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ARE SEPARATE LIABILITY LOSSES SEPARATE FOR CONSOLIDATED GROUPS?

*Don Leatherman**

This article considers how a consolidated group[1] should account for a separate liability loss ("SLL"),[2] a subject of continuing litigation between the government and taxpayers.[3] I conclude that a consolidated group should determine its SLL in the first instance as if it were a single entity, but that a member should use a separate-corporation approach in measuring how much of the group's SLL it may carry back to its separate-return year.[4]

The SLL is the portion of a net operating loss that is eligible for a ten-year, instead of the typical two-year, carryback.[5] The consolidated return regulations, which describe how the Code applies to a consolidated group, never mention SLLs, much less expressly describe how a consolidated group should compute an SLL or take it into account.

The regulations' silence forces courts, consolidated groups, and the Service to puzzle over how a group determines and uses its SLL.[6] More often than not, the debate has centered on a textual, rather than contextual, interpretation of regulatory language. This wooden approach invites a mind-numbing, desultory technical analysis that may overlook the fundamental principles embodied by the consolidated return regulations.

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[1]A consolidated group is a group of closely related "includible" corporations that elect to file a consolidated return. *See* I.R.C. §§ 1501 (providing election), 1504(a) (defining affiliated groups), 1504(b) (defining includible corporation to comprise most domestic corporations); *see also* Reg. § 1.1502-1(h) (defining consolidated group). One corporation, called the common parent, directly or indirectly owns a significant interest in the stock of each other group member. *See* I.R.C. § 1504(a)(1)(B)(i), (a)(2) (broadly requiring 80% ownership); *see also* I.R.C. § 1504(a)(4) (excluding non-voting, non-convertible, "pure vanilla" preferred stock from the 80% test). The other group members are called subsidiaries or subsidiary members. *See* Reg. § 1.1502-1(c).

[2]For a more complete description of SLLs, see *infra* pp. 671-73.

[3]*See, e.g.*, Amtel, Inc. v. United States, 31 Fed. Cl. 598 (1994), *aff'd*, 59 F.3d 181 (Fed. Cir. 1995); Intermet Corp. v. Commissioner, 111 T.C. 294 (1998); United Dominion Indus., Inc. v. United States, 98 U.S.T.C. ¶ 50,527, 82 A.F.T.R.2d 98 (W.D.N.C. 1998). *Intermet* and *United Dominion* are currently on appeal to the Sixth and Fourth Circuit Courts of Appeals, respectively.

[4]A "separate return year" of a member is a year in which the member filed a separate return or joined in filing a consolidated return with another group. *See* Reg. § 1.1502-1(e). A "consolidated return year" is any year that is not a separate-return year. *See* Reg. § 1.1502-1(d).

[5]*See* I.R.C. § 172(b)(1)(C) (providing a ten-year carryback for SLLs); *cf.* I.R.C. § 172(b)(1)(A) (general two-year carryback rule). Until 1997, the typical carryback period was three years. *See* I.R.C. § 172(b)(1)(A)(i). That carryback period was shortened to two years by section 1082(a) of the Taxpayer Relief Act of 1997, Pub. L. No. 105-34, 111 Stat. 950.

[6]The silence may surprise the casual observer, because the consolidated return regulations contain a detailed and lengthy account of how the Code applies to consolidated groups. Despite their apparent breadth, the regulations contain significant gaps as the Treasury and Service struggle to amend the regulations to keep pace with frenetic legislative change.

Those principles should provide the necessary context to interpret the regulations, and Congress provided two guideposts when it directed the Service to prescribe regulations the Service "deem[ed] necessary" so that

> the tax liability of [the consolidated group and each member], both during and after [periods of consolidation] may be . . . determined . . . in such manner as *clearly to reflect* the income tax liability and the various factors necessary for such liability, and in order to *prevent avoidance* of such tax liability.[7]

"Clear reflection" and "avoidance prevention" cry out for elaboration, but in that regard the consolidated return regulations are sadly lacking.

Although the regulations do not explain the congressional guideposts or otherwise articulate overarching principles,[8] a careful review reveals that the regulations promote two policies. First, a consolidated group should be neither penalized nor advantaged for federal income tax purposes in forming a new member or transferring assets between members. Second, the group should have no tax incentive or disincentive to acquire a prospective member or dispose of an existing member. The regulations reflect the first policy by sometimes treating a group like a single entity (the "single-entity approach"), and the second policy by sometimes treating group members as separate corporations (the "separate-corporation approach").

The regulations therefore adopt a hybrid of the two approaches, creating an inevitable tension that is at the heart of the SLL debate. A consolidated group may worry that it will reduce its consolidated SLL by forming a new member, a concern under a separate-corporation approach. The Service may worry that a group will acquire a prospective member and artificially extend the carryback of its consolidated net operating loss ("CNOL") to consolidated- or separate-return years, a concern principally under a single-entity approach.[9]

Both concerns are addressed by a better reading of the regulations. Under that reading, the SLL should be computed and taken into account like the CNOL, because the SLL is merely a facet of the CNOL.[10] As with the CNOL, a group should compute its SLL on a consolidated basis and should make that computation in one step as if it were a single entity. This "consolidated-first" approach

[7]I.R.C. § 1502 (authorizing the consolidated return regulations) (emphasis added).

[8]Recent amendments to the consolidated return regulations have replaced mechanical rules with rules tied to statements of principle, but no amendment explicitly describes the broader principles of the regulations.

[9]A group combines the gross income, gain, loss, and deductions of each member to compute its CNOL. *See* Reg. §§ 1.1502-11 and -12 (together defining consolidated taxable income), -21 (defining consolidated net operating loss). A group has a CNOL in a taxable year when its members' aggregate deductions for the year (excluding any net capital loss determined on a consolidated basis) exceed their aggregate gross income for the year. *See* Reg. § 1.1502-21(e). That CNOL may be carried over or back and offset income of the group in consolidated return years or income of individual members in separate-return years. *See* Reg. § 1.1502-21(b).

[10]*See* 2 ANDREW J. DUBROFF ET AL., FEDERAL INCOME TAXATION OF CORPORATIONS FILING CONSOLIDATED RETURNS § 41.04[6][b], at 41-67 (2d ed. 1997) (endorsing single-entity treatment for SLL in part because it would be "consistent with the general consolidated return approach to losses").

would allow a group to form new members without affecting its SLL and to avoid the uncertain and protracted task of computing SLLs separately for each member. Further, as with the CNOL, a group and its members should be restricted in their use of the SLL. The restrictions would limit a group's ability to artificially extend its CNOL carryback by acquiring a new member.

Because this approach tolerates some tax-motivated transactions, some may urge that groups should compute their SLLs first using a separate-corporation approach (a "separate-first approach"). Although a separate-first approach might limit a few more tax-motivated transactions, it would hurt more than help, handicapping groups that bear the economic loss associated with an SLL while affording the intended targets ample room to skirt any limitation.[11]

Neither the separate-first nor consolidated-first approach is the right tool to prevent tax-motivated transactions. If the Service wishes to attack this tax avoidance (as I believe it should), it should issue regulations that target the avoidance directly.

Part I of this article provides an overview of the consolidated return regulations and outlines how the regulations apply the single-entity and separate-corporation approaches. It also describes how we should choose between the approaches when the regulations are silent, as they are, for example, about SLLs. Part II explains the mechanics of and policy behind section 172(f), the SLL provision, and concludes that section 172(f) does not require a consolidated group to adopt either approach. Part III describes why a group should take its SLL into account in the same way it does its CNOL. Part IV considers the vexing problem of how a group should compute its SLL. Subpart A of that part uncovers the relevant policy concerns and concludes that the better policy supports the consolidated-first approach. Subpart B sets out the relatively straightforward technical case for that approach. Subpart C describes the elaborate but ultimately flawed technical case for any separate-first approach, considering both the Service's position (accepted by one court) and the case more generally for a separate-first approach. Part V concludes that the better policy and technical arguments support the consolidated-first approach. Finally, an appendix to the article suggests regulatory approaches the Service may adopt to limit tax avoidance under section 172(f).

I. OVERVIEW OF THE CONSOLIDATED RETURN REGULATIONS

For federal income tax purposes, a consolidated group is treated sometimes like a single entity and sometimes like a collection of separate corporations.[12]

[11] In part, that latitude flows from the general operation of the consolidated return regulations. The regulations blur the separate identities of members for tax purposes, because the income and losses of the members are combined, one member can easily merge or liquidate into another member, and assets can be transferred among members at a carryover basis. Although the regulations could be changed to limit that latitude, an effective change likely would alter fundamentally how groups compute their income and tax, with consequences extending far beyond the SLL provision.

[12] A forthcoming article will explain when consolidated groups should employ single-entity and separate-corporation approaches under the Code and the regulations.

This "hybrid" approach[13] is intended "clearly to reflect" the income tax liability of the group *and* each member.[14]

A. *The Single-Entity Approach*

In critical ways, a consolidated group is treated like a single entity in determining its federal income tax.[15] As the keynote to the single-entity approach, the gross income, gain, loss, and deductions of each member are combined to compute a group's consolidated taxable income ("CTI"),[16] and a group uses CTI to determine its federal income tax.[17]

A consolidated group also uses a single-entity approach to compute many components of its CTI, including its net capital gain,[18] net section 1231 gain or loss,[19] charitable deduction,[20] and dividends received deduction.[21] In addition, it adjusts its basis in subsidiary stock to achieve the following single-entity effect: preventing the subsidiary's income, gain, loss, and deductions "from being taken

[13]Numerous commentators have concluded that the regulations adopt a hybrid approach. *See, e.g.*, Dubroff & Broadbent, *Consolidated Returns: Evolving Single and Separate Entity Themes*, 72 TAXES 743, 744-47 (1994); David F. Abbott, *"A Matter of Equity and Convenience"—The Nature of the Consolidated Return Regulations as Reflected in Recent Developments*, 67 TAXES 1072, 1074-75 (1989); James L. Dahlberg, *Aggregate vs. Entity: Adjusting the Basis of Stock in a Subsidiary Filing a Consolidated Return*, 42 TAX L. REV. 547 (1987); Andrew W. Mellon, *Consolidated Returns Regulations—Summary of Provisions*, 7 NAT'L INC. TAX MAG. 105 (1929); *see also* Stephen S. Bowen, *Intercompany Transactions and Basis Adjustments*, 66 TAXES 1010 (1988); John Broadbent & Saul Duff Kronovet, *Consolidated Returns: Rules and Concepts; Operating in Specific Problem Areas: A Panel Discussion*, N.Y.U. 29TH ANN. INST. FED. TAX'N 577, 579 (1971); Jerome R. Hellerstein, *Losses Availed of in Consolidated Returns*, 2 TAX L. REV. 391, 391-92 (1946-1947); Ralph C. Jones, *Present Problems of the Consolidated Return Regulations*, 22 NAT'L TAX ASS'N 414, 420 (1929); D. Reed Maughan et al., *Wringing the Division Bell*, 72 TAXES 427, 428, 435 (1994); Irving Salem, *Judicial Deference, Consolidated Returns, and Loss Disallowance: Could LDR Survive a Court Challenge?*, 43 TAX EXEC. 167, 216-18 (1991) (arguing that support for pure single-entity model is shaky); Stanley P. Wagman, *The Entity Concept in Federal Income Tax Returns for Affiliated Corporations: Administrative Erosion of a Statutory Doctrine*, 17 TAX L. REV. 577 (1961-1962).

[14]*See* I.R.C. § 1502; *see also* FRED W. PEEL, JR., ET AL., CONSOLIDATED TAX RETURNS § 6.04 (3d ed. 1998) (reviewing single-entity and separate-corporation treatment for the group).

[15]"The original justification for the consolidated return provisions was that individual members of a controlled group of corporations should, as a matter of equity and convenience, be taxed as a single business unit." H.R. REP. NO. 100-391, pt. 2, at 1089 (1987), *reprinted in* 1987 U.S.C.C.A.N. 2313-1, 2313-704 (citing S. REP. NO. 617, at 9 (1918)); *see also* Paul H. Chappell, *Closing* Beck Builders *"Loophole"—The Dilemma of the Intercompany Transaction*, 43 TAXES 715, 728 (1965) (arguing that the regulations adopt primarily a single-entity view, citing to legislative history between 1918 and 1963 which suggested that a consolidated group is treated in certain ways as an economic unit).

[16]The gross income, gain, loss, and deductions of each member are combined (*i.e.*, consolidated) to compute CTI. *See* Reg. §§ 1.1502-11, -12; Dubroff & Broadbent, *supra* note 13, at 763 (describing the ability to combine tax items as the essence of the regulations).

[17]*See* Reg. § 1.1502-2. *But see* Gottesman & Co. v. Commissioner, 77 T.C. 1149 (1981) (holding that accumulated earnings tax was determined separately for each corporation when regulations did not detail a consolidated method).

[18]*See* Reg. § 1.1502-22.

[19]*See* Reg. § 1.1502-23.

[20]*See* Reg. § 1.1502-24.

[21]*See* Reg. § 1.1502-26.

into account a second time on [the group's] disposition of [the subsidiary's] stock."[22]

By treating the group like a single entity, the regulations reduce the significance of each member's separate existence and make the group's decision to incorporate a business or transfer assets between members more tax-neutral.[23] Although the regulations never articulate this neutrality policy as a principle, the single-entity approach, which advances the policy, increasingly dominates the field.[24]

B. *The Separate-Corporation Approach*

Despite the alluring simplicity of a pure single-entity approach, the Service has inlaid a separate-corporation approach in the regulations, probably for two principal reasons. First, under a pure single-entity approach, a group would lose the benefit of a cost basis in acquired member stock, instead taking a stock basis equal to the net inside basis of the acquired member's assets.[25] Second, Con-

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[22]*See* Reg. § 1.1502-32(a)(1) (explaining that the purpose of the basis adjustment rules is to treat the subsidiary member and owning member as a single entity); *see also* Reg. § 1.1502-19 (allowing "negative" basis); *cf.* I.R.C. § 705 (providing similar adjustments to determine partner's outside basis but not allowing "negative" basis).

[23]*See* Jerred G. Blanchard, *New Investment Basis Adjustment and Related Consolidated Return Regulations: A Comparison of the New and Old Regimes*, 48 TAX. LAW. 705, 710 (1995) (stating that principal policy of regulations is "to allow members to report income and deductions as if they were divisions of a single corporation").

Both the Service and Congress have recognized neutrality as a principle at least for aspects of the regulations. The Service used the principle to justify modifying the deferred intercompany transaction rules in 1990. In relevant part, the preamble to the amending regulations states: "The purpose of the temporary [deferred intercompany] regulations is to assure that the deferral rules operate as they were intended—*i.e.*, to promote neutrality so that the overall tax consequences to the group generally are not affected by transfers of property among members." T.D. 8295, 1990-1 C.B. 165, 166; *see also* T.D. 8597, 1995-2 C.B. 147, 149 ("[S]ingle entity treatment minimizes the tax differences between a business structured divisionally and one structured with separate subsidiaries."); T.D. 8310, 1990-2 C.B. 205 (adopting a neutrality principle so that "members of group [would not be treated] better or worse by reason of the enactment of section 833").

Congress also endorsed the neutrality principle on at least two occasions. In proposing section 1503(e), which changed how the group determined the stock basis of its members, a House Report stated, "[T]he committee does not believe that the consequences of a disposition of stock in a member of the group should be more favorable than if the operations of the subsidiary had been conducted (and the assets had been owned) directly by the parent corporation." H.R. REP. No. 100-391(I), at 1089 (1987), *reprinted in* 1987 U.S.C.C.A.N. 2313-1, 2313-704. It also endorsed neutrality in its proposal to eliminate the two-percent tax for corporations filing consolidated returns. It stated that: "[T]here appears to be no reason that, where a group of commonly controlled corporations are willing to have their operations consolidated for tax purposes, the mere occurrence of more than one corporate organization in the group should result in any penalty tax." H.R. REP. No. 88-749, at 116 (1963).

[24]*See* Dubroff & Broadbent, *supra* note 13, at 743, 747-50, 760, and 765-66. "The new regulations enhance single entity treatment by treating the members more uniformly as divisions of a single corporation." *See id.* at 743; *see also* Bryan P. Collins et al., *Calculation of Consolidated Taxable Income: The Treatment of Specified Liability Losses*, 25 J. CORP. TAX'N 58, 68 (1998).

[25]A corporation's net inside basis is the aggregate adjusted basis of its assets less its aggregate liabilities. *But see* Reg. §§ 1.1502-13(f)(6) (loss disallowance rule for common parent stock), -20 (loss disallowance rule for subsidiary stock), -30(b)(2) (special basis rule for reverse triangular mergers), -31(a)(1) (special basis rule for group structure changes).

gress allows a subsidiary member to have non-member shareholders,[26] an allowance better accommodated by sometimes using a separate-corporation approach.

As a consequence, the regulations respect the separate existence of each member in several fundamental ways.[27] For example, an acquired member generally retains its pre-consolidation tax attributes.[28] Further, a member recognizes gain or loss on an asset sale to another member, although the group generally takes those items into account using a single-entity approach.[29] Each member also determines its earnings and profits separately,[30] but upon deconsolidation, consistent with a single-entity approach, its earnings and profits may be eliminated to the extent they are taken into account by another member.[31] In addition, subject to an anti-avoidance rule, each member determines its method of accounting as if it filed a separate return.[32] Finally, losses may be carried between separate-return and consolidated-return years, and that carryover or carryback is limited under a separate-corporation approach.[33]

The separate-corporation approach makes more tax-neutral the group's choice to acquire a prospective member or dispose of an existing member. Because the regulations preserve a member's attributes distinct from group attributes, the acquisition of a subsidiary is less likely to affect the character of distributions to the subsidiary's non-member shareholders. Further, by limiting the carryover or carryback of losses between separate-return and consolidated-return years, the regulations limit the opportunity for loss trafficking, making a group's choice to buy or sell a subsidiary more tax-neutral.[34]

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[26]*See* I.R.C. § 1504(a)(2), (4).

[27]The members are respected as separate entities for non-tax reasons as well. For example, a member may separately issue its own stock or debt or separately file for bankruptcy.

[28]If the group acquires all of the stock of a target corporation and makes a section 338 election, the target member is treated as a new corporation, eliminating its historic tax attributes. *See* I.R.C. § 338(a).

