Office of Chief Counsel
Internal Revenue Service
memorandum

Number: **201033031**
Release Date: 8/20/2010

CC:CORP:B04
POSTS-105004-09

Third Party Communication: None
Date of Communication: Not Applicable

UILC: 108.02-00

date: April 26, 2010

to:
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subject: Reduction of Member's Net Operating Loss under Section 108(b)(2)(A)

Issue

Where a member of a consolidated group has excluded discharge of indebtedness income during a consolidated return year preceding the adoption of §1.1502-28T, whether the net operating loss subject to reduction under section 108(b)(2)(A) is the entire CNOL of the group or an allocated portion of that CNOL.

Conclusion

Where a member of a consolidated group has excluded discharge of indebtedness income during a consolidated return year preceding the adoption of §1.1502-28T, the net operating loss subject to reduction under section 108(b)(2)(A) is the entire CNOL of the group.

Law and Analysis

Attribute Reduction in General

Section 61(a)(12) generally requires a taxpayer to include in gross income any income from the discharge of indebtedness (COD). Section 108(a)(1)(A) permits a taxpayer to exclude COD income from gross income if the discharge occurs in a title 11 case. Under section 108(b)(1), the amount of COD income excluded from gross income under section 108(a)(1)(A) must be "applied to reduce the tax attributes of the taxpayer"

as provided in section 108(b)(2). Section 108(b)(2) lists the tax attributes that are subject to reduction and the order in which those attributes must be reduced. Absent an election under section 108(b)(5), the taxpayer must first reduce any net operating loss (NOL) for the taxable year of the discharge and any NOL carryover to such taxable year. Section 108(b)(2)(A).

IRS Position

The Service acknowledges that the reference to "the taxpayer" in section 108(b)(1) refers to the consolidated group member with excluded COD income (Debtor-Member) rather than the entire group. The sole issue in this case is the determination of the Debtor-Member's NOL, which is the item subject to reduction under section 108(b)(2)(A).

Under §1.1502-80, the Code or other law applies to the group to the extent the regulations do not exclude its application. Ordinarily, a corporation that is not a member of a consolidated group computes its NOL on a stand-alone basis. Therefore, where a corporation with excluded COD is not a member of a consolidated group, the NOL to be reduced is clear.

However, the consolidated return regulations change the computation of the NOL of a member of a consolidated group. Neither the Code nor the consolidated return regulations provide a generally applicable definition of a separate NOL for a member of a consolidated group. United Dominion Indus., Inc. v. United States, 532 U.S. 822, 829 (2001). Instead, a member's losses and deductions arising during a consolidated return year are included in the computation of the entire group's consolidated taxable income (CTI) or consolidated net operating loss (CNOL) for that year. See §§1.1502-11(a) and 1.1502-21(e). No specific portion of the CNOL is allocated to any particular member of the group for its use during consolidated return years. Rather, each member has the ability to offset its income with NOL generated by the operations of all members of the group during a consolidated return year. See §1.1502-11(a). However, §1.1502-21(b)(2) specifically provides that, if a member leaves the consolidated group, a portion of the remaining CNOL is allocated and apportioned to that member for its use in later separate return years.[1] Section 1.1502-21(b)(2) also applies to apportion the CNOL to various members for purposes of carrying back loss to pre-consolidation separate return years. In either case, in the years at issue, the regulation authorized allocation only for the purpose of carrying losses forward and backward into separate return years.

[1] Section 1.1502-21(b)(2)(i) provides:

> If any CNOL that is attributable to a member 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. * * *

During the period at issue, certain other consolidated provisions required the application of the principles of §1.1502-21(b)(2) to apportion the CNOL to various members for particular purposes. However, there was no such apportionment rule for purposes of implementing attribute reduction under section 108(b)(2).[2]

The status of a CNOL as a group attribute that is generally not apportioned among members was central to the Supreme Court's analysis in United Dominion. In that case, the Supreme Court considered the proper method for computing a consolidated group's product liability loss (PLL) eligible for the ten-year carryback period under former section 172(b)(1)(I).[3] For purposes of that provision, a PLL was defined as the lesser of (a) the taxpayer's NOL for the year or (b) its allowable deductions attributable to product liability expenses (PLEs). Section 172(j)(1) of the 1954 Code.

In each consolidated return year at issue in United Dominion, the consolidated group reported a CNOL that exceeded its members' aggregate PLEs. In addition, certain members with PLEs had positive separate taxable income (rather than negative) for each taxable year. Thus, the proper computation of the group's PLL eligible for ten-year carryback depended upon whether the comparison of PLEs to NOL for each taxable year was made on a consolidated basis (i.e., by comparing the CNOL to the group's aggregate PLEs) or on a separate-entity basis (i.e., by comparing a separate loss of each member to that member's PLEs, and then aggregating the resulting amounts).

In considering this issue, the Supreme Court closely analyzed the sections of the consolidated return regulations that govern the computation of the group's CTI and CNOL. The Supreme Court summarized the pertinent rules as follows:

> Under Treas. Reg. §§1.1502-11(a) and 1.1502-21(f), an affiliated group's "consolidated taxable income" (CTI), or, alternatively, its "consolidated net operating loss" (CNOL), is determined by "taking into account" several items. The first is the "separate taxable income" (STI) of each group member. A member's STI (whether positive or negative) is computed as though the member were a separate corporation (i.e., by netting income and expenses), but subject to several important "modifications." Treas. Reg. §1.1502-12. These modifications require a group member calculating its STI to disregard, among other items, its capital gains and losses, charitable-contribution deductions, and dividends-received deductions. Ibid. These excluded items are accounted for on a consolidated basis, that is, they are

[2] See, e.g., §§1.1502-42(e)(4) and 1.1502-47(m)(3)(vi).

