**DEPARTMENT OF THE TREASURY**
**INTERNAL REVENUE SERVICE**
**WASHINGTON, D.C. 20224**

OFFICE OF
CHIEF COUNSEL

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MEMORANDUM FOR

FROM: Assistant Chief Counsel (Field Service) CC:DOM:FS

SUBJECT: Portion of Consolidated NOL Attributable to Specified Liability Losses

This memorandum responds to your memorandum dated February 16, 1999 requesting advice on the portion of a consolidated net operating loss ("CNOL") attributable to specified liability losses. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

S =
P =
Year 1 =
Year 2 =
$x =
$y =
$z =
$b =
$xx =
$yy =
$zz =
$bb=

FACTS

S is one of several subsidiaries of P. The affiliated group files consolidated returns. In Year 1, the group had a consolidated net operating loss ("CNOL") of $x. The

aggregate separate taxable losses for all loss members was $y. S had a separate taxable loss of $z, and specified liability ("SL") deductions of $b.

In Year 2, the group had a CNOL of $xx. The aggregate separate taxable losses for all loss members was $yy. S had a separate taxable loss of $zz, and SL deductions of $bb.

S was a member of the consolidated group in the loss year and all potential carryback years. Some group members whose income was reported in the consolidated return for the loss years filed separate returns in the potential carryback years.

ISSUE #1

Whether Norwest supports treating only a pro rata share of the SL deductions of a member having a separate net operating loss ("NOL") as contributing to the group's CNOL.

CONCLUSION #1

Norwest supports treating only a pro rata share of the SL deductions of a member having a separate NOL as contributing to the group's CNOL.

ISSUE #2

Where the member that generated the SL loss is a member of the consolidated group in both the loss years and the carryback years, whether the amount of separate member SL deductions that the member contributes to the CNOL can be carried back to separate return years of other group members.

CONCLUSION #2

Where the member that generated the SL loss is a member of the consolidated group in both the loss years and the carryback years, we agree that the amount of separate member SL deductions the member contributes to the CNOL cannot be carried back to separate return years of other group members.

DISCUSSION #1

In Intermet Corp. v. Commissioner, 111 T.C. 294 (December 8, 1998), the Tax Court addressed the issue of how to determine the amount of SL deductions under section 172(f) to be included in the group's CNOL, and thus eligible for 10-year carryback treatment under section 172(b)(1)(C). The government argued, based on Treas. Reg. §§ 1.1502-12 & -21(f), that a consolidated group member having SL deductions under section 172(f), but net positive separate taxable income under

Treas. Reg. §1.1502-12 contributes no amount of SL deductions to the group's CNOL. Instead, that member's SL deductions are exhausted against that member's gross income, and no amount of its SL deductions are available for 10-year loss carryback to any prior years of either that member or the group. The Tax Court agreed with the government.

Norwest Corporation and Subsidiaries v. Commissioner, 111 T.C. 105 (August 10, 1998), involved an issue closely analogous to that in Intermet, but involved another type of special section 172 special deduction -- i.e., bank bad debt deductions under section 172(b)(1)(L). Similar to the Intermet court, the Norwest court interpreted Treas. Reg. §§ 1.1502-12 and -21(f) as requiring a separate member stacking rule and NOL limitation (or "separate entity approach") in determining the 10-year carrybacks under section 172(b)(1)(L).[1] Under this stacking rule, a member's bank bad debt deductions are given priority over its non bank bad debt deductions by treating the non bank bad debt deductions as offsetting the member's income before its bank bad debt deductions, thereby preserving the member's bank bad debt deductions in its loss.

In applying this separate entity approach, the Norwest court essentially viewed each member as having a separate NOL. A member having net positive taxable income effectively had a zero separate NOL. That member contributed no deductions to the CNOL. However, a member having a separate NOL did contribute deductions to the CNOL. The greater the separate NOL of the member, the more deductions that member contributed to the CNOL.

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

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[1]Norwest involved section 172(l) bank bad debt losses, whereas Intermet involved section 172(f) SL losses. However, both types of losses are subject to special 10–year carryback rules involving similar stacking and NOL limitation rules.