[29]*See* Reg. § 1.1502-13(c) (describing the "matching" rule for intercompany transactions, consistent with a single-entity approach). *But see* Reg. § 1.1502-13(f)(4) (providing that gain on member stock may be recovered under a separate-corporation approach).

[30]Subsidiary members may have non-member shareholders, and a non-member shareholder looks to the separate earnings and profits of the subsidiary to determine if a distribution is a dividend. *See* I.R.C. § 1504(a)(2), (4) (allowing non-member shareholders of subsidiaries).

In section 11201 of H.R. 3299 (the House bill that led to the Omnibus Budget Reconciliation Act of 1989), the House proposed determining earnings and profits on a consolidated basis and treating a distribution by a member as a dividend to the extent of the consolidated amount. Congress ultimately rejected that single-entity approach and instead adopted section 1503(f). *See* H.R. CONF. REP. NO. 101-386, at 751-55 (1989). Under that section, if a subsidiary member distributes a dividend on certain preferred stock owned by non-members and the subsidiary has taxable income determined on a separate-corporation basis, the group cannot offset a group loss or loss carryover against the income of the subsidiary member to the extent of the dividend. *See* I.R.C. § 1503(f)(1).

[31]*See* Reg. § 1.1502-33(e)(1).

[32]*See* Reg. § 1.1502-17(a) (general rule), (c) (anti-avoidance rule). As a corollary, special-status members, such as banks and insurance companies, determine their status separately. *See* 2 DUBROFF ET. AL., *supra* note 10, § 41.01, at 41-42.

[33]*See* Reg. § 1.1502-21(b)(2)(i) (describing how losses are carried to separate-return years), (c) (describing how losses are carried from separate-return years). *But see* Reg. § 1.1502-21(g) (providing a special rule for cases in which section 382 also applies to the loss).

[34]*See* CO-078-90, 1991-1 C.B. 757, 759 (stating in a slightly different context that these loss rules should be "neutral").

C. *Balancing the Two Approaches*

Courts, consolidated groups, and the Service sometimes struggle to balance the separate-corporation and single-entity approaches. Although the regulations state no principle to foster that balance, the two approaches should combine to make more tax-neutral not only transactions between members but also the acquisition, formation, and sale of a member.[35] This neutrality makes the regulations less likely to distort a group's economic choice to engage in those transactions,[36] complementing each approach.

Invariably, the approaches clash, and the consolidated return regulations appear to blend them to come as close to the tax-neutrality ideal as possible.[37] The regulations generally adopt a single-entity approach for activities between members and reserve a separate-corporation approach for activities that span a member's separate-return and consolidated years. In interpreting the regulations, however, courts eschew any tax neutrality debates, and recent courts have followed the regulations' "plain meaning."[38]

The "plain meaning" standard offers meager purchase when the regulations fail to address directly how a Code section applies to a consolidated group.[39] In those cases, we must ponder whether the group should apply the Code section using a separate-corporation, single-entity, or some blended approach, assuming

[35]*See* 2 DUBROFF ET. AL., *supra* note 10, § 41.04[6][b][i], at 41-71 (stating that the Service undermines general neutrality goals of regulations when it stresses mechanical computations that offer groups electivity).

[36]*See* Alvin C. Warren, *Three Versions of Tax Reform*, 39 WM. & MARY L. REV. 157, 161 (1997) (reporting a broad consensus among tax policy professionals that distinctions are to be avoided if, among other things, they "distort economic decisions"); Stephen S. Bowen, *Loss Disallowance*, 68 TAXES 918, 921 (1990) (describing neutrality as "a worthy enough objective"); *see also* George F. Break & Joseph A. Pechman, FEDERAL TAX REFORM 7 (1975) (describing how some promote a neutral tax system to achieve economic efficiency).

[37]For example, the regulations provide for the recognition but deferral of gain or loss on the sale of assets between members. *See* Reg. § 1.1502-13(a)(2), (c). Adopted in 1966, this recognition regime replaced a non-recognition regime that could give groups a significant tax advantage in disposing of member stock. *See* Henry C. Beck Builders, Inc. v. Commissioner, 41 T.C. 616 (1964) (providing that a group had no gain when a member sold an appreciated asset to another member and the group sold the acquiring member's stock; the transaction had the effect of allowing a group to dispose of the appreciated asset without gain even though a corporate buyer, by liquidating the purchased corporation, could acquire the asset at a cost basis generally without tax). Although the recognition regime modestly affected the group's choice to form a new member, it enhanced neutrality by making it much less likely that the group would have a tax incentive to dispose of member stock.

[38]*See* CSI Hydrostatic Testers, Inc. v. Commissioner, 103 T.C. 398, 411 (1994), *aff'd per curiam*, 62 F.3d 136 (5th Cir. 1995) (providing that the "court will apply the consolidated return regulations and the Code as written."); *see also* Woods Inv. Co. v. Commissioner, 85 T.C. 274, 282 (1985) ("This Court will apply [the consolidated return] regulations as written."), *acq.* 1986-2 C.B. 1; First Chicago NBD Corp. v. Commissioner, 135 F.3d 457, 461 (7th Cir. 1997) (adopting the "natural" reading of the regulations).

[39]A plain reading of the Code or regulations should consider more than a surface textualism, which would view a provision "in light of an ideal drafter's conception of grammar and style." *See* William D. Popkin, *Law-Making Responsibility and Statutory Interpretation*, 68 IND. L.J. 865, 872 (1993) (discussing and defining surface textualism). Instead, it should rely on the meaning shared by

the approach used makes a difference.[40] We should begin with the Code, because it may explicitly or implicitly mandate a particular approach.[41]

If the Code accommodates more than one approach, we should turn to the regulations, weighing tax neutrality and administrability in applying the Code section to the group.[42] If we can read the regulations only one way, we should sacrifice tax neutrality for the certainty afforded by that "plain reading."[43] Following that reading avoids arcane, technical forays into the bowels of the regulations, an incursion that only a few tax experts can (or want) to make.[44] Further, it makes the regulations more predictable and simpler to apply, and consequently should lessen administrative expense for the government and taxpayers. When the consolidated return regulations have several readily accessible and plausible readings, however, we should favor the reading that best promotes tax neutrality.

II. SEPARATE LIABILITY LOSSES

Because the consolidated return regulations never mention separate liability losses (*i.e.*, SLLs), we should weigh the goals of tax neutrality and administrability to figure out how a group should determine and carry back its SLL. Our starting

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the drafter and intended audience. *See id.* at 875 (discussing and defining plain meaning); *see also* Ilyse Barkan, *New Challenges to Use of Plain Meaning Rule to Construe the IRC and Regs*, 69 TAX NOTES 1403, 1404 (1995) (noting that even dictionary definitions are interpretations and that the choice among definitions may be subjective and require context); William D. Popkin, *The Collaborative Model of Statutory Interpretation*, 61 S. CAL. L. REV. 541, 598 (1988) (warning that a provision's "text may have a plain meaning, but that is not the same thing as the [provision's] meaning being plain").

Even if we adopt a plain reading, we must interpret words contextually. The Code is interrelated, self-contained, and highly detailed with a logic all its own. *See* Michael Livingston, *Congress, the Courts, and the Code: Legislative History and the Interpretation of Tax Statutes* 69 TEX. L. REV. 819, 826-31 (1991). The consolidated regulations, which apply the Code to consolidated groups, share those attributes. Because words have no exact meaning and the Code and regulations may use words in unique ways, we must consider the context in which they arise, including their place in the structure of the Code or regulations. *See id.* at 831; *see also* Deborah A. Geier, *Interpreting Tax Legislation: The Role of Purpose*, 2 FLA. TAX REV. 492, 497, 510-11 (1995) (advocating a structural analysis).

[40]Often, the inquiry may not be necessary because the approach used would not affect the tax results. *See, e.g.*, I.R.C. §§ 163 (interest deduction), 164 (deduction for taxes), 197 (amortization deduction for certain intangibles).

[41]*See, e.g.*, I.R.C. § 172(h)(4)(C) (requiring a single-entity approach in determining corporate equity reduction interest losses).

[42]These principles, particularly neutrality, provide the broad context necessary to interpret the consolidated return regulations and determine the appropriate approach.

[43]*See also* John F. Coverdale, *Text as Limit: A Plea for a Decent Respect for the Tax Code*, 71 TUL. L. REV. 1501 (1997) (arguing that courts should not adopt an interpretation of the Code incompatible with its text).

[44]In First Chicago NBD Corp. v. Commissioner, 135 F.3d 457, 461 (7th Cir. 1997), the Seventh Circuit followed the "natural" reading of the regulations and chastised the taxpayer for engaging in a wide-ranging review of various consolidated provisions, characterizing the taxpayer's and Service's give-and-take on those provisions as "an esoteric slugfest . . . in which the [Service] land[ed] as many blows as its opponent."

point must be section 172(b)(1)(C) and (f),[45] which describes how a taxpayer computes and uses its SLL.

A. *The SLL's Computation and Use*

Section 172(f) does not expressly state how a group should compute its SLL but describes more generally how a taxpayer computes the SLL portion of its net operating loss ("NOL"). Under that section, the SLL portion is generally the lesser of the taxpayer's NOL[46] or its specified liability ("SL") deductions.[47] Broadly speaking, SL deductions are deductions relating to: (i) a product liability,[48] or (ii) in limited cases, a liability under state or federal law that arises from an act occurring at least three years[49] before the taxable year of the deduction.[50] The SLL and non-SLL portions of the NOL are treated as separate NOLs, and if both portions are carried to a year, the non-SLL portion is absorbed first.[51]

Under section 172(b)(1)(C), a taxpayer may carry back the SLL portion of its NOL to each of the ten taxable years preceding the year of the loss.[52] Because that subsection does not spell out how a consolidated group should carry back its

[45]*See* Reg. § 1.1502-80(a) (stating that the Code applies to the group "to the extent the regulations do not exclude its application").

[46]When a corporation has a corporate equity reduction interest loss (a "CERT" loss), it appears that the SLL is limited to the NOL minus the CERT loss. *See* I.R.C. § 172(h)(1) (stating that CERT equals (i) the NOL minus (ii) the NOL computed without regard to certain interest expenses). *See infra* note 187 for a further discussion of CERT losses.

For convenience, the effect of CERT losses on the SLL is generally disregarded in this article.

[47]*See* I.R.C. § 172(f)(1), (2) (stating that SLL equals SL deductions but cannot exceed the NOL), (5) (providing that SLL treated as a separate NOL and therefore fully included in taxpayer's NOL carryback). These provisions implicitly establish the stacking rule that the taxpayer first offsets its gross income by deductions other than SL deductions (and those making up the CERT loss), thereby maximizing the portion of the NOL that is treated as an SLL.

[48]*See* I.R.C. § 172(f)(1)(A).

[49]This three-year requirement might have been adopted because, absent section 172(f), NOLs typically could have been carried back three years under section 172(b)(1)(A). The typical carryback period was shortened to two years under section 1082(a) of the Taxpayer Relief Act of 1997, P.L. 105-34, 111 Stat. 788. It might be only an oversight that corresponding amendments were not made at the same time to section 172(f)(1)(B).

[50]*See* I.R.C. § 172(f)(1)(B). The liability must arise under a federal or state law requiring "(I) the reclamation of land, (II) the decommissioning of a nuclear power plant . . . , (III) the dismantlement of a drilling platform, (IV) the remediation of environmental contamination, or (V) a payment under any workers compensation act." Reg. § 172(f)(1)(b)(i). Until section 172(f) was amended by Pub. L. No. 105-277, § 3004(a), 112 Stat. 2681-905 (1998), section 172(f) applied more broadly to liabilities arising under state and federal law and to tort liabilities.

The product liability provision was enacted in section 371(b) of the Revenue Act of 1978, Pub. L. No. 95-600, 92 Stat. 2763, and the statutory and tort loss provision was enacted in section 91(d)(2) of the Deficit Reduction Act of 1984, Pub. L. No. 98-369, 99 Stat. 404. These provisions were combined in section 11811(b)(1) of the Omnibus Budget Reconciliation Act of 1990, Pub. L. No. 101-508, 104 Stat. 1388.

[51]*See* I.R.C. § 172(f)(5).

[52]*Cf.* I.R.C. § 172(b)(1)(A)(i) (providing a two-year carryback in the typical case). A net operating loss is carried to the earliest taxable year first, any remaining amount is carried to the next earliest year, and so on. *See* I.R.C. § 172(b)(2).

SLLs, section 172 does not expressly require that a group compute or use SLLs under a separate-corporation, single-entity, or hybrid approach.

B. *The Policy Behind the SLL Provisions—a Loose Matching Principle*

None of these approaches is ruled out by the apparent policy of the SLL provisions, to promote a better possible match of SL deductions and corresponding income.[53] Because the statute only loosely implements that match, the policy offers no more than limited justification for any of the approaches.

Matching as a policy for the SLL provisions gains some support from the placement of the special carryback provision for tort losses[54] in section 91 of the Deficit Reduction Act of 1984.[55] In principal part, section 91 included the economic performance test, which postponed when an accrual-method taxpayer could otherwise deduct certain expenses.[56]

Congress added the economic performance test because the current deduction of "an amount to be paid in the future [overstated] the true cost of the expense to the extent the time value of money [was] not taken into account . . . ."[57] In a rational world, when a taxpayer postpones payment of a current expense, the payment should include an "interest" or "time-value" component to account for that delay. If a person receives income currently but pays a corresponding expense in the future, only the "principal" component of the expense matches current income. Accordingly, a current deduction of the entire expense would create a mismatch.[58]

The mismatch is addressed by the economic performance test.[59] Instead of requiring taxpayers to divide expenses into separate principal and interest components, a complex and sometimes uncertain administrative task, Congress generally postponed the deduction of an expense until payment.[60] If a taxpayer paid

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[53]Relevant legislative history gives no reason for the special ten-year carryback. *See* H.R. CONF. REP. No. 95-1800, at 286-87 (1978); H.R. REP. No. 98-432, at 1256-57 (1984); *see also* 2 DUBROFF ET. AL., *supra* note 10, § 41.04[6][b][i], at 41-66; Collins, *supra* note 24, at 64 (suggesting that section 172(f) was intended to match SL deductions and related income). *But see* JOINT COMMITTEE ON TAX'N, GENERAL EXPLANATION OF THE REVENUE ACT OF 1978, at 232 (1979) (stating that a taxpayer suffering a product liability loss was given an extended carryback to make it more likely that it would "obtain a current economic benefit from a tax refund").

[54]Until it was amended in 1998, section 172(f) could apply generally to tort liabilities. *See supra* note 50.

[55]*See* Deficit Reduction Act of 1984, Pub. L. No. 98-369, 99 Stat. 494; *see also* H.R. REP. No. 98-432, at 1256-57 (1984).

[56]For example, under that test an accrual-basis taxpayer could deduct a tort liability only as it was paid. *See* I.R.C. § 461(h)(2)(C); Reg. § 1.461-4(g)(2).

[57]H.R. REP. No. 98-432, at 1254 (1984).

[58]Further, if the principal component is currently deductible, the interest component arguably never should be deducted. *See* Noël B. Cunningham, *A Theoretical Analysis of the Tax Treatment of Future Costs*, 40 TAX L. REV. 577, 599-615 (1985).

[59]*Cf.* I.R.C. § 461(h)(3)(A)(iv)(II) (providing an exception to the economic performance test for certain recurring items if, among other things, the exception allowed a better match of corresponding income and expense).

[60]*See* H.R. REP. No. 98-432, at 1254 (1984); *see also* Cunningham, *supra* note 58, at 588.

tax at the same rate in the income and expense years, the postponed, full deduction would have the same present value as the earlier, discounted deduction.[61] However, when the taxpayer suffered a net loss in the expense year, only a carryback of the full amount could afford the taxpayer the same benefit as the earlier, discounted deduction. In other words, the carryback provided the appropriate match.

The typical two-year carryback might prove inadequate for SL deductions, because those liabilities generally arise out of acts that occur "at least 3 years before the beginning of the taxable year."[62] Congress addressed that inadequacy by adding the special ten-year carryback rule.

Despite that possible purpose, neither section 172 nor applicable regulations require a precise matching of an SL deduction and corresponding income.[63] Instead, the SLL must offset any income in the earliest carryback year to which the amount may be carried, regardless of the income's source.[64] For example, if an SL deduction arose out of a four-year-old product liability, a resulting SLL could still be carried back up to ten years. Moreover, following the merger of a target corporation, an SLL generated by the target business must be carried back to a taxable year of the acquiring corporation,[65] even if it corresponds to premerger target income.[66]

Thus, when the SLL offsets corresponding income, it is by happenstance. Even for corporations filing separate returns, the SL deductions of one corporation may offset the income of another corporation following a merger. Consequently, the loose matching policy of the SLL provisions should favor neither the separate-corporation nor the single-entity approach, and the Code does not directly answer how a group computes or uses SLLs.

III. THE GROUP'S USE OF SLLS

Because neither the Code nor the consolidated return regulations expressly answer those questions, we must glean the answers from the broad expanse of

[61]*See* Cunningham, *supra* note 58, at 585; *see also* Erik M. Jensen, *The Deduction of Future Liabilities by Accrual-basis Taxpayers: Premature Accruals, The All Events Test, and Economic Performance*, 37 U. FLA. L. REV. 443, 447-48 (1985).

[62]I.R.C. § 172(f)(1)(B)(ii)(I). Many product liability claims also arise from acts occurring more than three years before the claims are paid.

[63]A required matching strikes a chord similar to the now-defunct "Libson Shops" doctrine. *See* Libson Shops, Inc. v. Koehler, 353 U.S. 382 (1957) (holding that when a corporation with an NOL merged into a related corporation, the NOL could not offset income unless it was derived from the merged corporation's business); *see also* H.R. CONF. REP. No. 99-841, pt. 2, at 194 (1986), *reprinted in* 1986 U.S.C.C.A.N. 4076, 4279 ("[T]he *Libson Shops* doctrine will have no application" to ownership changes subject to section 382); *cf.* Certified Grocers of Cal., Ltd. v. Commissioner, 88 T.C. 238, 250-51 (1987) (providing that patronage losses for a cooperative could only offset patronage income, whether or not the cooperative was a member of a consolidated group). In any case, it often would be difficult, if not impossible, to figure out what the "corresponding" income was.

[64]*See* Reg. § 1.172-13 (describing the carryback of a predecessor to the SLL that did not provide for a "Libson Shops" type of limitation on the use of the carryback).