[3] This provision was contained in the Internal Revenue Code of 1954, and was the predecessor to section 172(b)(1)(C) of the current Code.

> combined at the level of the group filing the single return, where deductions otherwise attributable to one member (say, for a charitable contribution) can offset income received by another (from a capital gain, for example). Treas. Reg. §§1.1502-11(a)(3)-(8); 1.1502-21(f)(2) to (6). A consolidated group's CTI, or CNOL, therefore, is the sum of each member's STI, plus or minus a handful of items considered on a consolidated basis. [United Dominion, 532 U.S. at 826.]

The government argued that the group's PLL should be determined on a separate-member basis by comparing each member's separate net loss to that member's PLEs and then aggregating the members' PLLs. The government further argued that a member's negative STI under §1.1502-12 was analogous to a separate NOL, and thus, a member's PLL would equal its PLEs limited to the amount of its negative STI. As a result, a member with positive STI could have no PLL.

The Supreme Court rejected negative STI as a measure of separate NOL for purposes of determining a member's PLL because the calculation of STI excludes several items that a consolidated group takes into account only at the consolidated level (i.e., capital gains and losses, charitable-contribution deductions, and dividends-received deductions). Id. at 831-832 (citing §§1.1502-12(j) to (n)).

Furthermore, the Court examined the rule of §1.1502-79(a)(3) (currently designated as §1.1502-79A(a)(3) and substantively identical to the §1.1502-21(b) regulation herein at issue), which allocates portions of the CNOL to members for the purpose of carrying losses to separate return years. The Court concluded that this rule applies only for the specific purpose of establishing carryover and carryback amounts of NOL. Because no carrybacks to separate return years were at issue, the Court concluded that §1.1502-79(a)(3) did not apply to provide a measure of separate NOL for purposes of computing the group's PLL on a separate-entity basis. Id. at 833. In addition, because there existed no consolidated return rule that otherwise allocated and apportioned the CNOL to specific members of the group with regard to the matter at hand, the Court concluded that the CNOL could not be "unbaked" into separate NOLs for particular members.[4]

The Supreme Court emphasized that "the Code and regulations governing affiliated groups of corporations filing consolidated returns provide only one definition of NOL: 'consolidated' NOL . . . ." Id. at 829. The Supreme Court further held that no definition of separate NOL exists for a member of a consolidated group. Id. Specifically, the Supreme Court stated:

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[4] Id. (stating, "[s]ection 1.1502-79(a)(3) unbakes the cake for only one reason, and that reason has no application here.").

> Indeed, the fact that Treasury Regulations do provide a measure of separate NOL in a different context, for an affiliated corporation as to any year in which it filed a separate return . . . underscores the absence of such a measure for an affiliated corporation filing as a group member. Given this apparently exclusive definition of NOL as CNOL in the instance of affiliated entities with a consolidated return . . . we think it is fair to say, as United Dominion says [in its brief], that the concept of separate NOL "simply does not exist." [Id. at 829-830 (Emphasis added).]

In the current case, the government has applied section 108(b) and §1.1502-21(b) consistently with the Supreme Court's interpretation of the precursor to §1.1502-21(b) in United Dominion. Neither the Code nor the consolidated return regulations allocate and apportion the CNOL to a group member for purposes of reducing attributes under section 108(b)(2)(A). Thus, for periods before the adoption of §1.1502-28T, application of section 108(b)(2)(A) and the consolidated return regulations require that the entire CNOL of the consolidated group is treated as the NOL of the member with excluded COD income.

Taxpayer's Position

The Taxpayer argues that section 108(b)(2)(A) requires the reduction of only the portion of the CNOL that would be attributable to the Debtor-Member under an application of the allocation rules of §1.1502-21(b). In support of its position, the Taxpayer criticizes the government's reliance on the Supreme Court's decision in United Dominion. The Taxpayer argues that, because, for the years at issue, there were no consolidated return regulations that specifically addressed the application of section 108(b)(2)(A) within a consolidated group, there are no rules in place to govern the issue of identifying the NOL of each Debtor-Member of the group. Therefore, the Taxpayer argues that it may apportion the CNOL to the Debtor-Members for purposes of reduction under section 108(b)(2)(A).

United Dominion

The Taxpayer criticizes the Service's reliance on the Supreme Court's opinion in United Dominion for its position that section 108(b)(2)(A) requires reduction of the entire CNOL. The Taxpayer alleges that the Service misapplies United Dominion and overstates its impact on the issue at hand:

> There is no support for the view that another court would hold for the government on the basis of United Dominion when the government in our case has similarly failed to change its 1966 regulations following the 1980 enactment of section 108. On the contrary, it would be consistent with the

> "principle" or "rationale" of United Dominion for a court to penalize the government for failing to address this issue through regulations by similarly ruling in the taxpayer's favor. [Taxpayer's submission at 12 (Emphasis in original).]

The Taxpayer asserts that the Supreme Court in United Dominion "held for the taxpayer on the basis that the government had not modified its consolidated return regulations to determine a 'separate member' NOL for product liability purposes under section 172." Id. The Taxpayer also asserts that the issue addressed by the Court in United Dominion was limited to the computation of the ten-year carryback of PLL under a prior version of section 172 and that that provision is entirely unrelated to section 108(b).

