL to an affiliated 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.

United Dominion Ind., Inc. v. United States, 532 U.S. at 833.

[5]The set percentage would be the percentage of the entire CNOL represented by the CERT-tainted loss.

CERT-tainted loss would be computed, and that CERT-tainted loss might be carved off of the CNOL. However, both the CERT-tainted portion of the CNOL and the remaining portion of the CNOL would be apportioned for carryback on a pro rata basis, using the same formula, described above. Therefore, the amount of CERT-tainted loss apportioned to each member would the same, regardless of the ordering.

However, we do note the necessity of apportioning the CERT-tainted loss to specific group members (rather than treating it simply as a carryover to future years) when separate return carryback years exist. In particular, failure to apportion the CERT-tainted loss would be untenable where the CERT-tainted loss was incurred in the 2 years following the CERT.[6] Under those facts, the CERT-tainted loss would be eligible for carryback to the year of the CERT and any later year, although not to years preceding the year of the CERT. See §172(b)(1)(E)(i). Because CERT-tainted loss might be deductible in some carryback years, apportionment would be necessary to ensure that the benefit of the carryback inured to the proper taxpayer.

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[6]CERT-tainted loss can only be in a “loss limitation year”. §172(b)(1)(E)(i)(II). A “loss limitation year” is the taxable year in which a CERT occurs and the 2 succeeding taxable years. §172(b)(1)(E)(ii).