[65]*See* I.R.C. § 381(b)(3).

[66]No limitations (other than perhaps under sections 269 or 382) would prevent that carryback.

the regulations, keeping in mind the policies of tax neutrality and administrability. Consistent with how a group uses its CNOL, the group should adopt a single-entity approach for carrying back SLLs to consolidated-return years but a separate-corporation approach for carrybacks to separate-return years. By tracking how a group uses its CNOL, that hybrid approach not only follows the most readily accessible reading of the regulations but also promotes tax neutrality.

A. *Use of SLLs During Consolidated-Return Years*

Although the regulations do not expressly describe how a group uses SLLs generated in and carried back to consolidated-return years, we may easily dispense with any claim that those SLLs may be used by members separately. The regulations provide no mechanism for a group or its members to absorb members' losses or deductions separately; instead, they direct the group as a whole to offset its gross income and deductions in computing its CTI or CNOL.[67] In both computations, the group's deductions are accounted for without excluding any amounts taken into account by members separately.

To prevent double deductions,[68] no member should be able to separately deduct any amount, including an SL deduction. Otherwise, the group could use the same deduction twice, first on that separate accounting and second when the associated deductions reduce CTI or increase the CNOL. Because the regulations explicitly require member deductions to be taken into account in computing CTI or the CNOL,[69] a double deduction can be prevented only if no member takes a separate SLL into account.[70] *Example 1* illustrates this point.

> *Example 1: Duplicate Use of Same Deduction.* P and its wholly owned subsidiary S are organized in Year 1 and elect to be a consolidated group. In that year, P and S have $50 and $150, respectively, of gross income. Because neither has any deductions, the group's CTI for Year 1 is $200. In Year 2, P has no gross income or deductions, while S has $100 of SL deductions but no gross income.

[67] *See* Reg. §§ 1.1502-11 (providing that the separate items of members are combined to compute CTI); -21(e) (stating that CNOL is excess of gross income over deductions). Even when a loss is carried from a consolidated year to a separate-return year of a member, the group begins with the CNOL and attributes a portion of that amount to the member for carryover to that separate-return year. *See* Reg. § 1.1502-21(b)(2)(iv), § 1.1502-79(a)(3) (1996).

[68] Regulation section 1.161-1 states: "Double deductions are prohibited. Amounts deducted under one provision of the Internal Revenue Code . . . cannot again be deducted under any other provision thereof." *See* Charles Ilfeld Co. v. Hernandez, 292 U.S. 62 (1934) (interpreting the consolidated return provisions to prohibit double deductions); *see also* Reg. § 1.1016-6(a) (". . . adjustments [under section 1016] must always be made to eliminate double deductions or their equivalent."); *cf.* CSI Hydrostatic Testers, Inc. v. Commissioner, 103 T.C. 398 (1994), *aff'd per curiam*, 62 F.3d 136 (5th Cir. 1995) and Woods Inv. Co. v. Commissioner, 85 T.C. 274 (1985), *acq.* 1986-2 C.B. 1 (each allowing a deduction and a related stock loss; although the Service characterized that treatment as a "double deduction," the group in neither case deducted the same item twice).

[69] This consolidated offset may be the essence of the consolidated return regulations. *See supra* note 16 and accompanying text.

[70] Eliminating separate deductions also promotes tax neutrality because it removes tax incentives to form or acquire members.

Consequently, in Year 2, the group has a $100 CNOL,[71] all of which is carried back and offsets the group's CTI in Year 1 (whether or not the CNOL is treated as an SLL).[72] S would have a $100 separate SLL,[73] and if S could take that amount into account separately, it presumably could carry back the SLL to Year 1 and offset $100 of its gross income in that year. Thus, the same $100 deduction would be used twice if S could absorb its separate SLL.

Following the most readily accessible reading of the regulations, a group's SLL should be carried back in the same way as its CNOL, because the SLL is part of the CNOL.[74] Thus, the SLL should be carried back to a consolidated-return year on a single-entity basis, just like the CNOL.[75]

B. *Carryback of the Consolidated SLL to Separate-Return Years*

Also tracking how a group carries back its CNOL, the group's SLL should be apportioned and carried back to a member's separate-return year using a separate-corporation approach.[76] By tracking the carryback of a CNOL, that method not only follows the most readily accessible reading of the regulations but also limits loss trafficking and promotes tax neutrality.

This separate-corporation approach was endorsed in *Amtel, Inc. v. United States*.[77] In *Amtel*, a consolidated group attempted to carry back a portion of its

[71]The CNOL equals the excess of the group's deductions ($100 SL deductions) over its gross income ($0). *See* Reg. § 1.1502-21(e).

[72]*See* Reg. § 1.1502-21(b)(1).

[73]S's separate SLL equals the amount of its SL deductions.

[74]The group must compute a consolidated SLL. The SLL provisions apply to the group and its members, because the regulations do not exclude their application. *See* Reg. § 1.1502-80(a) (stating that the Code applies "to the group to the extent the regulations do not exclude its application"). By necessary inference, because members cannot use SLLs separately during consolidated-return years, the SLL provisions must apply to a consolidated group as a whole, and the group *at some point* must compute a consolidated SLL. *See* Intermet Corp. v. Commissioner, 111 T.C. 294 (1998) (providing that consolidated SLL is computed using a separate-first approach); United Dominion Indus., Inc. v. United States, 98-2 U.S.T.C. ¶ 50,527, 82 A.F.T.R.2d 5037 (W.D.N.C. 1998) (providing that consolidated SLL is computed using the consolidated-first approach); *see also* P.L.R. 94-44-020 (Aug. 2, 1994) (providing that group as a whole may elect to forego carryback of consolidated SLL).

The consolidated SLL should be part of the group's CNOL, because the CNOL is determined under the principles of section 172(b). *See* Reg. § 1.1502-21(b)(1) (providing in introductory language that the CNOL is determined under the principles of section 172); *see also* Reg. § 1.1502-21(b)(1) (requiring CNOL to be carried over and back "under the principles of section 172(b)"). Because section 172(b) includes the provision authorizing the special ten-year carryback for the SLL (*i.e.*, section 172(b)(1)(C)), those principles should embrace treating an appropriate portion of the CNOL as a consolidated SLL and limiting the consolidated SLL to the CNOL.

[75]*See* Reg. §§ 1.1502-21(b)(1) (describing use of CNOLs), -11(a)(2) (providing that CTI is offset by CNOL).

[76]The CNOL is apportioned and carried back to a member's separate-return year as follows: the CNOL is attributed to the member in the proportion that its separate net operating loss for the loss year bears to the aggregate separate net operating loss of all members having separate net operating losses in that year. *See* Reg. § 1.1502-21(b)(2)(iv). The apportioned amount is carried back to separate-return years of the member. *See* Reg. § 1.1502-21(b)(2)(i) (permitting the member to carry an attributable portion of CNOL to a separate-return year). Any apportioned amount that may be carried back to a member's separate-return year may not be carried back to an equivalent or earlier consolidated-return year. *See id.*

[77]31 Fed. Cl. 598 (1994), *aff'd*, 59 F.3d 181 (Fed. Cir. 1995).

SLL[78] equal to a member's SL deductions to the member's separate-return year. Because the member had positive taxable income determined on a separate-corporation basis in the year in which the SLL arose, the court denied the carryback. The court followed the attribution formula for CNOLs set out in the consolidated return regulations,[79] under which no portion of a CNOL may be attributed to a member with positive taxable income and carried back to that member's separate-return year.[80]

In arguing for a single-entity approach, the taxpayer asserted that a portion of the SLL should have been attributable to Amtel under the following analysis. First, a group's SLL must be calculated initially on a consolidated (*i.e.*, single-entity) basis, because the CNOL, of which the SLL is a part, is a consolidated item.[81] Second, on a consolidated basis, the group's SLL equaled the aggregate SL deductions of its members.[82] Third, because Amtel's SL deductions would then increase the group's SLL dollar-for-dollar, Amtel should be attributed a corresponding portion of the SLL.[83] Then, Amtel would (and must) carry back that attributable amount as an SLL to its separate-return years.

The court rejected the taxpayer's argument, focusing principally on the third step of the analysis. Because an SLL is limited to a taxpayer's NOL, the court reasoned that a member's attributable share of the consolidated SLL had to be limited to its attributable share of the CNOL.[84] Because no portion of the CNOL was attributed to Amtel under the CNOL attribution formula, the court concluded that Amtel was attributed none of the consolidated SLL.[85]

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[78]*Amtel* dealt with a predecessor to the SLL, the product liability loss, which is determined and taken into account in all relevant respects like an SLL. *See* I.R.C. § 172(j) (1985). For convenience, this article describes *Amtel* as if it involved an SLL and SL deductions.

[79]The formula was set out in Regulation section 1.1502-79 (1985), which in all relevant respects is the same as the current attribution formula found in Regulation section 1.1502-21(b)(1)(iv). *See* CO-078-90, 1991-1 C.B. 757, 760 (stating that a proposed attribution rule, which is identical to the current rule, "restat[es] the [rule] of . . . Reg. § 1.1502-79"). For a description of this formula, see *supra* note 76.

[80]Under Regulation section 1.1502-79(a)(3) (1985), the group computed a member's taxable income by looking to its taxable income, determined under the Code as if it were a separate corporation with adjustments to account for consolidated items taken into account in computing the CNOL, such as the dividends received deduction. A member with positive taxable income determined separately would have no separate loss and, under the attribution formula, would be apportioned none of the group's CNOL. The result would be the same under current law. *See* Reg. § 1.1502-21(b)(2)(iv).

[81]*See Amtel*, 31 Fed. Cl. 598 at 599, 601; *see also* Reg. § 1.1502-21(f) (1985) (providing that the CNOL is computed by combining all member's tax items for the year).

[82]*See Amtel*, 31 Fed. Cl. 598 at 601. For a non-consolidated corporation, an NOL is treated as an SLL to the extent of the corporation's SL deductions. *See* I.R.C. § 172(f)(2). Thus, if a group computes its SLL on a consolidated basis, its CNOL would be an SLL to the extent of its members' aggregate SL deductions. In *Amtel*, because the group's CNOL exceeded those aggregate SL deductions, the group's SLL would have equaled those deductions under that method.

[83]*See Amtel*, 31 Fed. Cl. 598 at 601.

[84]*See id.* at 600.

[85]*See id.* at 600-01.

The court's conclusion seems correct, fitting comfortably within the framework of the regulations. Consistent with the hybrid approach for using CNOLs, the court employed a separate-corporation approach to determine the portion of the consolidated SLL to be carried back to the separate-return year of a member. That approach limited the opportunity for loss trafficking,[86] making a corporation's decision to join a group (and the group's decision to acquire the corporation) less motivated by tax considerations.

As *Example 2* illustrates, the taxpayer's proposed approach may allow a group to accelerate the use of a new member's losses and engage in a form of loss trafficking.

> *Example 2: Loss Trafficking.* Corporation X, a profitable corporation, has had annual taxable income of $100 million for several years and, during that time, paid tax at a thirty-five percent rate. X anticipates settling a tort claim for $100 million, which it will pay next year. The claim is not deductible until paid[87] and will be an SL deduction. Next year, because of that deduction, X will have $0 of taxable income.
>
> A consolidated group ("group Y") may buy the X stock. Group Y anticipates having more than a $100 million CNOL next year and also anticipates that none of its deductions next year will be SL deductions. In addition, because of past losses, group Y could not carry back next year's CNOL to offset income in prior years.
>
> Whether or not group Y buys the X stock, X and group Y will pay no tax next year. X separately, group Y (without X), and group Y (with X) all would have allowable deductions equal to or in excess of gross income.[88]
>
> If group Y buys the X stock, the group will have at least a $100 million CNOL. However, if the taxpayer's position in *Amtel* were adopted, X (the new member) could carry back $100 million as an SLL to its separate-return years,[89]

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[86]Loss trafficking occurs, for example, when one corporation in effect purchases the tax losses of another corporation. The Code evidences a policy against loss trafficking, although its implementation of that policy is far from systematic. *See* I.R.C. §§ 269 (limiting acquisitions made to evade or avoid tax), 382 (limiting use of NOLs and built-in deductions following an ownership change), 384 (limiting use of target losses to offset built-in gains of acquirer), and 482 (allocating tax items among related parties to clearly reflect income); *see also* Reg. § 1.1502-20(a) (disallowing loss on subsidiary stock); *cf.* I.R.C. § 168(f)(8) (1981) (liberal safe-harbor lease provision); Tax Reform Act of 1984, Pub. L. No. 98-369, § 60(b)(5), 98 Stat. 579, *as amended by* Tax Reform Act of 1986, Pub. L. No. 99-514, § 1804(e)(5), 100 Stat. 2801 (affording groups an easy way to share in losses of Alaska Native Corporations).

[87]*See* I.R.C. § 461(h)(2)(C) (providing that a deduction is allowed under accrual method when economic performance occurs; economic performance occurs for tort liability when payments made); *see also* Reg. § 1.461-4(g)(2) (to the same effect).

[88]*See* Reg. § 1.1502-11(a) (providing that income and deductions of members are combined to determine CTI).

[89]This analysis assumes that section 382 would not apply to limit the carryback. Section 382 is briefly discussed in the appendix beginning *infra* p. 726.

> providing an immediate $35 million benefit to X and the group,[90] a benefit that arises only because group Y buys X.[91]
>
> Recognizing that benefit, the X shareholders would demand more for their X stock. In effect, the X shareholders would share in the group's losses, a form of loss trafficking.

Thus, a consolidated group should carry back its SLL using a hybrid approach, that is, a single-entity approach when its SLL is carried to consolidated-return years and a separate-corporation approach when it is carried to separate-return years. The hybrid approach promotes tax neutrality and, by tracking how a group uses its CNOL, follows the most readily accessible reading of the consolidated return regulations.

IV. THE GROUP'S COMPUTATION OF ITS SLL

It is less clear how a group should compute its SLL, although the group must make that computation at some point on a consolidated basis.[92] That consolidated computation could be the group's first and only computation (a consolidated-first approach), or members could be required as a first step to compute SLLs separately (a separate-first approach).[93] The Code and regulations may be read to support either approach.

Under a separate-first approach, each member's separate SLL would be limited to a separate loss amount,[94] and those separate SLLs would be combined in some fashion to form the consolidated SLL. The separate loss amount could equal the member's negative separate taxable income[95] or another amount more closely tied to the member's NOL calculated on a separate-corporation basis. Further, the separate SLLs, once determined, could be taken into account last or proportionately with other net member losses in figuring the CNOL and consolidated SLL. The regulations never discuss these issues, and their silence makes the profile of the separate-first approach less than certain.

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[90]On the carryback, the $100 million loss would offset $100 million of X income that had been taxed at a 35% rate. Accordingly, X (and group Y) should benefit from a $35 million tax refund because of the carryback (35% of $100 million). *See* I.R.C. § 172(b). Interest does not accrue on the refund before the due date for the tax return for the loss year (determined without extensions). *See* I.R.C. § 6611(f)(1), (4).

[91]Of course, the benefit is probably worth less than $35 million. Because of the carryback, group Y foregoes carrying forward $100 million of losses and reducing future taxes. Thus, the net benefit of the carryback will equal $35 million (i.e., the immediate tax savings) less the present value of the foregone future tax savings.

[92]*See supra* note 74. The consolidated SLL should not exceed the CNOL minus the consolidated CERT loss, because for a corporation filing a separate return, its SLL cannot exceed its NOL minus its CERT loss. *See supra* note 46.

[93]The North Carolina District Court has endorsed the consolidated-first approach, while the Tax Court has favored a separate-first approach. *See* Intermet Corp. v. Commissioner, 111 T.C. 294 (1998); United Dominion Indus., Inc. v. United States, 98-2 U.S.T.C. ¶ 50,527, 82 A.F.T.R.2d 5037 (W.D.N.C. 1998).

[94]*See supra* notes 46-47 and accompanying text.

[95]*See* Reg. § 1.1502-12 (defining separate taxable income); *see also* T.A.M. 97-15-002 (Dec. 12, 1996) (arguing that negative separate taxable income was the proper measurement).

Under the more straightforward and certain consolidated-first approach, a group would compute its SLL in the first instance as if it were a single entity. Following section 172(f), the consolidated SLL would equal the lesser of (i) the aggregate SL deductions for all members and (ii) the CNOL.[96]

Although the consolidated-first approach might tolerate more tax-motivated transactions than a separate-first approach, on balance, the consolidated-first approach is preferable.[97] It follows the more readily accessible reading of the consolidated return regulations and is simpler and more certain than any separate-first approach. It also better promotes tax neutrality by minimizing a group's tax incentive or disincentive to form a new member or transfer assets between members.[98]

[96] *See supra* notes 46-47 and accompanying text, describing how section 172(f) applies to a taxpayer.

[97] Other commentators also endorse the consolidated-first approach. *See, e.g.*, Collins, *supra* note 24, at 62; 2 DUBROFF ET. AL., *supra* note 10, § 41.04[6][b][i]; Lawrence M. Axelrod, *Consolidated Returns and SLLs: Praying for Intermet's Appeal*, TAX NOTES TODAY (Dec. 21, 1998) (LEXIS, FEDTAX lib., TNT file, elec. cit. 98 TNT 244-89).

[98] *See* 2 DUBROFF ET. AL., *supra* note 10, § 41.04[6][b][i] (suggesting that "only mischief" will result from adopting a separate-entity approach). Under a separate-first approach, Code limitations based on taxable income are applied at the member level, an approach at odds with a group's consolidated computation of its CTI or CNOL. If adopted more generally, this approach may hurt the fisc. Consider the following example:

Example. Merchant Marine Capital Construction Fund

Corporation P owns and operates a fishing boat, and fishing is better some years than others. Its fishing operations generate a net $500 loss in Year 1 and a net $700 profit in Year 2. In each of these years, P also has $200 of non-fishing income. Thus, P has a $300 net operating loss in Year 1 and, assuming the loss is carried forward, $600 of taxable income in Year 2 (*i.e.*, $700 of net profit from the fishing operations, plus $200 of non-fishing income, minus $300 loss carried from Year 1). Over the two years, P has only $200 of net taxable income attributable to its fishing operations.