The Taxpayer evidently reads United Dominion not as a case about whether, outside the separate return context, consolidated group members have NOLs separate from the CNOL of the group, but as a case in which the Supreme Court punished the government for not timely conforming its consolidated return regulations following the enactment of the Bankruptcy Tax Act of 1980. In other words, the Taxpayer essentially concedes that in the present case, in deference to United Dominion, a court might rule that section 108(b) mandates a reduction in the group's CNOL, but only if the litigating positions were reversed and the Taxpayer that was the one seeking that result.

The Taxpayer's position is baseless. First, the Supreme Court held against the government in United Dominion because the government attempted to argue against its regulations that were in place during the period at issue.[5] The government attempted to extend the application of the CNOL allocation rules beyond their stated purpose. Second, as discussed below, the analysis in United Dominion is not limited to the PLL context. Rather, the Court analyzed the consolidated net operating loss regulations in a general and broadly applicable manner. Its decision regarding the meaning of those regulations is clearly applicable in this case.

United Dominion concerned the application of the PLL rules within a consolidated group. A central and necessary legal determination in the case was whether separate NOLs existed for individual members of the group where there was no specific rule providing for a separate-member computation. Although the ultimate issue in United Dominion was the method for calculating a consolidated group's PLL, the critical reasoning in the opinion concerns whether the consolidated return regulations provide a

[5] The Supreme Court's holding in United Dominion was based on the text of the consolidated return regulations in effect during the years in issue and was not based on the government's failure to amend these regulations following Congress' enactment of the PLL rules. Although the Court does state that, "[t]he Treasury's relaxed approach to amending its regulations to track Code changes is well documented," United Dominion at 836, there is no indication in the opinion that its decision was intended to penalize the government or that, in future cases, the consolidated return regulations should be interpreted in a way that favors taxpayers over the government.

measure of separate-member NOL in any context other than the separate return context.[6] Virtually the entire analysis by the Court in United Dominion focuses on this issue. As a result of this analysis, the Supreme Court reversed the decision of the Court of Appeals for the Fourth Circuit, which had used §1.1502-21(b)(2) to apportion the CNOL in the PLL context. According to the Supreme Court, the Fourth Circuit had "applied concepts addressing separate return years to a determination for a consolidated return year, without any statutory or regulatory basis for doing so." Id. at 833.

Although the current case involves the application of section 108(b)(2)(A), rather than section 172, the central issue is the same as in United Dominion: whether the consolidated return regulations provide a measure of separate-member NOL. As discussed above, in United Dominion, the Supreme Court concluded that a group member does not have a separate NOL for a consolidated return year except where a specific consolidated return regulation allocates and apportions a part of the CNOL to that member. In this case, the Taxpayer appears to concede that no such allocation rule exists. Thus, the CNOL must be the pertinent NOL available for reduction under section 108(b)(2)(A).

Additional Case Law

The Taxpayer cites two cases as limiting the holding of United Dominion to the section 172(f) arena. However, neither of those cases so limits United Dominion. Further, neither case addresses the core issue of whether a CNOL can be apportioned among members of a group absent a rule in the consolidated return regulations allowing such apportionment.

The Taxpayer cites Temple-Inland, Inc. v. United States, 68 Fed. Cl. 561 (2005), a contract case concerning the damages resulting from the government's breach of an acquisition agreement under which a consolidated group acquired three failing thrifts. The damages included the value of lost income tax deductions caused by the government's enactment of legislation that eliminated the tax benefits associated with the thrift acquisition agreement. After an examination of the group's tax returns for the years at issue, the taxpayer and the IRS entered into a closing agreement which included an agreed-upon amount for the taxpayer's bad debt deductions for such taxable years.

Following the execution of the closing agreement, the government disagreed with the plaintiff taxpayer's computation of lost deductions. The government's argument was based on the assertion that the group's consolidated tax attributes should have been reduced under section 108(b). The government's expert relied on United Dominion and

[6] Because PLL was limited to the amount of the taxpayer's NOL, the Supreme Court stated, "[t]he first step in applying the definition and methodology of PLL to a taxpayer filing a consolidated return thus requires the calculation of NOL." United Dominion, 532 U.S. at 829.

testified that the law for the years at issue (1991 and 1992) required reduction of the CNOL.

The court held for the taxpayer in Temple-Inland. However, the ruling had nothing to do with the application of section 108(b)(2)(A) to a member of a consolidated group. Rather, the court held for the taxpayer on the basis of the finality of the closing agreement executed by the IRS and the taxpayer. That closing agreement specifically provided that attribute reduction would be limited to the tax attributes that were generated by the insolvent Debtor-Members. The court stated:

> We deem it unnecessary to determine whether the 2003 regulation merely discovered the correct state of the law or in fact created new law. [The taxpayer] is entitled to base its present claim on the state of its closed tax returns. It is entitled at this point to a heavy presumption of correctness . . . . It is entitled to present its claim on the assumption that the closing agreement is final, and that another executive agency, in this case, the Department of Justice, will not attempt to unscramble it. [Id. at 569 (Emphasis added).]

The Taxpayer also cites Brunswick Corp. v. United States, No. 07C3792, 2008 U.S. Dist. LEXIS 103136 (N.D. Ill. Dec. 21, 2008), in an attempt to support its argument that United Dominion should be limited to section 172(f) cases. The taxpayer in Brunswick cited United Dominion in a misguided attempt to support its argument that depreciation deductions to be claimed on a consolidated return should be computed on a consolidated group basis rather than a separate-entity basis.[7]

The court rejected the taxpayer's reliance on United Dominion as overbroad, and stated:

> The court disagrees with the suggestion that this holding [in United Dominion] means that the policies underlying the

[7] Brunswick, the parent of a consolidated group and a calendar-year taxpayer, purchased in December of 1986 all of the stock of two separate corporate groups. Brunswick made elections under § 338 for each stock purchase. The issue was whether the short taxable year rule applied to determine the acquired subsidiaries' depreciation deductions for the portion of the 1986 taxable year during which they were members of Brunswick's consolidated group. The short taxable year rule limited a taxpayer's annual depreciation deduction in a taxable year that was less than 12 months to a pro rata portion of such deduction based on the number of months in such taxable year. Because Brunswick acquired the stock in December, application of the short taxable year rule substantially reduced the amount of the subsidiaries' depreciation deductions otherwise allowable.