The Norwest court concluded that each member having a separate NOL contributed a pro rata share of deductions to the CNOL. The pro rata share of SL deductions that each member, having a separate NOL, contributed to the CNOL was determined by multiplying: a.) the member's SL portion of its separate taxable loss, by b.) the ratio that the CNOL bore to the sum of the separate taxable losses of all members having separate taxable losses. The aggregate amount of the pro rata shares of all members having separate NOLs that incurred SL deductions comprised the total amount of SL losses of all the group members (i.e., members having separate NOLs, as well as other members) included in the CNOL. It is important to note that the Norwest court's approach did not limit the amount of the SL deductions (contributed by a member having a net separate loss) only to the portion of the CNOL attributable to that member. The court's opinion thus effectively offsets one member's income proportionately between another member's SL and non SL deductions.

In Norwest, the taxpayer argued (as the taxpayer in the Intermet case similarly argued) that the section 172 stacking rule and NOL limitation should be applied by essentially treating all group members as a single taxpayer ("single entity approach"). Under a single entity approach, all group members' deductions would be treated as contributing to the CNOL, to the extent any CNOL existed. The Norwest court clearly indicated that the section 172 stacking rule and NOL limitation, under which a single corporation's use of SL losses is maximized, is not to be construed as providing that an entire consolidated group is treated as a single corporation to thereby maximize the group's SL losses. To the contrary, the court applied a separate entity approach (member by member approach) and viewed any application of a single entity approach as inappropriate to determine the group's SL loss.

The consolidated return regulations arguably provide that a consolidated group does not determine its SL loss on a single entity basis. Treas. Reg. §§ 1.1502-12 & -21(f) specifically provide that, except for certain expressly provided consolidated items, a member determines its separate taxable income in accordance with the provisions of the Code covering the determination of the taxable income of separate corporations. In making this determination, a member uses its own separate methods of accounting (see Treas. Reg. §§ 1.1502-12(d) & -17). Under section 63(a) taxable income concepts, a member determines its gross income and deductions on a separate member basis for a current tax year. For a member having more gross income than deductions on a separate member basis for the year, the member's gross income absorbs its deductions, which are exhausted in that year. As a result, none of its deductions are available to be carried back by the group or by any member to any tax period, let alone a tax period 10 tax years preceding the tax year of the loss. For a member having more deductions than gross income on a separate member basis for the year, the member's income does not totally absorb its deductions. As a result, that member contributes deductions to the group's CNOL.

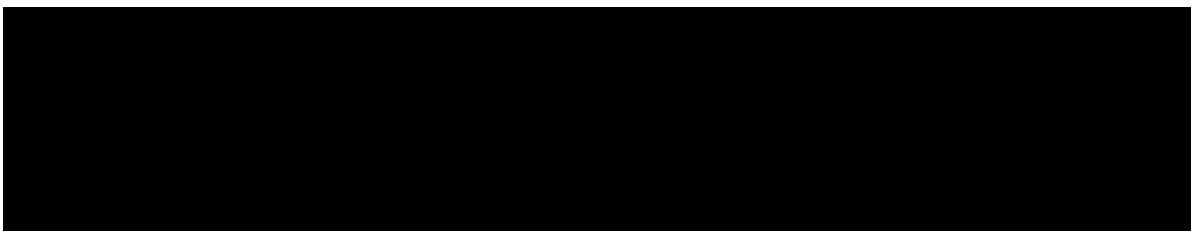
Although United Dominion Industries, Inc. v. United States, 98-2 USTC ¶50,527 (W.D. N.C. June 19, 1998) arguably provides contrary authority in this area, we believe the District Court's decision in United Dominion Industries is incorrect. United Dominion Industries is a case related to the Amtel case. In Amtel, a corporation had recently become affiliated with a group that had filed a consolidated return. The new member had SL deductions, but had separate taxable income, so no amount of the CNOL was apportioned to this member. Thus, such member was precluded from offsetting any of its income in any of its carryback years. This holding of the Amtel court reached a correct result. However, in the United Dominion Industries case, those same SL deductions of that same member were then effectively considered SL deductions of the group, i.e., of the other group members. The court thus allowed these SL deductions, which the court viewed as part of the CNOL, to become a loss carryback for a 10-year period to offset the income of the other group members. As a result, these other group members derived the benefit of these SL deductions even though these other group members did not generate the SL deductions, and even though the member that did generate these SL deductions was not in the group in the 10-year carryback period.