Assume that P has established a Merchant Marine Capitalization Fund. *See* 46 U.S.C. § 1177 (1999) (describing these funds). Under section 7518(c), a taxpayer may reduce its taxable income by its contributions to the fund out of taxable income attributable to operations of a fishing vessel. Because P has only $200 of net taxable income in Years 1 and 2 attributable to its fishing operations, it could receive no more than a $200 income reduction under section 7518 for those years. Thus, P's total taxable income for Years 1 and 2 would be at least $400. The result should be the same if P formed a subsidiary ("S"), P and S divided the fishing operations and filed consolidated returns, and section 7518 was applied using a single-entity approach.

If P and S divided the fishing operations but section 7518 were applied using a separate-corporation approach, the group might increase its section 7518 benefit. *See* I.R.C. § 7518(a)(2) (permitting both the owner and lessee to contribute amounts to Merchant Marine Capital Construction funds). Assume that S owns the fishing boat and rents it to P for a $300 annual payment (its fair rental value). Also assume that S has no other income or deductions. On a separate-corporation basis, S would have $300 of annual taxable income, all attributable to the operation of a fishing boat, and could qualify for up to an annual $300 reduction in its taxable income under section 7518. Thus, overall, the group could reduce its taxable income by up to $600, a $400 potential benefit that flows from a separate-corporation approach.

In the remainder of this section, I examine these matters in more detail. First, I discuss why neither the separate-first nor consolidated-first approach adequately addresses potential tax-motivated transactions and why, once we relieve each approach of that burden, policy considerations favor the consolidated-first approach. Next, I present the technical case for the consolidated-first approach. Finally, I discuss the technical (but ultimately flawed) case for the separate-first approach.

A. *The Policy Concerns—Tax Neutrality, Simplicity and Fairness*

The policy balance favors the consolidated-first approach, because it would be more tax-neutral, simpler, and fairer.

1. *The Formation of a New Member or the Transfer of Assets Between Members*

The consolidated-first approach makes more tax neutral a consolidated group's choice to form a new member or to transfer assets between historic members. Unlike under a separate-first approach, the consolidated SLL would not depend on which group member incurred SL deductions. *Examples 3a* through *3d* illustrate that difference between the two approaches.

> *Example 3a: The Base Case.* P and its wholly owned subsidiary S are the only members of a consolidated group. In Year 1, P has no income or loss, and S, which operates two businesses, has $500 of gross income and $1,500 of non-SL deductions in one business, and $1,000 of gross income and $1,000 of SL deductions in its other business (the "SL business"). Thus, in Year 1, the P group has a $1,000 CNOL[99] and the entire CNOL is a consolidated SLL, no matter which method is used to compute the SLL.[100]

> *Example 3b: Formation of a New Member.* The facts are the same as in *Example 3a*, except that at the beginning of Year 1, S transfers the SL business to G, a newly formed, wholly owned subsidiary of S. Although the P group still has a $1,000 CNOL, its consolidated SLL depends on whether the SLL is computed using a consolidated-first or separate-first approach. Under the consolidated-first approach, the group would still have a $1,000 consolidated SLL,[101] but under a separate-first approach, the group would have a $0 consolidated SLL, because no member would have a separate SLL.[102]

[99]The CNOL equals $500 gross income from Business 1, plus $1,000 gross income from Business 2, minus $1,500 non-SL deductions from Business 1, minus $1,000 SL deductions from Business 2.

[100]Under either approach, the P group's consolidated SLL would equal $1,000. Under the consolidated-first approach, it would equal the lesser of its SL deductions ($1,000) or its CNOL ($1,000). Under a separate-first approach, because S would have a $1,000 separate SLL (*i.e.*, the lesser of its $1,000 SL deductions and its $1,000 separate loss) and P would have no separate income or loss, the group's consolidated SLL would also equal $1,000 (i.e., the lesser of the sum of the members' separate SLL and the CNOL).

[101]*See supra* note 100.

[102]Neither P nor S would have a separate SLL, because neither would have SL deductions. G also would not have a separate SLL, even though it would have SL deductions, because it would not have a separate loss.

Example 3c: Placement of Assets Within Group. The facts are the same as in *Example 3a*, except that S owns the SL business and P owns the other business. The results and analysis are the same as in *Example 3b.*

Example 3d: Transfer of Assets Between Historic Members. The facts are the same as in *Example 3c*, except that at the beginning of Year 1, P transfers a portion of its business to S so that in Year 1, P has $300 of gross income and $300 of non-SL deductions, while S has $1,200 of gross income, $1,200 of non-SL deductions, and $1,000 of SL deductions. The group would have a $1,000 consolidated SLL, no matter which approach it used.[103]

As these examples illustrate, it is only under a separate-first approach that the consolidated SLL would hinge on the placement of assets within the group.

As a consequence, that approach would impede more significantly non-tax economic choices. Despite sound non-tax business reasons, a group may be disinclined to form a new member or transfer assets between members, because it may worry that it would lose the benefit of a ten-year carryback. Further, a group may be encouraged to transfer assets between members to increase its consolidated SLL, even when those transfers would otherwise be ill-advised.

A separate-first approach also seems unfair because it distinguishes between similarly situated groups and favors the larger and better-advised. As *Examples 3a* through *3c* show, otherwise identical groups could be treated differently, based solely on the placement of assets within each group,[104] something that may be entirely fortuitous. Although the disadvantaged group might increase its consolidated SLL through appropriate asset transfers (as *Example 3d* shows),[105] the group likely would incur added expense to make the transfers, a cost avoided by the advantaged group. More troubling, a group might be unable to tell which assets to transfer or even if it is limited by the separate-first approach (at least not until it was too late).

Discounting happenstance, the limitation might more readily be avoided by larger groups, making the separate-first approach a *de facto* penalty on smaller groups. Smaller groups are less likely to have advisors sophisticated enough to plan around the limitation.[106] Further, the relative cost of avoiding the limitation may be higher for smaller groups, because at least some costs (*e.g.*, counsel and accounting fees) should decline relatively as the transfers increase in size and because smaller groups are less likely to make large transfers.

Finally, a separate-first approach creates more administrative headaches for the government and taxpayers. First, it would require a loss group to compute a notional net operating loss amount and separate SLLs for each member with SL

[103] *See supra* notes 99-100 for a comparable computation.

[104] *See also* Collins, *supra* note 24, at 70 (criticizing separate-first approaches for putting undue emphasis on the "location within a consolidated group of activities giving rise to [SL deductions]").

[105] *See id.* at 71.

[106] They also may have more flexibility to transfer assets to avoid any limitation.

deductions.[107] Second, it could spark more tax disputes because the location of a group's tax items would matter. For example, if a member with SL deductions recognized a loss on an asset it received from another member,[108] the Service might assert that the loss must be allocated to the transferor member,[109] limiting the transferee member's separate SLL and thereby the consolidated SLL. Further, if several members contribute to a product liability, the group may allocate payment responsibility to maximize its consolidated SLL, an allocation the Service could dispute. The consolidated-first approach neatly sidesteps these and similar administrative concerns by making the location of tax items within the group irrelevant.

2. *Acquisitions of Target Corporations*

Although the policy balance favors the consolidated-first approach for intragroup transfers, that approach may tolerate more tax-avoidance transactions than the separate-first approach in a group's acquisition of target stock or assets. *Example 4* illustrates one tax-avoidance transaction.

> *Example 4: The Acquisition of a Member Anticipating SL Deductions.* Corporation X anticipates settling and paying a product liability claim next year. The claim is not deductible until paid,[110] and the deduction, expected to be $1,000, will be an SL deduction. Despite the deduction, X should have positive taxable income next year.
>
> The Y group, a consolidated group, may buy the X stock at the end of this year and, whether or not it buys that stock, it expects to have a $1,000 CNOL next year. If the Y group could carry the CNOL back only 2 years, it would use only $400 of the $1,000 CNOL, but if it could carry the CNOL back 10 years, it would use the entire amount. To the extent used, the CNOL would produce a tax refund at a thirty-five percent rate.

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[107]Currently, a notional loss amount must be computed for a group member if the group's CNOL must be apportioned and carried to the separate-return year of the member. *See* Reg. § 1.1502-21(b)(2)(iv). The Service, however, argues that the group must compute a different notional loss amount to apply the separate-first limitation. *See* T.A.M. 97-15-002 (Dec. 12, 1996). Even if it were computed the same way as under the apportionment rules, a group would have to make extra computations if it would not otherwise have to apportion its CNOL.

[108]Because the stock ownership requirement under section 351 is liberalized for transfers between members, it is more likely that a member's transfer of a loss asset will qualify under section 351 so that the transferee member will take a carryover basis in the transferred asset. *See* I.R.C. § 358(a)(1) (providing for a carryover basis in a section 351 transfer); Reg. § 1.1502-34 (liberalizing the stock ownership requirement for members).

[109]*See* Commissioner v. Court Holding Co., 324 U.S. 331 (1945) (Applying the substance-over-form doctrine, the Supreme Court required a liquidating corporation to recognize gain and loss on assets transferred to and in form sold by shareholders.); *see also* I.R.C. § 482 (providing for an allocation of tax items among related taxpayers clearly to reflect their income).

[110]As a general rule, a cash-method taxpayer deducts expenses in the year paid. *See* Reg. § 1.461-1(a)(1). An accrual-basis taxpayer deducts a tort liability only as it is paid. *See* I.R.C. § 461(h)(2)(C); Reg. § 1.461-4(g)(2); *see also* Reg. § 1.461-1(g)(8), *Ex. 1* (illustrating the payment of a tort liability by an accrual-method taxpayer).

If the Y group did not buy the X stock, assume that no member of the group would have SL deductions. Then, no portion of its CNOL would be a consolidated SLL, and the group could carry back its CNOL only 2 years,[111] resulting in an immediate $140 benefit.[112] The benefit would be the same if the group bought the X stock and used a separate-first approach, because still no portion of its CNOL would be a consolidated SLL.[113]

The benefit would increase to $350 if the group used a consolidated-first approach, because the entire CNOL would be a consolidated SLL, eligible for a 10-year carryback.[114] Thus, the consolidated-first approach would provide a tax incentive for the Y group to acquire X. The X shareholders, if economically rational, would recognize that benefit and demand more for their X stock. In effect, the X shareholders would sell the SLL attribute, a form of loss trafficking.

Under the facts of *Example 4*, a separate-first approach promotes tax neutrality in a group's purchase of another member. More generally, however, the approach is a scattershot attack, snaring some groups that bear the full cost of SL deductions, while allowing a well-advised or lucky group to compromise its limitation through asset transfers or corporate combinations.

As *Example 5* shows, the separate-first approach could limit a group's use of SL deductions even when the group bears their full economic cost.

Example 5: The Acquisition of a Member Before SL Deductions Are Anticipated. The facts are the same as in *Example 4*, except that the Y group acquires the X stock six years before X pays the tort claim and before either X or the Y group realize the claim may arise. Thus, the group does not discount the stock price to account for the claim and bears its full economic cost.[115]

As *Example 4* shows, for the year in which X pays the claim, the Y group would be able to carry back its CNOL only 2 years if it used a separate-first approach, while it could carry it back 10 years if it used a consolidated-first approach.

[111] *See* I.R.C. § 172(b)(1)(A)(i).

[112] The carryback would generate a $140 tax refund (35% of $400).

[113] Under a separate-first approach, a group's consolidated SLL is limited to the sum of its members' separate SLLs, and a member's separate SLL equals the lesser of its separate NOL or SL deductions. For the Y group, only X could have a separate SLL, because only X would have SL deductions. However, because X would not have a separate NOL, it would also have no separate SLL. Because no member of the Y group would have a separate SLL, the group's consolidated SLL would be $0.

[114] *See* I.R.C. § 172(b)(1)(C) (allowing ten-year carryback). Under the consolidated-first approach, the group's consolidated SLL would equal $1,000, the lesser of the group's SL deductions ($1,000), or its CNOL ($1,000). Because that amount, which is the entire CNOL, could be carried back 10 years, it would be fully absorbed and generate an immediate $350 benefit (i.e., a $350 tax refund or 35% of $1,000).

This analysis assumes that none of the SL deductions would be limited by sections 269 or 382. This article briefly discusses section 382 in the appendix beginning *infra* p. 726.

[115] The X shareholders do not bear that economic cost because the stock price is not discounted to account for the claim.

In situations like *Example 5*, the better policy seems to support the 10-year carryback and therefore the consolidated-first approach. That extended carryback would better match SL deductions with corresponding income.[116] Because the acquiring group would bear the full economic cost of the SL deductions, its income would correspond to the SL deductions and that income would often arise years before the deduction,[117] supporting use of the consolidated-first approach.

That approach also more closely approximates what happens following a non-taxable corporate combination[118] when the acquiring corporation files a separate return. Following such a combination, the acquiring corporation computes its SLL by comparing its aggregate SL deductions with its NOL, without considering whether the SL deductions were generated in a target or acquiring business.

Although the analogy is far from perfect, a non-taxable corporate combination achieves an effect similar to the filing of consolidated returns, because, in either case, the tax items of various corporations are combined.[119] Thus, the consolidated-first approach gains some, albeit muted, support[120] from the way an SLL is computed following a combination of corporations filing separate returns.[121]

Of far more importance, a corporate combination may offer some groups a ready alternative to compromise any limitation under a separate-first approach, as the following variation of *Example 4* reveals.

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[116]*See supra* notes 53-66 and accompanying text for a discussion of the loose matching policy of section 172(f).

[117]For example, when the acts or omissions that result in SL deductions occur before the target acquisition, the acquiring group would fund the cost of the SL deductions out of pre-acquisition income, at least to the extent the acquisition was not debt-financed. Then, the corresponding income would be group income generated before the target acquisition.

[118]A "non-taxable corporate combination" is an acquisition described in section 368 in which one corporation (the "acquiring" corporation) acquires the assets of another corporation (the "target").

[119]*See supra* note 16 and accompanying text for a discussion of how a consolidated group combines members' tax items.

The analogy is imperfect because the consolidated return regulations fall far short of adopting a pure-merger model for target acquisitions and instead use a hybrid approach. For example, losses attributable to the target cannot be carried back to the target's pre-acquisition years after a non-taxable corporate combination, *see* section 381(b)(3), but may be carried back to those years after a consolidated group acquires the target stock, *see* Reg. § 1.1502-21(b)(2).

[120]The support is muted not only because the consolidation falls far short of adopting pure-merger model but also because Congress may have refused to limit an SLL following a non-taxable corporate combination primarily for administrative reasons—a concern that any limitation would involve a burdensome tracing of the net income associated with the former target's businesses. *See supra* note 63.

[121]In at least one respect, a non-taxable corporate combination presents a less compelling case for "consolidated" treatment. If the former target shareholders receive acquiring common stock in a corporate combination, those shareholders may suffer from any decline in value of the acquiring corporation and therefore would bear at least some portion of the SL deductions' cost. As a consequence, the historic acquiring shareholders would not bear the full economic cost of those deductions unlike for many taxable target stock purchases. Thus, a taxable target stock acquisition by a consolidated group may present a case for a consolidated approach more compelling than a non-taxable corporate combination.

Example 6. Corporate Combinations. The facts are the same as in *Example 4*, except that, instead of the Y group's acquiring the X stock, X merges into Z, a subsidiary member of the Y group, and the merger qualifies as a section 368 reorganization. Assume that the Y group anticipates that next year the combined entity will have at least a $1,000 separate loss.[122] Under either the separate-first or consolidated-first approach, the consolidated SLL would be $1,000.[123]

Example 6 shows that a separate-first approach could be inconsistent with the tax-neutrality ideal, favoring non-taxable corporate combinations over stock acquisitions, even though the acquiring group might bear a smaller portion of the SL deductions' economic cost following a corporate combination.[124]

More generally, a separate-first approach could serve tax-neutrality poorly, providing a tax incentive to acquire the stock of a target corporation with expected SL deductions. *Example 7* illustrates this point.

Example 7: The Acquisition of a Member Anticipating SL Deductions. The facts are the same as in *Example 6*, except that the Y group acquires all X stock and, at the time of the acquisition or shortly thereafter, Z merges into X.[125] Under either the separate-first or consolidated-first approach, the consolidated SLL would be $1,000 and could be carried back 10 years to the separate-return years of X.[126]

[122]It is not altogether clear how a member's separate loss should be computed under a separate-first approach. Assume that no matter how it would be calculated, the group anticipates that Z would have a $1,000 separate loss.

[123]Even if the acquiring corporation is considered to assume the liability for the SL deductions as part of the reorganization, it should be able to deduct the SL deductions when paid or accrued because of sections 381(c)(4) or (16). *See* Reg. §§ 1.381(c)(4)-1(a)(1) (permitting an acquiring corporation to deduct amounts which the target could not deduct before the reorganization because of its method of accounting), 1.381(c)(16)-1(a)(1) (providing that if the target could have deducted a liability when paid or accrued, the acquiring corporation can as well, subject to certain limitations); Rev. Rul. 83-73, 1983-1 C.B. 84 (discussing the interplay of section 381(c)(4) and (16)); *see also* Peter C. Cannellos, *Reasonable Expectations and the Taxation of Contingencies*, 50 TAX LAW. 299, 310-11 (1997); Kevin M. Keyes, *Dealing with Contingent Stock and Contingent Liabilities in Tax-Free Transactions*, 5 TAX STRATEGIES FOR CORP. ACQUISITIONS, DISPOSITIONS, SPIN-OFFS, JOINT VENTURES, FINANCINGS, REORGANIZATIONS AND RESTRUCTURINGS 1047, 1085-87 (Prac. Law Inst. 1997); James M. Lynch, *Transferring Assets Subject to Contingent Liabilities in Business Restructuring Transactions*, 67 TAXES 1061, 1063 (1989).

[124]*See supra* note 121.

[125]The merger could take place at the time, or sometime after, the Y group acquires the X stock. *See* Reg. § 1.338-2(c)(3)(ii) (providing that if the target stock is acquired in a qualified stock purchase, the stock purchase and subsequent merger will be respected as separate steps for federal income tax purposes). Until recently, this combination would expose the assets of the profitable member to the liabilities of the former loss member. Because of the liberal treatment of single-member limited liability companies ("LLCs"), a group can now combine members for federal income tax purposes without this exposure.

If a domestic LLC has a single owner, it is generally disregarded as an entity separate from its owner unless a special election is made. *See* Reg. § 301.7701-3(b)(1)(ii). Thus, in the example, if Z had merged into a single-member LLC owned by X and the LLC were disregarded, X and the LLC would be treated for federal income tax purposes as a single entity, allowing X and the LLC to combine their tax items.