Brunswick contended that the depreciation deductions should be computed based on Brunswick's full taxable year, and thus, the short taxable year rule did not apply because it did not have a short taxable year.

> consolidated return system requires [sic] that all tax items be considered at the consolidated group level, not the subsidiary level. [Brunswick, 2008 U.S. Dist. LEXIS 103136, at *26.]

As part of its rejection of the taxpayer's argument in Brunswick, the court emphasized that the Supreme Court in United Dominion resolved the issue of whether NOLs associated with PLL were determined at the consolidated or subsidiary level by examining the definition of CNOL in the Code and regulations. Id. The court further noted that, in doing so, the Supreme Court considered §§1.1502-11(a) and 1.1502-21(f) and held that "net operating losses had to be accounted for at the consolidated return level, as opposed to the subsidiary level, because the only definition of net operating loss in the code and regulations was for a consolidated net operating loss." Id. at *27-28 [Emphasis added.] The court next stated:

> United Dominion thus does not stand for the blanket proposition that depreciation is determined at the consolidated return level. Instead, it teaches that courts considering whether to look at the consolidated return level or the subsidiary level should look to the applicable IRC provisions and regulations. [Id. at *28 (Emphasis added).]

Accordingly, the court in Brunswick considered the applicable consolidated return regulations in deciding whether the acquired subsidiaries' depreciation deductions should be computed at the consolidated or subsidiary level. Although there are no consolidated return regulations that expressly direct the calculation of depreciation deductions, the court found that the general computations provided for in §§1.1502-12 and 1.1502-11(a)(1) control the analysis. Under those general rules, individual taxable income items are computed at the member level, rather than on a consolidated level, subject to stated exceptions.

The court's analysis in Brunswick supports the government's interpretation of section 108(b)(2)(A) in the current case. The reasoning of the Brunswick court was controlled by the general consolidated return regulations with regard to the computation of taxable income in the absence of a specific rule addressing the calculation of depreciation within a consolidated group. Under the more general regulations, individual taxable income items are accounted for at the separate-entity level, subject to stated exceptions. Similarly, in the current case for the years at issue, no statute or regulation specifically addressed the application of section 108(b)(2) within a consolidated group. However, the more general consolidated return regulations provide controlling authority. Under those consolidated return regulations, the only NOL constructed and in existence within a consolidated group is the CNOL, subject to stated exceptions. Accordingly, due to the absence of an applicable exception, the NOL for purposes of reduction under section 108(b)(2)(A) must be the CNOL.

Taxpayer's Statutory Construction Argument

The Taxpayer states that "[t]he NOPA's position cannot be supported by the statute, the legislative history or the rules of statutory construction." Taxpayer's submission at 18. In addition, the Taxpayer argues that the CNOL cannot be considered an attribute of each member of a consolidated group. Taxpayer's submission at 17-18.

Although the Taxpayer argues that the government's position is unsupportable, the Taxpayer does not support in any way its failure to take into account the rules provided in §§1.1502-11(a) and 1.1502-12, which govern the computation of the CNOL. Further, the Taxpayer fails to support on legal grounds its use of §1.1502-21(b) to allocate the CNOL – an action that the Supreme Court specifically prohibited in United Dominion. The Taxpayer makes no attempt to refute the logic of the Supreme Court's directive in United Dominion as to the operation and meaning of these regulations.[8] Rather, the Taxpayer baldly claims that the Supreme Court's pronouncements regarding the status of the CNOL within a consolidated group do not apply.[9]

Taxpayer appears to assert that the text of section 108(b)(2) is clear on its face, and requires that only an allocated portion of the CNOL be reduced. Taxpayer's submission at 19-20. In support of its claim, the Taxpayer cites The Limited, Inc. v. Comm., 286 F.3d 324 (6th Cir. 2002), for the rule of statutory construction that requires a statute to be interpreted by assigning an ordinary and natural meaning to an undefined term. This citation of The Limited appears to actually support a point not at issue – whether only the NOL of the Debtor-Member is exposed to attribute reduction under section 108(b)(2)(A). In any case, the Taxpayer's reliance on The Limited is flawed. In The Limited, the term at issue was "bank", which was not specifically defined in the provision at issue. However, in this case, that "ordinary meaning" rule of statutory construction does not apply because the term at issue, NOL, is expressly treated in the consolidated return regulations. As the Supreme Court held in United Dominion, under the consolidated return regulations, the CNOL is not apportioned and allocated to a member except as specifically provided by the regulations. Therefore, absent such a special allocation rule, the only NOL is the CNOL.

The Taxpayer further states that it "is completely puzzling how the logic of the NOPA could support an assertion that a particular member may exclude COD income under section 108(a) but other members of the consolidated group must have their

[8] Further, the Taxpayer does not contend that the consolidated return regulations applicable in this case are different in any material way from those at issue in United Dominion.