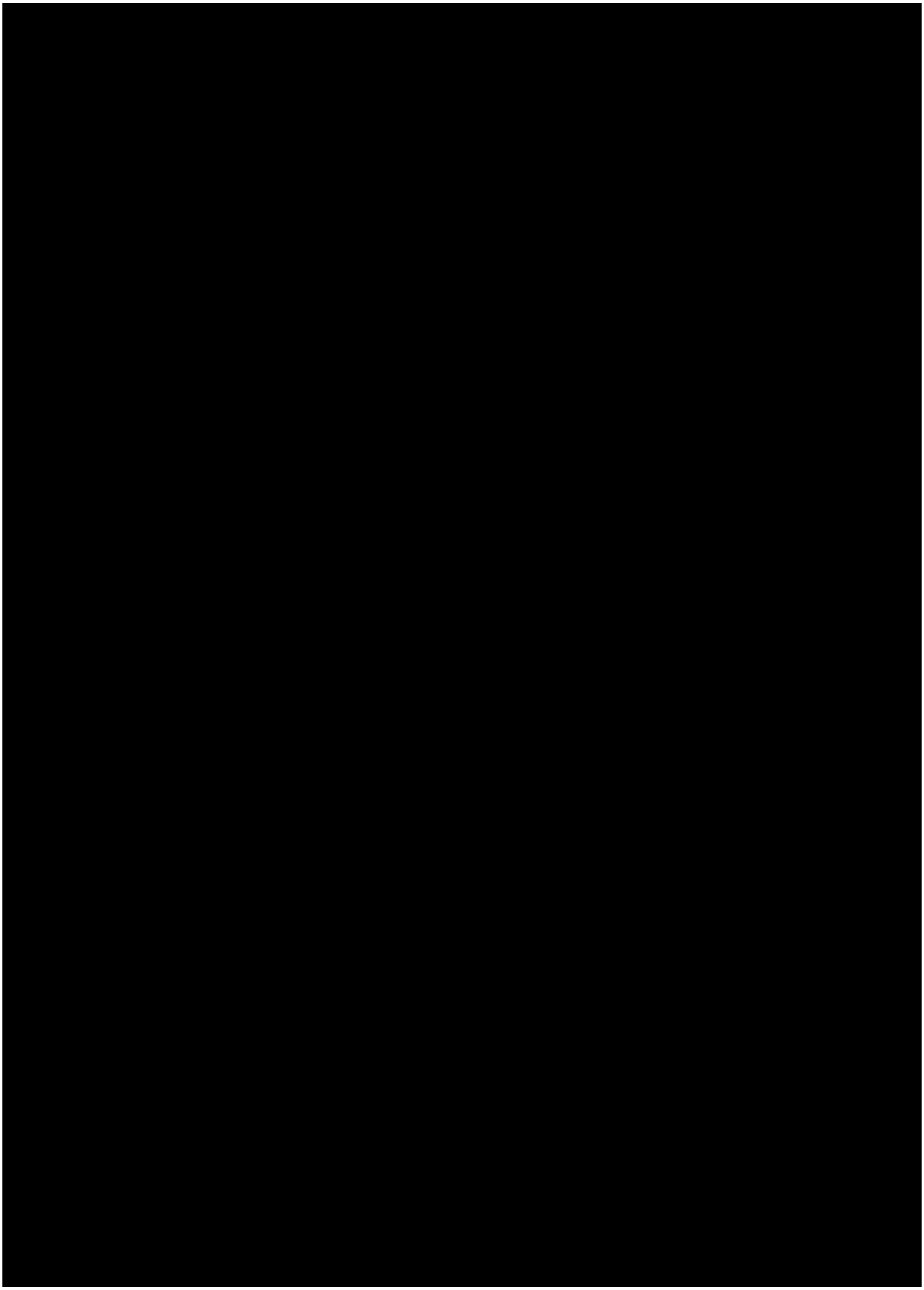
As discussed above, Intermet and Norwest support a position that only members having separate NOLs contribute SL deductions to the CNOL. Norwest supports the conclusion that the group's CNOL must be proportionately allocated between a member's SL and its non SL deductions to determine the portion of the CNOL comprised of the member's SL deductions.

DISCUSSION - ISSUE #2

We agree with you that where the member that generated the SL loss was a member of the consolidated group in both the loss years and the carryback years, the amount of the SL deductions that the member contributes to the CNOL which is included in the CNOL may be carried back to consolidated return years of the group. See Treas. Reg. § 1.1502-21(b) However, the SL deductions of that member cannot be carried to the separate return years of other group members. Only the portion of a CNOL attributable to a member under Treas. Reg. § 1.1502-79(a)(3) can be carried back to the separate return year of that member. Although United Dominion Industries may indicate otherwise, we believe the District Court's decision in United Dominion Industries is incorrect (see above).

CASE DEVELOPMENT





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If you have any questions, please call (202) 622-7930.

By: _____

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