[126]*See* Reg. § 1.1502-21(b)(2)(i) (describing the carryback of an attributable portion of the CNOL to a separate-return year of a member). Note that the result would be the same if it were Z (the historic group member) rather than X that anticipated the SL deductions. *But see* I.R.C. § 269(a)(2) (limiting use of tax attributes when a corporation's principal purpose to acquire assets in a carryover-basis transaction is to evade or avoid tax).

As *Examples 6* and *7* illustrate, a group may have a tax incentive to acquire target stock or assets under either the consolidated-first or separate-first approach. Although a separate-first approach may limit some tax-avoidance transactions, it falls far short of being tax-neutral for target acquisitions.

If we were to adopt that approach, consolidated groups would be encouraged to transfer assets to avoid any separate-first limitation, resulting in the economic inefficiencies and administrative concerns noted above.[127] It also seems more likely that the limitation would be avoided in the most vexing case—when a group acquires a target knowing it will probably soon incur SL deductions—for it is at the time of a target acquisition that a group most often enjoys the benefit of sophisticated tax planning.

In many other cases, the group's tax professionals might be consulted only after the SL deductions are paid, which is generally too late to avoid a separate-first limitation through propitious asset transfers. In those cases, the limitation would be more random, depending on the net income of the member when it recognizes the SL deductions. Thus, the separate-first approach seems unfair, if not perverse, directing an arbitrary assault as likely to limit one group as another but more likely to miss the mark in the most vexing case.

3. *The Policy Balance*

Neither the consolidated-first nor separate-first approach can effectively curtail tax-motivated acquisitions of target corporations, because, by itself, neither adequately promotes tax neutrality for these target acquisitions. We should not require either approach to shoulder this burden; the poison deserves a more comprehensive and precise antidote than either approach can offer.[128]

Once we remove this burden, the consolidated-first approach becomes the clear front-runner. Not only is it simpler to apply, but it is also fairer and, for intra-group transfers, more tax-neutral.[129] We should adopt this approach if it is supported by an accessible and plausible reading of the Code and consolidated return regulations.

B. *The Technical Case for the Consolidated-First Approach*

The Code and consolidated return regulations comfortably accommodate a consolidated-first approach. The Code limits the SLL for any taxable year to the net operating loss for that year,[130] and, under the regulations, a group's net

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[127]*See supra* pp. 680-82.

[128]The appendix to this article suggests several responses to these tax-motivated transactions.

[129]One commentator argues, at least in part, that a separate-first approach should be rejected because it would buck the trend of the consolidated return regulations; increasingly, the regulations use a single-entity approach for activities during consolidation generally and for the treatment of the CNOL in particular. *See* Collins, *supra* note 24, at 68-69. The argument adds little to the debate, however, because a mere statistical preference for one method does not prove that the method should be applied in a particular case.

[130]*See* I.R.C. § 172(f)(2).

operating loss is its CNOL.[131] The group computes its CNOL by taking into account each member's losses and other tax items.[132] Because nothing in the regulations expressly requires that members first compute separate NOLs,[133] we may read the Code and regulations to provide that a group computes its consolidated SLL by looking first to its CNOL, rather than to separate loss amounts for each member.[134] Thus, a readily accessible and plausible reading of the Code and regulations supports the consolidated-first approach.[135]

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[131]*See* Reg. § 1.1502-21.

[132]*See* Reg. § 1.1502-21(e) (providing that a group computes its CNOL by combining the gross income and deductions of its members generally as determined under Regulation section 1.1502-11).

Although the litigation involving consolidated SLLs has thus far considered Regulation section 1.1502-21 (1996), the predecessor to the current Regulation section 1.1502-21, in this regard those two sections differ only in style, not in substance, and the CNOL (and SLL) should be determined the same way under either section. *See* CO-78-90, 1991-1 C.B. 757, 760 (preamble to proposed regulations stating that those regulations were "generally intended to simplify, but not change, the [corresponding old regulations]"; in relevant part, the proposed regulations are the same as the current regulations).

To the extent CO-78-90 made significant changes, the Service endorsed a single-entity policy, stating that "[c]orporations that file a consolidated return should be able to use each other's losses as if they were divisions of a single corporation rather than separate corporations." *Id.* at 759 (discussing a change to the separate return limitation year ("SRLY") rules). By implication, the quoted language supports the consolidated-first approach, because that approach, unlike any separate-first approach, treats members like corporate divisions rather than separate corporations.

[133]In fact, a member starts with the CNOL to determine its loss carryback to any separate-return year. *See* Reg. § 1.1502-21(b)(2) (providing that a member is allocated an attributable portion of the group's CNOL). In *Amtel, Inc. v. United States*, the court explained this carryback as follows:

> The term "net operating loss" in the context of a consolidated income tax return generally means the net operating loss of the consolidated group as a whole, and not the separate net operating loss of a member . . . .
>
> [A] member of an affiliated group *may* have a separate net operating loss with independent significance for income tax purposes. The [Service] does not apply the single entity approach *when* a taxpayer seeks to carry back a net operating loss from a consolidated return year to a separate return year. In that context, the Service treats the members as separate by apportioning the [CNOL].

Amtel, Inc. v. United States, 31 Fed. Cl. 598, 600 (1994), *aff'd*, 59 F.3d 181 (Fed. Cir. 1995) (emphasis added) (citation omitted).

[134]Further, a group carries its CNOL to consolidated-return years on a single-entity basis and determines that carryover or carryback under the principles of section 172 (in the current regulations) or section 172(b) (in the old regulations). *See* Reg. § 1.1502-21(b)(1), Reg. § 1.1502-21(b)(1) (1996). Because the SLL has relevance only if it is carried back under section 172(b), these references to "principles" should embrace the computations under section 172(f), so that these computations arguably should also be made on a single-entity basis (*i.e.*, using a consolidated-first approach); *see* 2 DUBROFF ET. AL., *supra* note 10, § 41.04[6][b][i], at 41-71; *cf.* F.S.A. 1999-12-007, TAX NOTES TODAY (Mar. 29, 1999) (LEXIS, FEDTAX lib., elec. cit 99 TNT 59-56) (stating that "the only NOL that any group member has that can reduce the consolidated tax liability of the group for a carryback or carryover year is the CNOL").

[135]Without significant discussion, the District Court for the Western District of North Carolina endorsed the consolidated-first approach, quoting the following portion of the group's brief with favor: "This is a simple, plain vanilla case, involving only a single consolidated group and its effort to carry a net operating loss from one consolidated return year to another consolidated return year of the same group." United Dominion Indus., Inc. v. United States, 98-2 U.S.T.C. ¶ 50,527, at 85,194, 82 A.F.T.R.2d 5037, 5043-44 (W.D.N.C. 1998).

C. *The Technical Case for a Separate-First Approach*

We may also read the Code and regulations to support a separate-first approach. Under such an approach, a consolidated group would compute a separate SLL for each member and combine those separate SLLs to form its consolidated SLL. Because it is not clear how a group should compute and combine those separate SLLs, the Code and regulations offer weaker technical support for the separate-first approach; we therefore should adopt the consolidated-first approach.

If we were to compute a member's separate SLL, it could be limited by the member's negative separate taxable income, and a fairly direct reading of the regulations would favor that limitation. However, that reading appears inconsistent with the drafters' intent and may reach results at odds with any sensible policy of taxing consolidated groups.

As an alternative, a separate SLL could be tied more closely to the member's NOL calculated as if it filed separate returns, but we should not adopt that interpretation for two reasons. First, it draws only indifferent support from the Code and consolidated return regulations.[136] Second, it is fairly inaccessible, relying primarily on inference and implication and requiring a detailed, winding foray through the Code and regulations.

Even if we interpret the regulations to require a group to compute separate SLLs for members, it is not altogether clear how the group should combine those separate SLLs to form its consolidated SLL.[137] The separate SLLs could be taken into account after other net member losses or proportionately with those losses. That ambiguity also cuts against adopting a separate-first approach.

Perhaps only one technical factor weighs in favor of a separate-first approach. That approach might fit more comfortably with the rules to allocate a portion of the consolidated SLL for carryback to a separate-return year of a member. Nevertheless, the allocation rules are flexible enough to accommodate (and even appear to contemplate) the consolidated-first approach.

Thus, we should adopt the consolidated-first approach because we can construct the better technical (and policy) case for that approach. In the remainder of this Article, I discuss why the technical case for any separate-first approach falls short.

1. *One Separate-First Approach—A Separate Taxable Income Limitation*

Although a group's CNOL is a consolidated amount, the group determines that amount by "taking into account," among other things, each member's sepa-

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[136] *Cf.* T.A.M. 81-45-027 (July 31, 1981) (stating that the consolidated return regulations "do not provide for the calculation of a [member's] separate net operating loss" for which a section 172(b)(3) election could be made).

[137] At some point, the group must determine a consolidated SLL. *See supra* note 74.

rate taxable income ("STI").[138] If STI is a netted amount[139] and a group uses those netted amounts to compute its CNOL,[140] a member's contribution to the consolidated SLL generally would be limited to the lesser of its SL deductions or its negative STI (the "STI limitation").[141]

With some exceptions and modifications, a member's STI includes all of its tax items[142] and "is computed in accordance with the provisions of the Code covering the determination of the taxable income of separate corporations."[143]

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[138]Under the current regulations, the CNOL equals "[a]ny excess of deductions over gross income, as determined under Reg. § 1.1502-11(a) . . . ." Reg. § 1.1502-21(e). One of the factors taken into account under Regulation section 1.1502-11(a) is each member's STI. *See* Reg. § 1.1502-11(a)(1); *see also* Reg. § 1.1502-12 (introductory language) (providing that STI includes the case in which a member's deductions exceed gross income). In the old regulations, the CNOL's connection to STI was even more direct, because those regulations defined the CNOL as an amount "determined by taking into account" several amounts, including each member's STI. Reg. § 1.1502-21(f)(1) (1996). In this regard, the old and current regulations should be interpreted consistently. *See supra* note 132; *see also* Intermet Corp. v. Commissioner, 111 T.C. 294, 301 (1998) (stating that it is "quite clear" that a group computes its CNOL by taking each member's STI into account).

[139]In *Intermet*, the Tax Court concluded that STI is a netted amount. *See Intermet*, 111 T.C. at 301-02.

[140]In *Intermet*, the Tax Court concluded without discussion that a group determines its CNOL by considering members' STIs, as netted. *See id.* The court could have concluded, instead, that a group "takes into account" a member's STI by considering the component tax items that make up the STI. See *infra* notes 245-47 and accompanying text for a discussion of how a group takes into account member NOLs (which also would be netted amounts) by considering their component tax items.

[141]Then, to the extent a member's SL deductions exceed its negative STI, that excess would be "absorbed by the current income items of the member in the computation of [STI]" and "exhausted." *Intermet*, 111 T.C. at 302. In other words, the excess could not be included in the consolidated SLL, so that a member's contribution to the consolidated SLL would be limited by its negative STI.

Intermet involved facts indistinguishable from a District Court case that employed the consolidated-first approach. *See* United Dominion Indus., Inc. v. United States, 98-2 U.S.T.C. ¶ 50,527, 82 A.F.T.R.2d 5037 (W.D.N.C. 1998). The Tax Court distinguished *United Dominion* because it involved a predecessor statute that did not expressly limit the use of SL deductions to those "taken into account" in computing the NOL for the taxable year. *See Intermet*, 111 T.C. at 304 n.13. It is not clear why that distinction makes a difference, and the Tax Court offered no explanation.

The phrase "taken into account" could mean "reflected." *See* Reg. §§ 1.338-4(c)(1), 1.1502-20(c)(2)(iii) (using "taken into account" to mean "reflected"). Using this definition, the SL deductions in *Intermet* would have been taken into account in computing the group's CNOL under either a separate-first or consolidated-first approach, because they would have affected the amount of the CNOL for the taxable year in either case. *See* Axelrod, *supra* note 97 (criticizing *Intermet*, including the "taken into account" discussion). The "taken into account" language may have been added to prevent SL deductions carried from other taxable years from being included in the SLL for the carryover year. *See* § 172(f)(1)(B) (defining SL deductions without requiring that they be paid or incurred in the taxable year for which the SLL is computed).

Even if the phrase "taken into account" is interpreted more narrowly, the language still should support either a separate-first or a consolidated-first approach. The phrase might mean that the SLL must be less than SL deductions in certain cases, something that could occur with a separate-first approach (*i.e.*, when a member's SL deductions exceed its separate SLL) or with the consolidated-first approach (*i.e.*, when the aggregate SL deductions exceed the CNOL). Thus, it is not clear why even this narrow interpretation of the phrase favors the separate-first approach. *See* I.R.C. § 172(h)(1), (4)(C) (limiting relevant expenses used to compute CERT loss to those "taken into account" in computing NOL; group computes consolidated CERT loss using consolidated-first approach).

[142]*See* Reg. § 1.1502-12 (defining STI).

[143]Reg. § 1.1502-12 (introductory language).

We could interpret the quoted language in at least two ways. It could mean, simply, that we compute a tax item included in STI by applying any special Code requirements relating to corporations.[144] It could also mean, in addition, that we net those items, because a separate corporation nets its tax items in computing its taxable income.[145] Only the second interpretation would favor the STI limitation.

Both interpretations follow a plain reading of the regulations, because in either case the group would comply with the regulatory directive to "compute" a member's STI.[146] Under the first interpretation, we would determine STI by computing its component tax items. Under the second, we would also net those components, an additional computation.

Thus, a plain reading eliminates neither interpretation, largely because the regulations never directly answer whether STI is merely a collection of component tax items or a netted amount. To answer that question, we must probe the regulations in more depth to discern the drafters' intent.

We can muster colorable arguments for netting and the second interpretation. First, depending on our interpretation of Regulation section 1.1502-80(a), the introductory language of Regulation section 1.1502-12 could be mere surplusage if we failed to net. Furthermore, the CNOL components (other than STI) are netted amounts, implying that STI should be as well.

The weight of the arguments, however, should favor the first interpretation, and we should reject netting and an STI limitation. First, we should interpret Regulation section 1.1502-80(a) and may categorize the CNOL components in a way that supports the first interpretation. Further, netting and the second interpretation seem inconsistent with the drafters' intent. Netting would clash with the regulations' treatment of foreign expropriation losses, and it could also reach odd results because it strays from a pure separate-corporation approach.

This Part explores each of these points in turn.

a. *Section 1.1502-80(a)*

We might favor the second interpretation and adopt an STI limitation if the first interpretation would make the introductory language in Regulation section 1.1502-12 surplusage.[147] That would happen if the Code already applied sepa-

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[144]Section 172(f), which is the SLL provision, has no special requirements relating to corporations.

[145]*See* I.R.C. § 63(a) (defining taxable income as "gross income minus . . . deductions).

In the netting process, we presumably would follow the netting priority of section 172(f) (as a separate corporation would), so that the deductions other than SL deductions would first offset the gross income included in the STI computation. Consequently, this approach generally has the same effect as treating a member's negative STI as its NOL in determining the member's separate SLL.

[146]*See* II THE OXFORD ENGLISH DICTIONARY 749-50 (1970) (providing that "compute" means "to estimate or determine by arithmetical or mathematical reckoning; to calculate, reckon, count"); WEBSTER'S THIRD NEW INTERNATIONAL DICTIONARY 468 (1976) (providing that "compute" means "to determine or ascertain [especially] by mathematical means").

[147]*See supra* note 143 and accompanying text.

rately to members under a broad, separate-corporation "default" rule.[148] Although several courts have cited Regulation section 1.1502-80(a) to support such a default rule, that section is better read to require a hybrid, consolidated/separate approach, which could accommodate either the first or second interpretation.[149] Thus, Regulation section 1.1502-80(a) should not compel the second interpretation (*i.e.*, netting) or an STI limitation.

A separate-corporation default rule gains support from *Gottesman & Co., Inc. v. Commissioner.*[150] In *Gottesman*, the court held that a group could determine its accumulated earnings tax under section 531 separately for each member,[151] even though the applicable regulations might be read to support a consolidated computation.[152] Under the regulations, a consolidated group computed "the tax imposed by section 531 on . . . *consolidated* accumulated taxable income."[153] The regulations never spelled out how to make a consolidated computation,[154] and proposed regulations, withdrawn without explanation, would have permitted the Gottesman group to calculate the tax on a separate-corporation basis.[155] Following the advice of counsel, the group computed the tax separately for each member and made distributions adequate to avoid that tax.[156] Noting the confused state of the law, the court refused to determine the accumulated earnings tax on a consolidated basis, because the tax was a penalty provision, the group took reasonable steps to comply with the law, and any failure to comply was the government's fault since no one could be sure how a consolidated computation would be made absent further guidance.[157]

Although not necessary to its decision, the court added the following statement that breathed life into a separate-corporation default rule: "[Regulation] section [1.1502-80(a)] . . . provides the general rule that to the extent the consolidated return regulations do not mandate different treatment, corporations

[148]The first interpretation would require group members to separately apply any special Code requirements for corporations, making the quoted language no more than a subset of a broader separate-corporation default rule. In other words, because of the default rule, the introductory language of Regulation section 1.1502-12 would be mere surplusage under the first interpretation.

[149]*But cf.* PEEL, *supra* note 14, § 6.04 ("By and large, each member . . . was treated . . . as a separate entity [under the pre-1996 regulations] unless the Regulations specifically provided for consolidation.").

[150]77 T.C. 1149 (1981).

[151]*See id.* at 1157-58.

[152]*See id.* at 1154 (discussing the development of that regulation section).

[153]Reg. § 1.1502-2(d) (1972) (emphasis added).

[154]*See Gottesman*, 77 T.C. at 1154.

[155]*See id.* at 1154-55 (describing the 1968 proposed regulations); *id.* at 1157 (concluding that, although the proposed regulations generally required a complex consolidated approach, the group would have been eligible to use a separate-corporation approach under an exception in the proposed regulations). Although the 1968 proposed regulations were withdrawn before the years at issue (1973-75), the Service waited until 1979 to issue guidance that again described the computation of the accumulated earnings tax by consolidated groups. *See id.* at 1155; *see also* 36 Fed. Reg. 16,661 (1971) (withdrawing the 1968 proposed regulations); 44 Fed. Reg. 28,001 (1979) (proposing new regulations).

[156]*See Gottesman*, 77 T.C. at 1157.