[9] The taxpayer's justification for disregarding the holding of United Dominion is that the opinion "cannot be used to change the words of a statute, or to otherwise put a gloss on what Congress intended 21 years earlier when it enacted section 108(b)." However, putting a gloss on the intentions of Congress and construing its enactments are among the Supreme Court's main jobs, and this fact does not depend on how clear a litigant believes the statute in question happens to be.

share of the CNOL reduced under section 108(b)." Taxpayer's submission at 19. In its apparent amazement with the government's position, the Taxpayer fails to consider that the consolidated return rules generally provide for the sharing of tax attributes by members of a consolidated group.[10] Under the regulations, the CNOL is a tax attribute that is fully available to each and every member of a consolidated group. The portion of the CNOL that might be economically traced to a particular member's operations is not made available specifically or exclusively to that member.[11] Rather, each member can use the CNOL to offset its income and reduce its several liability for the tax of the entire group under §1.1502-6[12].

Because the group's income or loss computation is applied on a consolidated basis, any income of the group – including COD income of any member – could be offset by application of the entire CNOL. In fact, there is no question that non-excluded COD income of any member of the group could be offset by the entire CNOL; not only by the portion of the CNOL that is "allocable" to the member that incurred the COD. Thus, the offset of the CNOL against excluded COD income should be hardly a novel idea.[13]

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[10] This sharing of attributes is widely regarded as the most attractive feature of the consolidated return regulations. See Dubroff, et al., Federal Income Taxation of Corporations Filing Consolidated Returns, § 1.01 (stating, "[t]he ability to offset one member's losses against another member's income may be the single most important feature of filing on a consolidated basis.").

[11] Section 1.1502-12 provides that a member=s separate taxable income (STI), whether positive or negative, is computed as though the member were determining its taxable income under the Code as a corporation filing a separate return, subject to several modifications. In particular, STI does not include the items, including NOL deductions, that are taken into account on a consolidated basis under §1.1502-11(a). See §1.1502-12(h) and (j) to (n). Under §1.1502-11(a), a consolidated group's CTI (or CNOL) for a consolidated return year is determined by taking into account each member's STI (or loss) plus a number of items that are determined on a consolidated basis, including any CNOL deduction. In other words, the losses that constitute the CNOL for a consolidated return year are carried to other consolidated return years only on a consolidated basis and deducted by the group as part of the CNOL deduction under §1.1502-11(a). They are not made available specifically or exclusively to the member that generated them.

[12] Section 1.1502-6 provides that the common parent and each subsidiary that was a member of the consolidated group during any part of a consolidated return year are severally liable for the tax of the entire group for such year.

[13] See Deborah L. Paul, United Dominion: Implications for Attribute Reduction, 95 Tax Notes 262 (Apr. 9, 2002) (concluding, in light of United Dominion, that the entire CNOL is the NOL of the Debtor-Member); Lee Sheppard, Consolidated Returns, The Courts, and Insolvent Subsidiaries, 2002 TNT 35-2 (Feb. 20, 2002) (reporting discussions of the NYSBA in which panelists concluded that the entire CNOL should be the NOL of the Debtor-Member).

In a related argument, the Taxpayer argues:

> The NOPA fails to address the determinative question of how the CNOL should be considered a tax attribute "of the taxpayer" within the literal language of section 108(b). * * * Admittedly, the CNOL is the only NOL for the consolidated group. But the NOPA's position would require that the entire CNOL of the consolidated group be treated in full as a tax attribute of each of the separate

In making its statutory/regulatory construction argument, the Taxpayer points to certain examples in consolidated return regulations issued in 1994 under §§1.1502-19 and 1.1502-32. The Taxpayer argues that the language used in those examples "strongly suggests" that only an allocated share of the CNOL (rather than the entire CNOL) is reduced under section 108(a)(1)(A). Needless to say, no consolidated return regulations nor any other official guidance issued by the Service prior to the United Dominion opinion specifically addresses section 108(b) attribute reduction resulting from the exclusion of income by a member of a consolidated group. Further, §§1.1502-11(a), 1.1502-12, and 1.1502-21(b) are the regulatory provisions that control the construction, definition, and allocation of a CNOL. Examples cannot change the meaning of a rule contained in regulatory text. This is particularly true where the examples at issue were promulgated under a regulatory section that is merely ancillary to the rule at issue.

Legislative History of Section 108(b)

The Taxpayer has accused the government of placing undue emphasis on the legislative history of section 108(b). Taxpayer's submission at 20. At the same time, the Taxpayer claims that the government's analysis "makes no attempt to discern whether Congress in 1980 intended to require a reduction of the debtor-member's group CNOL". Id. at 8. As demonstrated above, the government's rationale and conclusion are based on the interaction of section 108(b) and the consolidated return regulations, as they existed at the time of the excluded COD income. That being said, the required application of those regulations to a member of a consolidated group does indeed comport well with the stated intent behind the enactment of section 108(b).

The legislative history of section 108(b) does not include any specific indication of legislative intent with regard to application to consolidated groups. Therefore, the best method of determining the intent of Congress is to examine the general purpose of the provision in question.

> members of the group. There is nothing in the Code provisions or Treasury regulations—nor, for that matter, anything that can be taken from the United Dominion [sic]—that provides that the consolidated group's CNOL is also a tax attribute of each individual member of the group. [Taxpayer's submission at 18.]

As discussed above, each member has access to the full amount of the group's NOL, and may offset its income items against that CNOL. Therefore, the interpretation of the consolidated return regulations most in line with their ordinary operation supports treating the full amount of the CNOL as an attribute of the Debtor-Member. The alternatives are: (1) apportioning the CNOL in contravention of Supreme Court authority, or (2) treating all members of a consolidated group as having no attributes except stock basis. For reasons previously discussed at length, the first alternative is unacceptable. The second alternative would lead to the absurd result of giving group members the benefit of COD exclusion under section 108(a) without the clearly intended corresponding attribute offset under section 108(b). See, e.g., Abbott Laboratories v. United States, 84 Fed. Cl. 96, 107 (2008), citing Kelly v. United States, 826 F.2d 1049, 1052-53 (Fed. Cir. 1987) ("Statutes and regulations must be construed to avoid absurd and whimsical results, unrelated to congressional purpose.").

For debtors in bankruptcy, Congress intended the current version of section 108 "to preserve the debtor's 'fresh start' after bankruptcy" by excluding from the debtor's gross income any COD income realized by the debtor in bankruptcy. See S. Rep. No. 1035, 96th Cong., 2d Sess. 9-10 (1980). At the same time, Congress enacted the attribute-reduction rules to ensure that the tax associated with excluded COD income was eventually collected within a reasonable period. Id. at 10. Thus, section 108 merely defers the recognition of COD income by making the debtor's tax attributes unavailable to offset income in later years. The purpose of the section is not to give a wholesale permanent tax benefit to a taxpayer with excluded COD income.

The exclusion of a member's COD income from gross income under section 108(a)(1) reduces the CTI of the entire group for the consolidated return year during which the member realizes COD income under section 61(a)(12). Because attribute reduction is a substitute for income inclusion in the year of the discharge, the deferral policy of section 108 is served by reducing the tax attributes that are available to reduce the group's CTI, and hence, the consolidated tax liability in future consolidated return years. Under the principles of section 172, a consolidated group may carry forward a CNOL of the group to offset CTI in future years.[14] As discussed above, the entire CNOL is available to offset the income generated by any member. Therefore, the entire CNOL should be available to offset the excluded COD income that stands in the place of taxable income.[15]

Taxpayer's Section 1017 Argument

The Taxpayer makes a specific legislative intent argument based on the enactment of section 1017(b)(3)(D) by the Bankruptcy Tax Act of 1980. Section 1017(b)(3)(D) provides a specific rule in the context of the election under section 108(b)(5), which offers a taxpayer the opportunity to reduce the basis of its depreciable property before reducing its other tax attributes. Under section 1017(b)(3)(D), the stock of a member of a consolidated group is treated as depreciable property to the extent the subsidiary consents to a corresponding reduction in the basis of its depreciable property. The Taxpayer argues that the existence of section 1017(b)(3)(D) indicates that the statute invoked consolidated treatment where Congress intended such treatment. The Taxpayer's position appears to be that the existence of section 1017(b)(3)(D), as the sole statutory mention of consolidated treatment, means that Congress intended all other attribute reduction rules to apply at a separate-entity level. See Taxpayer's submission at 19.

[14] Sections 1.1502-21(b) and 1.1502-21A(b).

[15] Because each member of a consolidated group is severally liable for the tax of the entire group, the CNOL deduction reduces each member=s tax liability without regard to that member=s contribution to the CNOL deduction. See §§1.1502-6, 1.1502-11(a)(2), and §1.1502-21(a).

The fact that Congress enacted a special rule in section 1017(b)(3)(D) for consolidated groups is not instructive as to what it intended under section 108(b)(2)(A). Section 1017(b)(3)(D) permits debtors that are members of a consolidated group to elect a treatment that is not otherwise imposed by the statute or regulations. Section 1017(b)(3) applies only for purposes of reducing basis in depreciable property, but subsidiary stock is not depreciable property. Section 1017(b)(3)(D) allows members of a consolidated group to elect to treat subsidiary stock as depreciable property, but only if the subsidiary consents to a corresponding reduction in the basis of its depreciable property. Such consolidated treatment can only be accomplished by a specific rule in the statute because asset basis is not otherwise a consolidated tax attribute.[16]

In contrast, a specific consolidated return rule is not required to reduce the CNOL under section 108(b)(2)(A) when a member of a consolidated group has excluded COD income because the consolidated return regulations clearly provide that the CNOL, as well as many other tax attributes, is computed and applied on a consolidated basis. Of course, Congress is presumed to understand the existing law when it enacts a statute. See, e.g., Goodyear Atomic Corp. v. Miller, 486 U.S. 174, 184-185 (1988) ("We generally presume that Congress is knowledgeable about existing law pertinent to the legislation it enacts."), citing Director, OWCP v. Perini North River Associates, 459 U.S. 297, 319-320 (1983). Congress enacted section 108(b)(2) against a backdrop of established consolidated return regulations. At the time of the enactment of the Bankruptcy Tax Act of 1980, the consolidated return regulations provided that the only NOL that a consolidated group member could have from a consolidated return year was the CNOL. If Congress had intended for section 108(b)(2)(A) to be applied to group members by reducing an NOL determined at the separate-member level, it would have enacted a specific rule to allocate and apportion the CNOL to such members for that purpose.

The Law Applicable to

The Taxpayer argues that "[t]he NOPA fails to explain how a 'principle' or 'rationale' from a 2001 judicial decision is considered part of the 'law applicable to' within the meaning of section 172(e)." Taxpayer's submission at 23. Thus, the Taxpayer questions how the government may apply the Supreme Court's analysis and holding with regard to the meaning of the consolidated return regulations to the issue at hand.