[157]*See id.* at 1156-58.

filing consolidated returns are to be treated as separate entities when applying . . . provisions of the Code."[158]

The quoted statement seems wrong, leading to unexpected results[159] and running counter to the language of Regulation section 1.1502-80(a). In relevant part, that section reads as follows: "The Internal Revenue Code, or other law, shall be applicable to the *group* to the extent the regulations do not exclude its application."[160] As the Service historically advocated,[161] nothing in Regulation section 1.1502-80(a) requires that the Code be applied to members separately. Instead, a strict textual interpretation could support a consolidated default rule,

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[158]*Id.* at 1156. Two companion cases repeat this separate-corporation theme, but neither should be read more generally to endorse a default separate-corporation approach. In H Enterprises International, Inc. v. Commissioner, 105 T.C. 71 (1995), the court considered whether sections 246A and 265 applied separately to group members. The court stated that

> [Regulation Section 1.1502-80] provides that the Code and other laws shall be applicable to a consolidated group to the extent the consolidated return regulations do not exclude such applicability. Where the consolidated return regulations do not require that corporations filing such returns be treated differently from the way separate entities would be treated, these corporations shall be treated as separate entities when applying provisions of the Code.

Id. at 85 (citing *Gottesman*, 77 T.C. 1149 (1981)). The court quoted this language principally to justify applying sections 246A and 265 to the group, because the consolidated return regulations did not specifically discuss their application. Despite articulating a separate-corporation view, the court applied these two sections by considering the activities of the group as a whole. *See id.* at 78-82. The court justified this single-entity approach by looking to the sections themselves, rather than to the consolidated return regulations. *See id*; *see also* H Enters. Int'l, Inc. v. Commissioner, 75 T.C.M. (CCH) 1948 (1998), 1998 T.C.M. (RIA) ¶ 98,097 (a companion case treating the group as a whole in applying those sections); T.A.M. 97-25-004 (Mar. 7, 1997) (stating that "[g]enerally the consolidated return regulations require that each member's income be computed as if it were a separate corporation, with certain exceptions, and those exceptions do not include [section] 265(2)"); T.A.M. 90-51-001 (Aug. 30, 1990) (asserting that in applying section 1033 to a consolidated group, Regulation sections 1.1502-12 and 1.1502-80 required members to be treated as separate corporations).

[159]Adopting a separate-corporation default rule would be inconsistent with how many taxpayers have viewed the consolidated return regulations. *See* William F. Huber et al., *Consolidated Return Temp. Regs Modernize SRLY Treatment for Credits and Create OFL Problems*, 89 J. TAX'N 12, 20 & n.18 (1998) (noting that the Service's position in T.A.M. 97-15-002, in which it adopted a separate-first approach, was inconsistent with most commentators' view of how SLLs should be treated).

[160]Reg. § 1.1502-80(a) (emphasis added).

[161]In T.A.M. 83-46-144 (July 29, 1982), the Service used a consolidated approach to attribute a new jobs credit to a member, even though the regulations did not specifically discuss that credit. In interpreting Regulation section 1.1502-80(a), the Service said,

> [I]f the regulations do not mandate a consolidated treatment, section 1.1502-80 of the regulations requires that corporations filing consolidated returns are to be treated as separate entities, unless it would be reasonable to apply consolidated principles. . . .
>
> [I]t would appear to be appropriate to apply consolidated principles if [the application] of these principles is consistent with the single economic entity theory underlying consolidated returns.

Id; see also T.A.M. 84-34-001 (May 14, 1984) ("[I]f the regulations do not mandate a consolidated treatment, section 1.1502-80 of the regulations requires that corporations filing consolidated returns are to be treated as separate entities, unless, under all the facts and circumstances, it would be reasonable to apply consolidated return principles.").

because the section states that the Code applies to the "group," not to members separately.

Neither default rule is likely to fulfill the guiding directives, for the consolidated return regulations "clearly to reflect the income tax liability" of the group and each member and "to prevent avoidance" of that tax liability.[162] To satisfy those directives, we should interpret Regulation section 1.1502-80(a) to balance the separate and consolidated approaches to best achieve tax neutrality.[163] At the least, then, the section should not advance a separate-corporation default rule or oblige us to adopt the second interpretation and the STI limitation.[164]

b. *The CNOL Components*

Depending on how we categorized the CNOL components other than STI (the "consolidated" CNOL components), we could favor either the first or second interpretation.[165] Those components are consolidated capital gain net income,[166] consolidated section 1231 net loss,[167] the consolidated charitable contributions deduction,[168] the consolidated dividends received deduction,[169] and the consolidated section 247 deduction.[170]

Each consolidated CNOL component is a net amount, implying that STI should be as well. Because a consolidated group computes STI for each member, the implication supports separate netting for each member and, consequently,

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[162]I.R.C. § 1502.

[163]*See supra* pp. 669-71. We should not engage in this tax-neutrality analysis when the only plain reading of the Code and regulations mandates a consolidated or separate approach. This "plain reading" approach should answer most issues faced by consolidated groups, generally promoting certainty in applying the consolidated return regulations. It should not resolve whether a group uses an STI limitation, however, because Regulation section 1.1502-12 may be plainly read to support both the first and second interpretations.

[164]In fact, a tax-neutrality analysis would favor a consolidated-first approach and, consequently, the first interpretation, because we should favor the plain reading that best advances tax neutrality. *See generally supra* pp. 680-86.

[165]The components that make up CNOL are all components that make up CTI except for the consolidated net operating loss deduction and the consolidated section 922 deduction. *See* Reg. §§ 1.1502-21(e), 1.502-21 (f) (1996). Accordingly, the CNOL components other than STI are those described in Regulation section 1.1502-11(a)(3)-(5), (7), and (8).

Although Regulation section 1.1502-21(e) does not expressly exclude the consolidated section 922 deduction, it should not be taken into account in the CNOL computation. First, section 922 was repealed effective for taxable years beginning after December 31, 1979. *See* Tax Reform Act of 1976, Pub. L. No. 94-455, § 1052(b), (d), 90 Stat. 1648. Further, Regulation section 1.1502-25, which described the computation of the consolidated section 922 deduction, was removed from the consolidated return regulations in 1993. *See* T.D. 8474, 1993-1 C.B. 242.

[166]*See* Reg. §§ 1.1502-11(a)(3), -22(a), (b) (providing that the netting of capital gain and loss amounts specified in § 1222(5)-(11) occurs first at the group level, not the member level).

[167]*See* Reg. §§ 1.1502-11(a)(4), -23 (providing that netting of section 1231 gains and losses occurs first at the group level, not at the member level).

[168]*See* Reg. §§ 1.1502-11(a)(5), -24 (providing that the limitation for charitable deductions is determined for the group as a whole).

[169]*See* Reg. §§ 1.1502-11(a)(7), -26 (providing that the section 246(b) limit is determined at the group level).

[170]*See* Reg. §§ 1.1502-11(a)(8), -27 (using a subgroup approach to compute the section 247 deduction relating to a group's public utilities).

the second interpretation.[171] Further, for the first two of those components, the regulations require that netting occur first at the group level.[172] Because we lack a similar regulatory directive for STI, by implication the tax items making up STI should be netted on a member-by-member basis.

Although those implications favor netting (*i.e.*, the second interpretation), the consolidated CNOL components may also be categorized to support the first interpretation. Under the first interpretation, the items comprising STI are computed simply by applying any special requirements relating to corporations. Because each consolidated CNOL component also expressly[173] or implicitly[174] involves a Code or regulatory provision that applies specifically to corporations, the regulations may expressly require consolidated treatment for those components merely to assure that they are not computed separately,[175] fitting hand in glove with the first interpretation.

c. *Foreign Expropriation Losses*

If the drafters' intent were measured solely by categorizing the CNOL components, we might well endorse the second interpretation. When we complete the picture, however, it seems clear the drafters rejected that interpretation (*i.e.*, netting) and, consequently, the STI limitation.

The most direct evidence is the regulations' historic treatment of foreign expropriation losses ("FELs"). FELs were included in STI, but all FELs were taken into account in computing the group's consolidated FEL. When a member's

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[171]*See* Reg. § 1.1502-12 (introductory language).

[172]The operative provisions state that these amounts are not determined separately but instead are "determined for the group as a whole." Reg. §§ 1.1502-22(a), -23(a).

[173]*See* I.R.C. §§ 170(b)(2) (limiting a charitable deduction to ten percent of the taxable income of a corporation), 246(b) (limiting the dividends received deductions under sections 243(a)(1), 244(a), and 245, each of which applies to a corporation), 247 (limiting the deduction for dividends paid by a public utility), 1211(a) (limiting the allowance for capital losses of a corporation to its capital gains), 1212(a) (providing for a capital loss carryback for a corporation).

[174]Because section 1231 depends on the applicable accounting method and, under Regulation section 1.1502-17, each group member may have its own accounting method, this section arguably should apply separately to each member absent regulations that required consolidated treatment. *See* I.R.C. § 1231(b)(1)(A), (B) (referring to inventory and property held for sale in the ordinary course of business, both categories of property that would be determined separately for each member); *see also* T.A.M. 94-28-004 (Apr. 7, 1994) (concluding that section 447 applied separately to members because it applied to "corporations"), T.A.M. 83-30-001 (Jan. 25, 1983) (providing for separate determination of independent producer status for purposes of section 613(d)).

[175]Without the consolidated directive, the components may be computed using a separate-corporation approach, as is illustrated by a case involving section 902(a). Under that section, "a domestic corporation" may be entitled to a tax credit if it receives a dividend from a foreign corporation and owns at least ten percent of the foreign corporation's voting stock. One court has concluded that a group must determine that tax credit separately for each member, in part because section 902(a) limits the credit to "a" corporation. *See* First Chicago NBD Corp. v. Commissioner, 135 F.3d 457, 458 (7th Cir. 1998); *see also* Norwest Corp. v. Commissioner, 111 T.C. 105, 170 (1998) (concluding that a group must compute its commercial bank bad debt under section 172(g) using a separate-first approach; members qualify separately as banks and section 172(g) contains no consolidated directive); *cf.* I.R.C. § 172(h)(4)(C) (requiring group to apply a limitation on a single-entity basis; the provision generally applied to "a corporation").

FELs exceeded its negative STI, a group could fully account for those FELs only if STI was a collection of component tax items rather than a netted amount.

FELs were ordinary losses resulting from a foreign government's expropriation, seizure, or similar taking of property,[176] and until 1990 a taxpayer could elect to extend the carryforward period for any portion of its NOL attributable to FELs.[177] For a corporation filing a separate return, that portion equaled the lesser of the corporation's FELs or its NOL.[178] A consolidated group computed its consolidated FEL using a consolidated-first approach,[179] taking into account all FELs of each member, unless in the aggregate they exceeded the group's CNOL.[180] Because FELs were included in STI[181] but a member's FELs could exceed its negative STI, the group could fully account for those FELs only if those deductions constituted a distinct component of STI. *Example 8* illustrates this point.

> *Example 8: Consolidated FEL.* P and S were the members of a consolidated group. In a year when the FEL provision was in effect, P had $0 of gross income and a $200 non-FEL loss, and S had $100 of gross income and $300 of FELs. Thus, the group had a $400 CNOL for the year.[182]
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> Assume that the group elected the special carryforward for its FELs.[183] Under the consolidated-first approach authorized by the regulations,[184] the consolidated FEL equaled $300, the lesser of the group's aggregate FELs ($300) or its CNOL ($400). In making this computation, STI could not be taken into account as a netted amount, because the consolidated FEL would then have equaled only $200.[185]

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[176]*See* I.R.C. § 172(h)(1) (1990) (defining FELs but not limiting them by any net member loss amount).

[177]*See* I.R.C. § 172(b)(1)(D) and (3)(A) (1990). The FEL provisions were repealed by Omnibus Budget Reconciliation Act of 1990, Pub. L. No. 101-508, § 11811(b)(2)(A), 104 Stat. 1388.

[178]*See* I.R.C. § 172(h)(2) (1990).

[179]*See* Reg. § 1.1502-21(b)(2)(iii) (1996).

[180]*See id.* The group made this computation by taking all FELs of each member into account, and a member's FELs were not limited by its negative STI or any other separate net loss amount. *See* Reg. § 1.1502-21(b)(2)(iii) (1996) (including in the computation all members' FELs, as defined in the Code); I.R.C. § 172(h)(1) (1990) (defining FELs without reference to any separate loss amount including negative STI). Thus, FELs were akin to SL deductions, and a group computed its consolidated FEL using the consolidated-first approach. *See* T.A.M. 97-15-002 (Apr. 11, 1997) ("For consolidated groups, § 1.1502-21(b)(2)(iii) (1996) required FELs to be computed on a consolidated basis."); *cf.* Reg. § 1.1502-22(b)(1) (1996) (using language comparable to Regulation section 1.1502-21(b)(2)(iii) (1996) in a companion provision on foreign expropriation capital losses ("FECLs"); net capital loss attributable to FECLs also determined using a consolidated-first approach).

[181]The CNOL is determined by taking into account STI and the consolidated items described in Regulation section 1.1502-11(a)(3)-(5), (7), and (8). Because FELs were included in none of the consolidated items, through the process of elimination, they must have been included in STI.

[182]The CNOL equals $200 (P's loss) plus $300 (S's FELs) minus $100 (S's gross income). *See* Reg. § 1.1502-21(f) (1996).

[183]A group could make that election only if its aggregate FELs exceeded 50% of its CNOL. *See* Reg. § 1.1502-21(b)(2)(iii) (1996).

[184]*See id.*

[185]The consolidated FEL would have equaled $200 because S, the only member with FELs, would contribute only a net $200 FEL ($300 FELs less $100 gross income) to the CNOL.

Thus, at least until the FEL provision was repealed in 1990, we should consider STI to be a collection of distinct tax items rather than a netted amount. Because the descriptions of STI and the CNOL components have remained unchanged in all relevant respects since then (and in fact since 1966),[186] we should continue to treat STI as a collection of tax items, rejecting netting and the STI limitation.[187]

d. *Consequences of Netting*

Netting also produces odd outcomes, because a member's negative STI may differ from its NOL computed on a pure separate-corporation basis.[188] As a consequence, netting (and the second interpretation) are difficult to square with any rational single-entity, separate-corporation, or hybrid approach for consolidated groups.[189]

Example 9 illustrates that, in certain cases, netting results in a smaller consolidated SLL than either a consolidated-first or pure separate-corporation approach.

> *Example 9: Consequences of Netting—Consolidated SLL May Be Less Than Under a Consolidated or Pure Separate-Corporation Approach.* P and S are members of a consolidated group. P, a pure holding company, has no income or loss items, while S has $100 of gross income, $100 of SL deductions, and a

[186]*Compare* Reg. §§ 1.1502-11 (1966) (CTI computation), -12 (1966) (STI computation), *and* -21(f) (1966) (CNOL computation) *with* Reg. §§ 1.1502-11(a), -12, *and* -21(e).

[187]This conclusion is consistent with the current treatment of corporate equity reduction interest losses ("CERT" losses). Section 172(b)(1)(E) limits the carryback of a CERT loss, which equals the lesser of a corporation's NOL or its interest deductions attributable to certain major stock acquisitions. *See* I.R.C. § 172(h)(2). By statute, a consolidated group computes its CERT loss using a consolidated-first approach, taking into account the relevant interest deductions of all members. *See* I.R.C. § 172(h)(4)(C) (treating the group as a single taxpayer). If those deductions are included in STI, they must comprise a distinct component of STI to be fully considered, because a member's relevant deductions may exceed its negative STI. In other words, STI could not be a netted amount if CERT losses were included in STI.

Following the consolidated return regulations as written, we would conclude that CERT losses must be included in STI because they are not included in a consolidated CNOL component. *See supra* notes 166-70 and accompanying text. If the Service had intended a different result, it could have modified the consolidated return regulations.

Nevertheless, we cannot be certain that CERT losses are included in STI for two reasons. First, by expressly providing consolidated treatment, Congress may have intended that those losses comprise a new consolidated CNOL component, although the applicable legislative history is silent on this point. *Cf.* H.R. Rep. No. 101-247, at 1250-53 (1989), *reprinted in* 1989 U.S.C.C.A.N. 2720-23; H.R. Conf. Rep. No. 101-386, at 570-71 (1989), *reprinted in* 1989 U.S.C.C.A.N. 3173-74. Second, we should assign no more than modest weight to the Service's failure to amend the consolidated return regulations. *See infra* pp. 708-09.

Although the treatment of CERT losses, by itself, does not assure that STI is not a netted amount, it dampens any argument in favor of netting.

[188]The difference may occur because STI excludes section 1231 amounts and capital gains and losses, among other items. Because of that difference, STI could be greater than or less than a pure separate-corporation amount and netting may produce counter-intuitive results.

[189]Further, depending on the method we use to attribute the CNOL among members, netting could result in a member being allocated a portion of the CNOL greater than its separate loss. *See infra* Example 15 p. 717.

$100 section 1231 loss. The P group has a $100 CNOL,[190] all of which is attributable to S. If STI is a netted amount, the group would have a $0 consolidated SLL because S, the only member with SL deductions, would have a $0 separate SLL and contribute no amount to the consolidated SLL.[191]

If the P group determined its consolidated SLL using a consolidated-first approach, the consolidated SLL would equal $100.[192] It would also equal $100 under a pure separate-corporation approach because S would have a $100 separate SLL[193] if it filed separate returns.

Example 10 illustrates that, in other cases, netting may result in a larger consolidated SLL than under a pure separate-corporation approach.

Example 10: Consequences of Netting—Consolidated SLL May Exceed Amount Determined Under a Pure Separate-Corporation Approach. The facts are the same as in *Example 9*, except that P has a $200 section 1231 loss, and S has $100 of SL deductions and a $100 section 1231 gain. The P group has a $200 CNOL,[194] all of which is attributable to P. If STI is a netted amount (and netting is the only member limitation in computing the consolidated SLL[195]), the group would have a $100 consolidated SLL, equal to the lesser of the aggregate separate SLLs of its members ($100, equal to S's separate SLL[196]) and its CNOL ($200).

Although the P group would also have a $100 consolidated SLL using a consolidated-first approach,[197] the group would have a $0 consolidated SLL under a pure separate-corporation approach, because no member would have an SLL if it filed a separate return.[198]

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[190]The CNOL equals S's $100 gross income, minus S's $100 SL deductions, minus S's $100 section 1231 loss.