What the Taxpayer refers to as merely a purported "principle" is in fact the chief holding of United Dominion and must be regarded as a controlling legal principle. As discussed above, the definition of the NOL of the Debtor-Member is the central question in this case. The Taxpayer takes the position that, in this case, the NOL subject to reduction under section 108(b)(2)(A) is the Debtor-Member's share of the CNOL determined by applying the allocation and apportionment rules of §1.1502-21(b). As

[16] See Brunswick, 2008 U.S. Dist. LEXIS 103136 (discussed above).

discussed above, the Taxpayer's position is unsupportable under the consolidated return regulations, which provide for the allocation and apportionment of the CNOL only under specified circumstances. In United Dominion, the Supreme Court expressly rejected the application of the allocation rule of §1.1502-21(b)(2) except under circumstances specifically sanctioned in the regulations. The Court held that, aside from those specified allocation and apportionment instances, the only NOL in a consolidated return is the CNOL. United Dominion, 532 U.S. at 829. In fact, the Court stated that "it is fair to say . . . that the concept of separate NOL 'simply does not exist.'" Id. at 830.

Thus, the Supreme Court in United Dominion provided the answer to the central question in this case. However, the Taxpayer argues that the Supreme Court's jurisdiction on this point should not be applied to years prior to the date of United Dominion. The Taxpayer argues that "the law applicable to" (the year in which the Debtor- Members realized excluded COD income) does not include the United Dominion decision.

The Taxpayer is incorrect. Supreme Court opinions generally have "full retroactive effect." See Harper v. Virginia Dept. of Taxation, 509 U.S. 86, 97 (1993) ("When this Court applies a rule of federal law to the parties before it, that rule is the controlling interpretation of federal law and must be given full retroactive effect in all cases still open on direct review and as to all events, regardless of whether such events predate or postdate our announcement of the rule."); see also Rivers v. Roadway Express, Inc., 511 U.S. 298, 311-12 (1994), citing United States v. Security Industrial Bank, 459 U.S. 70, 79 (1982) ("The principle that statutes operate only prospectively, while judicial decisions operate retrospectively, is familiar to every law student . . . ."); Kuhn v. Fairmont Coal Co., 215 U.S. 349, 372 (1910) ("Judicial decisions have had retrospective operation for near a thousand years.") (Holmes, J., dissenting); Hawknet, Ltd. v. Overseas Shipping Agencies, 590 F.3d 87, 91 (2d Cir. 2009), citing Harper v. Virginia Dept. of Taxation, 509 U.S. 86, 97 (1993); Mayberry v. United States, 151 F.3d 855, 860 (8th Cir. 1998) ("[A] judicial construction of a statute [by the Supreme Court] is an authoritative statement of what the statute meant before as well as after the decision of the case giving rise to that construction"); Texas v. United States, 497 F.3d 491, 515 (5th Cir. 2007) ("The Supreme Court does not create law, it discovers it . . . ."); Hemelt v. United States, 122 F.3d 204, 208 (4th Cir. 1997) (retroactively applying Supreme Court precedent regarding IRC section 104(a)(2)); Miller v. Comm., T.C. Memo 2001-55. Thus, the fact that the year in issue here is 1998 and that the United Dominion opinion was issued in 2001 is irrelevant. That is, "the law applicable to " includes the Supreme Court's interpretation of the consolidated return regulations in United Dominion.

The Taxpayer next argues that,

> Even if the holding in United Dominion is considered to have retroactive effect with respect to its interpretation of the ten-

> year NOL carryback rule in section 172(f), it is by no means clear that a "principle" or "rationale" from that decision would be considered part of the "applicable law" in 1998 for purposes of interpreting an entirely different Code section. [Taxpayer's submission at 24-25.]

The Taxpayer appears to argue that the "law applicable to" language that appears in section 172(e), which deals with the treatment of NOLs and NOL carryovers and carrybacks, somehow calls for a different, special analysis in this case. In support of its position, the Taxpayer cites Callanan Road Improvement Co. v. United States, 404 F.2d 1119 (2d Cir. 1968), a case in which substantive changes to the statute at issue resulted in different possible outcomes regarding the computation of an NOL.

Because of their impact across taxable years, the application of NOL carryovers and carrybacks may be complicated by changes in the statute, which occur over time. In fact, the government agrees with the Taxpayer that the identification of the NOL that is subject to reduction under section 108(b) must be made under the statute and regulations applicable to the year in which the COD income was excluded. However, in the present case, the Taxpayer does not dispute that the applicable consolidated return regulations in were in substance identical to those which the Supreme Court analyzed in United Dominion.[17] Because the applicable law in the current case has not changed, Callanan is irrelevant to the issue at hand. James B. Beam Distilling Co. v. Georgia, 501 U.S. 529, 534 (1991) ("It is only when the law changes in some respect that an assertion of nonretroactivity may be entertained . . . "); Hemelt v. United States, 122 F.3d 204, 208 (4th Cir. 1997).

As noted above, the government and the Taxpayer are in agreement about much in this case: that the "taxpayer" to which section 108(b) applies is the individual Debtor-Member; that only the NOL of that Debtor-Member is subject to reduction under section 108(b)(2)(A); and that the identification of the NOL that is subject to reduction under section 108(b)(2)(A) must be made under the law applicable to the year in which the COD income was excluded. The sole issue of contention is the definition of the NOL of the Debtor-Member. That question is squarely answered by the Supreme Court's decision in United Dominion. The Taxpayer is attempting to operate in a world in which United Dominion does not exist. In light of the Supreme Court's retroactivity jurisprudence discussed above, the Taxpayer's position must fail.