[191]Because S's $100 § 1231 loss is excluded from its STI, S has $0 STI ($100 gross income minus $100 of SL deductions). *See* Reg. § 1.1502-12(k) (excluding § 1231 gains and losses from STI). Thus, although S has $100 of SL deductions, it has a $0 separate SLL if its separate SLL is limited by its STI.

[192]The consolidated SLL would equal $100, equal to the lesser of the group's aggregate SL deductions ($100) and the CNOL ($100).

[193]As a separate corporation, S would have a $100 NOL ($100 gross income minus $100 SL deductions minus $100 section 1231 loss) and all of that NOL would be treated as an SLL. *See* I.R.C. § 172(f)(2).

[194]The CNOL equals S's $100 section 1231 gain, minus S's $100 SL deductions, minus P's $200 section 1231 loss.

[195]Even if STI is a netted amount, a member may also be required to limit its contribution to the consolidated SLL to its NOL computed separately. Then, a consolidated group would apply two separate limitations at the member level (as well as a consolidated limitation) in computing its consolidated SLL. For reasons why the group must apply a consolidated limitation in computing its consolidated SLL, see *supra* note 74.

[196]Because S's section 1231 gain is excluded from STI, S has a $100 negative STI (equal to its SL deductions). Thus, its separate SLL is $100, equal to the lesser of its SL deductions ($100) and its negative STI ($100).

[197]The consolidated SLL would equal $100, the lesser of the group's aggregate SL deductions ($100) or its CNOL (also $100).

[198]S's SLL would equal $0 if it filed separate returns, because S would have a $0 NOL ($100 section 1231 gain minus $100 SL deductions) and therefore a $0 SLL. Because S is the only member with SL deductions, the group would have a $0 consolidated SLL if it computed its consolidated SLL on a pure separate-corporation basis.

As *Examples 9* and *10* illustrate, netting reaches results more arbitrary than under other possible approaches.[199] Consequently, netting would further complicate a group's choice to form or acquire a new member or to transfer assets between members, and the policy arguments favoring netting appear elusive at best.

Not only does netting and the second interpretation seem inconsistent with the drafters' intent, it advances no discernible tax policy. To account for SL deductions completely and consistently (whether using a consolidated-first or a purer separate-corporation approach), we should adopt the first interpretation.[200]

2. *Other Separate-First Approaches*

Although the first interpretation may accommodate either the consolidated-first or a separate-first approach, any case for a separate-first approach relies primarily on inference and implication built on a plodding tour through the Code and regulations.

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[199]Netting is also a separate-first approach, and no separate-first approach is as tax-neutral, fair, or simple as the consolidated-first approach. *See supra* pp. 680-86.

[200]Under admittedly unlikely circumstances, under the law in effect before 1998, an SL deduction could have been a capital loss, which would be excluded from STI and accounted for as part of the group's computation of capital gain net income. Because some SL deductions might have been excluded from STI and escape the STI limitation, the limitation (and netting) seems even harder to support.

The following example, involving a corporation filing separate returns, illustrates a case in which a capital loss would have been an SL deduction:

Example. SL deduction as capital loss

X, an accrual-basis corporation, owns a $0-basis building that it uses in its trade or business. In Year 1, the building burns down and X collects insurance proceeds, recognizing a $100,000 gain that it treats as a long-term capital gain under Section 1231. *See* I.R.C. § 1231(a)(1) and (a)(3)(A).

The insurance company suspects arson and timely sues X for restitution, claiming that X committed the tort of insurance fraud. *See* United Services Auto. Ass'n v. McCants, 944 P.2d 298 (Okla. 1997) (involving a suit where insurer sued insured in tort for insurance fraud, alleging that the insured concealed that his spouse deliberately burned their home). The company wins its suit in Year 5, and X pays the company $100,000 in Year 6. In Year 6, X should treat the $100,000 payment as a capital loss. *See* Rev. Rul. 67-331, 1967-2 C.B. 290 (citing Arrowsmith v. Commissioner, 344 U.S. 6 (1952)); *see also* I.R.C. § 461(h)(2)(C); Reg. § 1.461-4(g)(2) (requiring tort liability to be deducted no earlier than year of payment).

In Year 6, X has no other capital loss but has at least a $100,000 capital gain. Under Section 1211(a), X can deduct the entire $100,000 capital loss resulting from the payment. *See* I.R.C. § 1211(a). Assume that X also has a $300,000 NOL in Year 6.

Under prior law, when a taxpayer had an NOL, a current deduction was an SL deduction if it arose out of a tort, the liability for which arose out of actions a substantial portion of which occurred more than three years before the beginning of the taxable year. *See* I.R.C. § 172(f)(1) and (f)(1)(B) (1998); *see also* I.R.C. § 172(c) and (d) (describing deductions taken into account in computing an NOL). Under that standard, the capital loss should have been an SL deduction because it arose out of a tort (*i.e.*, insurance fraud) that occurred more than three years before the year of the payment. Thus, $100,000 of the $300,000 NOL would have been an SLL. *See* I.R.C. § 172(f)(2).

In that tour, we score at least as many points for the consolidated-first approach as for any separate-first approach.[201] Section 172 could accommodate either approach, and the same regulatory provisions that may favor a separate-first approach also may support the consolidated-first approach.

For example, the Code and regulations sometimes refer to the separate NOLs of members, suggesting at first blush that members must compute separate loss amounts (including separate SLLs). On closer examination, none of these references requires separate loss computations, and in most other cases when separate member computations appear necessary, the Code and regulations define those amounts.

Although the regulations never define separate SLLs, neither approach is favored by the regulations' silence. Because the regulations describe the computation of several consolidated items but not the consolidated SLL, we might infer that the group should compute SLLs separately for members. On the other hand, because it is not clear how we should compute and combine separate SLLs, we might infer that we should use the more certain consolidated-first approach.

It is also not clear how we should apportion the consolidated SLL among members. In fact, the literal language of the existing apportionment rule fits neither the consolidated-first nor any separate-first approach particularly well. However, we should read the rule flexibly enough to accommodate any of these approaches.

Thus, we should favor the consolidated-first approach. Not only is it simpler, more certain, and easier to apply, but it also follows a more accessible and plausible reading of the Code and regulations than any separate-first approach.[202]

The material that follows reviews the technical case for a separate-first approach. The review considers, in turn, (i) section 172(f) (the SLL provision), (ii) section 172(h) (the CERT loss provision), (iii) Code and regulatory references to separate member loss amounts, (iv) the regulations' silence on SLLs, (v) the uncertain computation and combination of separate SLLs, and (vi) the apportionment rules.

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[201]In First Chicago NBD Corp. v. Commissioner, 135 F.3d 457 (7th Cir. 1997), the Seventh Circuit concluded that the group had to compute a section 902 credit using a separate-corporation approach, despite some language in the regulations supporting a consolidated approach. The court based its conclusion on the overall language of section 902 and the implementing consolidated return regulations, language that, in the court's view, more closely followed a separate-corporation approach. *See id.* at 459-61. The court chastised the taxpayer for engaging in a wide-ranging review of various other consolidated provisions, characterizing the taxpayer's and the Service's give-and-take on those provisions as "an esoteric slugfest . . . in which the [Service] lands as many blows as its opponent." *Id.* at 461.

Those same principles support using a consolidated-first approach to compute the SLL, because the implementing CNOL provisions employ a consolidated approach. Although we can make arguments for any separate-first approach (other than netting), each seems to evolve into the same type of "esoteric slugfest" that worried the *First Chicago* court.

[202]The length of the discussion that follows may present the best argument against any separate-first approach.

a. *Section 172(f)*

We begin our review with Code section 172(f), the provision that authorizes SLLs. Nothing in that subsection speaks directly to whether a group should use a consolidated-first or separate-first approach.[203] Section 172(f) applies to a "taxpayer,"[204] and although the Service has argued that the "taxpayer" reference compels a separate-first approach,[205] neither the use of that word generally nor in this context necessarily favors that approach.

As a general matter, "taxpayer" may refer to each member separately or to the group as a whole. The Code defines "taxpayer" as "any person subject to any internal revenue tax."[206] "The term 'person' . . . mean[s] and include[s] an individual, a trust, estate, partnership, association, company or corporation."[207] Although a consolidated group is not specifically listed as a person under section 7701(a)(1),[208] the list is not exclusive.[209]

A group should be treated as a single taxpayer because it computes and pays its tax liability as a whole, not member by member.[210] Consistent with that

[203]*See* 2 DUBROFF ET. AL., *supra* note 10, § 41.04[6][b][i], at 41-72 ("Separate entity treatment is not compelled from a plain reading of the limitation under Section 172(f)(2) . . . .").

[204]Section 172(f), and section 172 generally, are replete with references to the "taxpayer." *See, e.g.*, I.R.C. § 172(b)(1)(C), (b)(3), (f)(1)(A)(ii), (f)(1)(B), (f)(4), and (f)(6).

[205]*See* T.A.M. 97-15-002 (Apr. 11, 1997); *cf.* 2 DUBROFF ET. AL., *supra* note 10, § 41.04[6][b][i], at 41-70 (asserting that the technical advice memorandum goes too far in stating that references to taxpayer in the Code are generally to members).

[206]I.R.C. § 7701(a)(14).

[207]I.R.C. § 7701(a)(1).

[208]Although a consolidated group is an association of corporations, a group is not an "association" within the meaning of § 7701(a)(1). *See* Reg. §§ 301.7701-3(a), 301.7701-2(a)(1) (1996).

[209]*See* I.R.C. § 7701(c) (stating that when used in a definition, the term "includes" is not deemed to exclude other things otherwise within the meaning of the term defined).

[210]*See* Reg. § 1.1502-2.

In some ways, a consolidated group is like a husband and wife filing joint returns although spouses filing joint returns are treated as separate taxpayers. *See* Reg. § 1.6013-4(b) (providing that the taxable income of spouses filing joint returns is computed on an aggregate (*i.e.*, single-taxpayer) basis, although the spouses are treated as separate taxpayers); *see also* Dolan v. Commissioner, 44 T.C. 420, 428 (1965) (treating joint filers as separate taxpayers for purposes of assessment and collection). In at least one respect, a husband and wife have more of a single-entity character than a consolidated group, because sales of property between spouses do not result in recognized gain or loss. *See* I.R.C. § 1041(a) (applying to property transfers but not service arrangements); *cf.* § 1.1502-13 (providing that gain or loss on intercompany transactions is generally taken into account using a single-entity approach).

In most important respects, however, joint filers are less like a single entity. First, each joint filer must sign the joint return, and if either gives notice to the Service that the spouses have separate residences, a notice of deficiency must be sent to the last known address of each spouse. *See* Reg. § 1.6013-1(a)(2) (signature requirement); I.R.C. § 6212(b)(2) (notice requirement). In contrast, the common parent acts on behalf of the group in filing a consolidated return, receives the only notice of deficiency, and may receive any refund of tax. *See* Reg. § 1.1502-77(a). Further, the election to file joint returns is made annually, making it a less permanent joinder than consolidated filing, which generally continues indefinitely once made. *See* Reg. § 1.1502-75(a)(2) (continued filing requirement); *cf.* Reg. § 1.1502-75(c) (election to discontinue filing, which may be made for good cause or at the discretion of the Commissioner). Finally, an "innocent" spouse may be relieved of tax liability in an appropriate case and a former spouse may be able to elect proportional liability.

treatment, each member has several liability for the group's tax.[211] Consequently, the government may look to any group asset to satisfy the group's tax liability, like it may satisfy the tax liability of a corporation filing separate returns by looking to any of its assets.[212]

In some cases, however, a member should be treated as a taxpayer distinct from the group.[213] It may be treated as a separate taxpayer to account for interactions between consolidated-return and separate-return years.[214] A member may also be treated as separate for certain purposes if it has shareholders other than group members, if it is a special-status corporation (*e.g.*, a thrift institution or life insurance company),[215] or if the Code and regulations otherwise expressly require separate treatment.[216]

Thus, sometimes the group is properly treated as a single taxpayer and sometimes its members are properly treated as separate taxpayers,[217] illustrating noth-

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I.R.C. § 6015. The consolidated returns have no similar provision for "innocent" members. *But see* Reg. § 1.1502-6(b) (providing that the district director may limit the liability of a member after it was sold in a bona fide sale). Because of these important differences, members of a group do not have to be treated as separate taxpayers even if joint filers are.

[211]*See* Reg. § 1.1502-6(a). Several liability is necessary not because the members are separate taxpayers but instead because each member probably has limited liability. The regulations have provided several liability since 1929. *Compare* Art. 15 of Reg. 75 (1929) (dealing with 1929 and subsequent years) *with* Art. 731 of Reg. 74 (1929) (dealing with pre-1929 years), both *reprinted in* 138 *Internal Revenue Acts of the United States 1909-1950 Legislative Histories, Laws, and Administrative Documents* (1979).

[212]If the members of a group were treated consistently as separate taxpayers in collecting the tax, each would bear only some share of the group's tax.

[213]In *dicta*, one court stated: "The single entity framework does not mean that all items of income, deductions, and credit for the affiliated corporations are combined into single accounts as if the corporations are one. The consolidated return regulations, in fact, primarily deal with the affiliated corporations as separate corporate entities." American Standard, Inc. v. United States, 602 F.2d 256, 261 (Ct. Cl. 1979). Despite that statement, the court concluded that the disputed item was not determined separately for each corporation. *See id.* at 263.

[214]It is in this context that courts most often state that members of a consolidated group are separate taxpayers. *See* Woolford Realty Co. v. Rose, 286 U.S. 319, 328 (1932) (In treating members as separate taxpayers in taking into account pre-affiliation year losses of one member, the Court stated that "[t]he fact is not to be ignored that each of [the] corporations joining . . . in a consolidated return is none the less a taxpayer."); Wegman's Properties, Inc. v. Commissioner, 78 T.C. 786, 791 (1982) (treating group members as different taxpayers in carrying over a member's attributes from a pre-affiliation year); Trinco Indus., Inc. v. Commissioner, 22 T.C. 959, 962 (1954) (In denying the carryback of a subsidiary loss to the separate-return year of the common parent, the court stated that "the separate identity of affiliated taxpayers is preserved notwithstanding the filing of consolidated returns.").

[215]*See* Norwest Corp. v. Commissioner, 111 T.C. 105, 170 (1998) (dealing with commercial banks).

[216]For example, under Regulation section 1.1502-17, accounting methods generally are determined separately for each member. Nevertheless, in Insilco Corp. v. Commissioner, 73 T.C. 589, 592 (1979), *aff'd*, 659 F.2d 1059 (2d Cir. 1981), the Service argued that a group must use a consolidated approach to qualify for an inventory method. Consistent with Regulation section 1.1502-17, the court concluded that each member measured its qualification for the inventory method separately.

[217]*See* Tennessee Natural Gas Lines, Inc. v. Commissioner, 71 T.C. 74, 91 (1978), *acq.* 1979-2 C.B. 2 (determining investment tax credit eligibility separately for each member under Regulation section 1.1502-3(a)(2); the court stated that "in this case" members were treated as separate taxpayers, implying that in some circumstances the group would be treated as one taxpayer).

ing more than that a consolidated group uses a hybrid approach.[218] Consequently, when a Code provision uses the word "taxpayer," we must look to how the word is used to determine whether a group should be treated as a single entity or a collection of separate corporations.

Perplexingly, section 172(f) uses the term "taxpayer" in two ways. It refers to members separately when used to describe SL deductions but refers to the group as a whole when used to describe the carryover or carryback of the SLL. That dichotomy mirrors the hybrid approach.

When used to define SL deductions, the word "taxpayer" refers to members separately. The operative language keys on "claims against the taxpayer on account of product liability,"[219] a "tort of the taxpayer,"[220] and a "liability of the taxpayer,"[221] references better read to relate to members separately. Because corporations have limited liability, a tort or product liability claim is likely to be against members individually, not the group as a whole.[222] Further, the statute contemplates members individually when it limits some SL deductions to accrual-basis taxpayers,[223] because members may have different methods of accounting.[224] Thus, SL deductions should be determined separately for each member.

In contrast, when section 172(f) (and section 172 generally) use "taxpayer" to describe the carryback or carryover of the SLL or net operating loss (as opposed to the recognition of SL deductions), it applies to the group as a whole.[225] That interpretation is consistent with the group's use of its CNOL.[226] Under section

[218]*See supra* notes 12-44 and accompanying text (discussing how the regulations balance the single-entity and separate-corporation approaches to create a hybrid approach).

[219]I.R.C. § 172(f)(1)(A).

[220]I.R.C. § 172(f)(1)(B) (1997).

[221]I.R.C. § 172(f)(4)(A); *see also* I.R.C. § 172(f)(4)(B) (referring to damages that arise after the taxpayer has completed the product).

[222]Although multiple members may be liable for the same tort or product liability claim when groups have integrated operations or "environmental" liabilities, multiple-member liability is the exception, not the rule. Generally, members are separately liable for torts because of their limited liability.

In contrast, if a single-member LLC is disregarded as an entity separate from its owner, its limited liability would not compel comparable treatment, because its tort should be treated as the tort of its owner, following the express regulatory directive to treat the LLC and owner as a single entity. *See* Reg. § 301.7701-3(b)(1)(ii). The consolidated return regulations contain no similarly broad single-entity statement.

Note that the Service continues to argue in another context, perhaps inconsistently, that the group should be treated as an economic family. *See* Rev. Rul. 77-316, 1977-2 C.B. 53 (discussing how to treat a "captive insurance" subsidiary); *see also* Rev. Rul. 88-72, 1988-2 C.B. 31 (affirming the economic-family theory); *cf.* Sears, Roebuck & Co. v. Commissioner, 972 F.2d 858 (7th Cir. 1992) (rejecting the economic-family theory).

[223]*See* I.R.C. § 172(f)(1)(B)(ii)(II). *But see* I.R.C. § 448(a) (requiring most corporations to be accrual-method taxpayers).

[224]*See* Reg. § 1.1502-17.

[225]*See* Collins, *supra* note 24 (making the same point).

[226]Historically, when the carryback or carryover of a group's CNOL had been affected by a member's special attributes, the group determined its CNOL first on a consolidated basis and carried the CNOL to consolidated years using a single-entity approach. *See* Reg. §§ 1.1502-21(b)(1)(i) (1996) (relating to regulated transportation corporations), 1.1502-21(b)(1)(ii) (1996) (relating to trade expansion losses).