Taxpayer Asserts that its Position is Reasonable

[17] The Supreme Court in United Dominion analyzed the rules provided in §§1.1502-11(a) and 1.1502-12, which govern the computation of the group's CTI and CNOL, and stated that the only definition of NOL in the consolidated return regulations is the CNOL. Additionally, the Supreme Court examined the rule of §1.1502-79(a)(3) (currently designated as §1.1502-79A(a)(3) and substantively identical to §1.1502-21(b)), and concluded that this rule applies only for the specific purpose of establishing carryover and carryback amounts of NOL.

The Taxpayer in effect asserts that there was no governing regulation in existence during the period at issue, and thus, that its "reasonable" actions should prevail. The Taxpayer specifically argues, "[t]he government lost in United Dominion because it asserted a position that it could have addressed by amending its consolidated return regulations but failed to do so." Taxpayer's submission at 15. The Taxpayer is wrong. In United Dominion, the government lost because it took a position regarding the definition of NOL within a consolidated group that was contrary to the rule contained in the consolidated return regulations. In this case, it is the Taxpayer that is disregarding the definition of NOL that is contained in those regulations.[18]

In its submission, the Taxpayer provides no statutory or regulatory authority to support its use of §1.1502-21(b)(2) to apportion a part of the CNOL to individual Debtor-Members. As discussed above, the only NOL in a consolidated group is the CNOL, absent an apportionment rule that specifically allows for its division for a particular purpose.

In United Dominion, the Supreme Court was faced with the issue of whether the CNOL of a group should be used for the section 172(f) computation, or a "separate NOL" of an individual member. The Court found that a "separate NOL" cannot be used because such an item "simply does not exist." United Dominion, 532 U.S. at 830. In other words, the consolidated NOL regulation – the same regulation at issue herein – answered the question at hand. There were no regulations issued that specifically dealt with the application of section 172(f) to a consolidated group member, but the effect of section 172(f) in the consolidated context depended on the general consolidated NOL rules. The Court found the appropriate answer on the basis of those general consolidated NOL rules.

The rationale of United Dominion applies equally to the present case. The Taxpayer would like to create a "separate NOL" to be reduced under section 108(b)(2). It invokes Gottesman v. Comm., 77 T.C. 1149 (1981), and other authorities that allowed taxpayers to take "reasonable" action where the applicable law did not provide guidance on an issue. The Taxpayer argues that, because the government issued no regulations specifically applying section 108(b)(2) in a consolidated context in the year at issue, it is free to choose its own method. However, as discussed above, just as in United Dominion, the current case concerns the identification of the NOL within a consolidated group. The Taxpayer has chosen to apply an approach to the issue that is not only different from the binding precedent of United Dominion, but is an approach that was expressly rejected by the Supreme Court in that case. See Rivers v. Roadway Express,

[18] Throughout its submission, the Taxpayer accuses the government of attempting to retroactively apply single-entity principles to the application of the attribute reduction rules. However, as demonstrated above, the government's analysis is based exclusively on the statute and consolidated regulations in existence at the time of the COD.

Inc., 511 U.S. 298, 312 (1994) (explaining that, under our federal court system, the Supreme Court's interpretation of a statute is correct, and all other readings are wrong.)

In support of its argument that the use of the apportionment formula of §1.1502-21(b) to allocate the NOL is not "unreasonable," the Taxpayer notes that the regulations under §1.1502-28T (issued in 2003) incorporate an apportionment rule using the formula contained in the §1.1502-21(b) regulation.[19] Thus, the Taxpayer appears to argue that if it was reasonable for the government to amend a regulation to include a provision, it is reasonable for the Taxpayer to act as if a somewhat similar provision existed prior to the amendment, regardless of Supreme Court precedent. The Court in United Dominion held that the §1.1502-21(b) apportionment method can be used only where the consolidated return regulations specifically so indicate. The Court further stated that, to the extent that the government is unsatisfied with the answer provided by the current regulations, it is free to amend its regulations to change the prevailing answer. See United Dominion at 838. For cases involving the application of section 108(b)(2) beginning in 2003, the government did so. However, that prospective amendment does not change the impact of the law applicable to the year at issue herein.

Conclusion

The sole issue in this case is the definition of the "NOL" of the Debtor-Member. The Supreme Court's decision in United Dominion squarely answered this question by holding that the only NOL in a consolidated group is the CNOL, absent a specific regulation providing for apportionment for a specified purpose. The Taxpayer argues that the NOL of the Debtor-Members should be determined on a separate-entity basis. The Taxpayer applied §1.1502-21(b) to allocate the CNOL to the Debtor-Members for reduction under section 108(b)(2)(A). However, for the year at issue, there was no consolidated return regulation that allocated and apportioned the CNOL to a group member for attribute reduction purposes under section 108(b). Thus, the CNOL must be the pertinent NOL available for reduction under section 108(b)(2)(A). For the reasons discussed above, the CNOL is the NOL subject to reduction under section 108(b)(2)(A) and the consolidated return regulations when a member of a consolidated group realizes excluded COD income.

Procedural Matters

This Chief Counsel Advice responds to your request for assistance and may not be used or cited as precedent. The writing may contain privileged information. If disclosure is determined to be necessary, please contact this office for our views.

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[19] This apportionment is part of a hybrid single-entity methodology that first allocates attributes to particular members of a group, then reduces Debtor-Member specific attributes under section 108(b), but which ultimately exposes all group attributes (including the entire CNOL) to reduction under section 108(b). We note that, if the 2003 regulation had applied to this case, group attributes equivalent to the entire amount of the excluded COD income would have been reduced under section 108(b)(2).

Please call (202) 622-7530 if you have any further questions.

Sincerely,

_____

William D. Alexander
Associate Chief Counsel (Corporate)