172(b)(3), a "taxpayer" may elect to forego the carryback of its NOL, and the Service has concluded that a consolidated group is a taxpayer for this purpose.[227] More telling for purposes of section 172(f), in describing the comparable election for the SLL component of the CNOL under section 172(f)(6), the Service has also concluded that the group is the taxpayer.[228] Thus, the group's carryback and carryover of the CNOL and SLL should be determined on a consolidated basis.

Neither use of the word "taxpayer" definitively answers how the SLL should be computed, because the computation slips between the recognition of SL deductions (determined for each member separately) and the carryback of the SLL (determined on a consolidated basis). Thus, when section 172(f) uses the word "taxpayer," it fails to answer whether a group should use a consolidated-first or separate-first approach; it merely raises the question in a different form.

b. *Section 172(h)*

We may also read section 172(h) to support either the consolidated-first or a separate-first approach. That subsection limits a corporation's use of a CERT loss, which is the portion of its NOL attributable to interest on certain corporate indebtedness.[229] Under section 172(h)(4)(C), a consolidated group must compute its consolidated CERT loss[230] as if it were a single taxpayer (*i.e.*, using a consolidated-first approach). Because the SLL provision lacks a similar single-entity dictate, we might infer that a group should compute its consolidated SLL

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[227]*See* T.A.M. 88-16-001 (Apr. 22, 1988) (providing that the group as a whole makes § 172(b)(3) election); T.A.M. 84-48-004 (July 31, 1984) (to the same effect); G.C.M. 39,305 (July 27, 1984) (to the same effect); T.A.M. 81-45-027 (July 31, 1981) (to the same effect). Each of these authorities considered the old regulations, which did not expressly provide for a consolidated election. *Cf.* Reg. § 1.1502-21(b)(3) (expressly providing for a consolidated election). *But see* Reg. § 1.1502-21(b)(3)(ii)(B) (reflecting a hybrid approach by allowing a separate waiver for members acquired from another consolidated group).

Although each of these authorities supports treating the group as a taxpayer for purposes of § 172(b)(3), T.A.M. 88-16-001 (Apr. 12, 1988) contains the language that most broadly supports using a single-entity approach generally under § 172, stating in relevant part,

> Because the single entity approach is the underlying basis for the application of the net operating loss deduction in the consolidated return regulations, section 172 of the Code, which provides the statutory authority for taking a net operating loss deduction, should be similarly construed as it relates to the consolidated return regulations.

Id. Although none of these authorities is precedential, they show how the Service has administered the regulations in the past. *See* I.R.C. § 6110(k)(3) (providing that written determinations have no precedential value); Reg. §§ 1.6110-7(b) (to the same effect), -2(a) (defining written determinations). To promote certainty and fairness, taxpayers should be able to assume, absent notice, that the Service will consistently administer its regulations.

[228]*See* P.L.R. 94-44-020 (Aug. 2, 1994) (providing that the election to forego the carryback of an SLL was made on a consolidated basis); P.L.R. 94-41-020 (July 8, 1994) (to the same effect); *see also* P.L.R. 99-27-012 (Apr. 6, 1999) (revoking some of the rulings of P.L.R. 94-41-020, but still concluding that the election to forego the carryback of an SLL was made on a consolidated basis). To reach this conclusion, the Service necessarily concluded that the SLL component of the CNOL should be treated as a separate loss and, despite no express guidance in the consolidated return regulations, that the SLL was determined, at least at some point, on a consolidated basis.

[229]*See* I.R.C. § 172(h)(2)(A).

[230]See *supra* note 187 for a description of how a group computes its CERT losses.

using a separate-first approach.

However, the consolidated-first directive might simply assure that the group computes its CERT loss in the same way it generally computes its CNOL, using the consolidated-first approach. Without that directive, section 172(h) might have required a group to use the separate-first approach, because it expressly applies to "a" corporation.[231]

Applicable legislative history does not explain why section 172(h) includes the directive,[232] but it was probably included to prevent groups from easily avoiding the CERT loss limitation. Under a separate-first approach, a group could lodge the critical debt with a profitable member or lard the debt member with income-producing assets, reducing or eliminating the amount the debt member would add to the consolidated CERT loss and minimizing the portion of the CNOL subject to the CERT loss limitation.

Thus, the directive makes section 172(h) more tax-neutral, simpler, and fairer.[233] Although these last points favor using the consolidated-first approach to compute the consolidated SLL, in the final analysis, section 172(h) provides thin gruel to sustain either the consolidated-first or any separate-first approach.[234]

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[231] I.R.C. § 172(h)(3)(B), (C); *see also supra* notes 173-75 and accompanying text.

In contrast, section 172(b)(1)(D) and (g), which describes a special bad debt rule for commercial banks, does not contain a specific consolidated directive. Because members qualify separately as banks, that special bad debt rule should be applied using a separate-first approach. *See* Norwest Corp. v. Commissioner, 111 T.C. at 170 (concluding that a group must compute this commercial bank bad debt using a separate-first approach). For a further discussion of why a separate-first approach makes sense for commercial bank bad debts, see *infra* notes 286-90 and accompanying text.

[232] *Cf.* H.R. Rep. No. 101-247 at 1250-53 (1989), *reprinted in* 1989 U.S.C.C.A.N. 2720-23; H.R. Conf. Rep. No. 101-386 at 570-71 (1989), *reprinted in* 1989 U.S.C.C.A.N. 3173-74.

[233] *See supra* pp. 680-82 (discussing policy reasons for adopting the consolidated-first approach in computing the consolidated SLL).

[234] Because the consolidated SLL cannot exceed the CNOL minus the consolidated CERT loss, the group's CERT loss may limit its SLL. *See supra* note 92. Although the SLL depends on the CERT loss and we compute the CERT loss using a consolidated-first approach, we could still compute the SLL using a separate-first approach. *Cf.* Amtel, Inc. v. United States, 31 Fed. Cl. 598, 599 (1994) (in which the taxpayer argued for consolidated-first treatment because of a comparable tie-in between the predecessor to the SLL and the consolidated FEL); T.A.M. 97-15-002 (Dec. 12, 1996) (in which the taxpayer made the same argument).

Under a separate-first approach, the consolidated SLL would equal the lesser of (i) the members' aggregate separate SLLs and (ii) the excess of the group's CNOL over its consolidated CERT loss. *See supra* note 46. Thus, if the CNOL did not exceed the consolidated CERT loss, the consolidated SLL would be $0. That would happen whenever the aggregate interest deductions of members taken into account to compute the group's CERT loss equaled or exceeded the CNOL. *See* I.R.C. § 172(h)(1). In those cases, we would not need to compute separate SLLs.

In all other cases, those interest deductions would be less than the CNOL, the group's CERT loss would equal those deductions (*see id.*), the consolidated SLL could be greater than $0, and we would need to compute separate SLLs to determine the consolidated SLL. A member's separate SLL would equal the lesser of (i) its SL deductions and (ii) the excess of its separate NOL over its interest deductions included in the consolidated CERT loss. *See supra* note 46. Of the factors making up a separate SLL, only the relevant interest deductions depend on the consolidated CERT loss. Because in these cases all relevant interest deductions of each member are included in the consolidated CERT loss, we could compute separate SLLs and the consolidated SLL.

Accordingly, in all cases, we could compute the consolidated SLL using a separate-first approach, even though separate SLLs would depend on an amount computed using the consolidated-first approach.

c. *Code and Regulatory References to Separate NOLs*

The Code and regulations sometimes refer to a member's separate NOL, implying that a member must first compute a separate loss amount. The implication stems more from careless drafting than meaningful design, however, because those authorities never require separate loss computations as a first step.

i. *Section 1503(f)(2)(A)*

Section 1503(f) refers to a member's NOL. Under that section, "group loss items" of a consolidated group cannot offset the "disqualified" income of a subsidiary when the subsidiary pays dividends to non-members on certain preferred stock.[235] Group loss items include the "net operating loss" of any member other than the distributing subsidiary.[236]

The reference to a member's "net operating loss," without more, suggests that members must calculate separate NOLs, but section 1503(f) looks to group losses as a whole,[237] requiring as the only member computation that the distributing subsidiary calculate its disqualified *income*.[238] The group determines any loss limitation by comparing two consolidated amounts: CTI determined with, and without, the disqualified income.[239] To the extent the latter amount results in greater excess group losses[240] than the former,[241] the group's deductions, losses,

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[235]Without section 1503(f), a profitable subsidiary of a loss group could pay dividends, even though the group would pay no tax on the subsidiary's profits because of overall group losses. *See* H.R. CONF. REP. No. 101-386, at 752 (1989). The legislative history states that when these dividends are paid

> on nonvoting preferred stock . . . , it is appropriate to treat the amount paid as income that is in effect committed to non-member shareholders of the subsidiary and . . . such income should not be considered income eligible to be sheltered from tax by attributes of other group members.

Id. Congress was concerned about dividends paid to corporate shareholders that were eligible for a dividends received deduction. *See id.* at 751. If eligible, the distributed amount might avoid at least one full level of corporate tax, a benefit that corporate shareholders should be willing to pay for. Essentially, those shareholders would pay a bonus to use the group's losses, which is a form of loss trafficking and presumably the target of section 1503(f).

[236]I.R.C. § 1503(f)(2)(A).

[237]The legislative history considers group losses as a whole, stating that "[i]t is intended that [section 1503(f)] operate so that losses . . . of group members may be used against income of all other group members, and also against the separate computed taxable income of the distributing subsidiary to the extent [allowed]." H.R. CONF. REP. No. 101-386, at 755 (1989).

[238]A distributing subsidiary's disqualified income for a taxable year equals the portion of its separate income distributed by the subsidiary during the year on applicable preferred stock. *See* I.R.C. § 1503(f)(3)(A) (defining disqualified income), (B) (defining "separately computed taxable income"), and (C) (defining applicable preferred stock as section 1504(a)(4) stock held by a non-member and issued after November 17, 1989).

[239]A similar "with and without" computation was made in computing the separate return limitation year restriction under Regulation section 1.1502-21(c)(2) (1996).

[240]For this purpose, separate-return loss carryovers of the distributing subsidiary would not be taken into account.

[241]If the group's capital loss carryover or CNOL is greater in the latter CTI computation, those excess losses would otherwise offset the disqualified amount. It is that offset that is prohibited by Regulation section 1503(f). *See* Reg. § 1503(f)(1)(A); *see also* H.R. CONF. REP. No. 101-386, at 751, 754 (1989) (stating that group loss items can be used to offset all group income except the disqualified amount).

and carryovers are limited. Thus, section 1503(f) neither requires nor prohibits separate loss computations, and the section can abide either the consolidated-first or a separate-first approach.

ii. *Section 1.1502-21*

On a first pass, Regulation section 1.1502-21 may also appear to favor the separate-first approach. Unlike companion sections issued as part of the same regulations package,[242] Regulation section 1.1502-21 never expressly requires use of the consolidated-first approach.[243] Further, at various places it even refers to the net operating loss of a member. As a consequence, we might reason that members must compute separate NOLs, but a careful study reveals that Regulation section 1.1502-21 may also support the consolidated-first approach.

Although Regulation section 1.1502-21 never expressly requires that approach, the drafters could have omitted the requirement so that Regulation section 1.1502-21 could accommodate separate loss computations when otherwise required by the Code.[244] Still, by referring to the separate NOLs of members, Regulation section 1.1502-21 may imply that the group must compute separate loss amounts as a matter of course.

It states that "[n]et operating losses of members . . . are taken into account in determining the group's CNOL under [Regulation section 1.1502-21(e)]."[245] In that determination, a group combines certain consolidated items and each member's STI.[246] Thus, a group takes a member's NOL into account through those CNOL components. Because those components account for every tax item of any member and none requires the computation of a separate member loss

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[242]*See* T.D. 8823, 64 Fed. Reg. 36,092 (1999).

[243]In contrast, the companion provisions contain express consolidated directives. In relevant part, Regulation section 1.1502-22(a), which describes consolidated capital gain and loss, reads as follows: "The determination under section 1222 . . . with respect to members during consolidated return years are not made separately. Instead, consolidated amounts are determined for the group as a whole." Regulation section 1.1502-23(a), which applies to consolidated net section 1231 gain and loss, reads as follows: "Net section 1231 gains and losses of members arising during consolidated return years are not determined separately. Instead, the consolidated net section 1231 gain or loss is determined under this section for the group as a whole."

[244]For example, until 1994 the Code required that groups account for bad debts of commercial bank members using a separate-first approach. *See* I.R.C. § 172(b)(1)(D), (g)(1) (providing a special carryback rule for pre-1994 periods for the portion of a commercial bank's NOL attributable to bad debts); *see also* Norwest Corp. v. Commissioner, 111 T.C. 105, 169-71 (1998) (adopting a separate-first approach for those bank losses).

Note that we can determine a component of the CNOL using a separate-first approach, even if that component is limited by an amount computed using a consolidated-first approach. *See supra* note 234. Thus, these bank losses could have been determined using a separate-first approach even if the SLL (which could limit the consolidated bank losses) were computed using the consolidated-first approach.

[245]*See* Reg. § 1.1502-21(b) (introductory language).

[246]These CNOL components are defined in Regulation section 1.1502-11(a). *See* Reg. § 1.1502-21(e) (defining CNOL as "any excess of deductions over gross income, as determined under [Regulation section] 1.1502-11(a)"); *see also* Reg. § 1.1502-21(f) (defining CNOL as a combination of the specific Regulation section 1.1502-11(a) items). See *supra* notes 166-70 and accompanying text for a description of the CNOL components.

amount,[247] Regulation section 1.1502-21 allows a group to compute its CNOL without first determining separate NOLs (or net loss amounts) for members.

Regulation section 1.1502-21(b)(2)(iv) also refers to the "separate net operating loss of a member," but in defining that amount it starts with the CNOL.[248] The CNOL is then adjusted to reflect only the member's tax items. Because this amount is computed only after the CNOL, the computation says nothing about whether a group must first compute separate member loss amounts in determining its CNOL. Accordingly, Regulation section 1.1502-21 can support either a separate-first or the consolidated-first approach.[249]

d. *The Regulations' Silence on SLLs*

We may also read the consolidated return regulations' silence on SLLs to support either approach. We might infer that a group must compute SLLs separately for members, because the regulations describe several consolidated items but fail to describe a consolidated SLL. Nevertheless, at some point a group must compute a consolidated SLL, and because the regulations never require or describe the computation of separate SLLs, we might instead infer that a group should use the consolidated-first approach.

Several courts have endorsed a separate-first approach in part because of the regulations' silence on SLLs. In *Amtel*, the Court of Federal Claims rejected the taxpayer's assertion that a group's SLL could be carried back to the separate-return year of a member, principally because no part of the group's CNOL was allocated to the member under the attribution rules.[250] Although not necessary to its conclusion, the court also suggested that members must compute separate SLLs:

> [The consolidated return] regulations do not use the term ["consolidated SLL"] or incorporate such a concept by directing that [the consolidated SLL] be treated on a consolidated basis. Since the consolidated return regulations specifically identify several deductions which are treated on a consolidated basis, and do not specifically identify a "consolidated" [SLL], and in light of the general principle that deductions are construed narrowly, the court must reject [the taxpayer's broad single-entity] approach.[251]

[247]Each CNOL component other than STI is computed using a consolidated-first approach. Although STI is determined for each member, it is a collection of tax items rather than a netted amount. See *supra* pp. 694-98.

[248]*See also* Reg. § 1.1502-79(a)(3) (1996) (containing similar language).

[249]Under similar reasoning neither Regulation section 1.1502-21 (1996) nor Regulation section 1.1502-79(a)(3) (1996), the predecessors to Regulation section 1.1502-21, required a group to compute separate loss amounts for members in computing its CNOL.

[250]Amtel, Inc. v. United States, 31 Fed. Cl. 598, 600-01 (1994), *aff'd*, 59 F.3d 181 (Fed. Cir. 1995); *see also* Reg. § 1.1502-79(a)(3) (1996).

[251]*Amtel*, 31 Fed. Cl. at 602 (citations omitted). As part of the taxpayer's broad single-entity approach, it argued that members did not compute separate SLLs. *See id.* at 599, 601.

Following *Amtel*, the Tax Court concluded in *Intermet Corp. v. Commissioner*[252] that a consolidated group must compute separate SLLs to determine the group's SLL carryback to a consolidated-return year. In each case, the courts apparently inferred that members compute SLLs separately, because the regulations expressly provide consolidated treatment for certain items included in CNOL but not for the SLL.[253]

The inference seems too weak to support the conclusion.[254] Each "consolidated" item would probably have to be computed separately in the absence of the specific consolidated directive.[255] In contrast, nothing in the Code or regulations would otherwise require SLLs to be separately computed, so that the consolidated return regulations' silence on SLLs seems at best a neutral factor.

In fact, the silence may better tolerate the consolidated-first approach. Since a group's SLL is part of its CNOL[256] and the CNOL is computed on a consolidated basis,[257] at some point the group must also compute its SLL on a consolidated basis.[258] Because the regulations never provide for a separate computation, the SLL by implication should be computed only on a consolidated basis.

We should hesitate, however, to read too much into the regulations' silence.[259] Given the snail's pace with which regulations have been updated to reflect Code changes, we would be unwise to assume that government inaction reflects affirmative policy. For example, Regulation section 1.1502-26 still allows an eighty-five percent dividends received deduction ("DRD"), although Congress gener-

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[252]111 T.C. 294 (1998).

[253]In *Intermet*, the Tax Court concluded that members must compute separate SLLs primarily because it believed STI was a netted amount. *See id.* at 301-02. *See supra* pp. 694-98 (discussing why STI should not be a netted amount).

[254]The inference might be viewed as an adjunct to a separate-corporation default rule, which we should reject for the reasons discussed above. *See supra* notes 147-64 and accompanying text.

[255]Each consolidated component expressly or implicitly involves a Code or regulatory provision that applies specifically to corporations, and the regulations might require consolidated treatment for those components simply to assure that they are not computed separately. See *supra* notes 173-75 and accompanying text (discussing items described in Regulation sections 1.1502-22 to -27); *see also* Reg. § 1.1502-42 and I.R.C. § 593(a) (limiting section 593 to certain savings and loan institutions); Reg. § 1.1502-44 and I.R.C. § 613A(d)(3)(A) (referring, in relevant part, to the taxpayer to whom the section applies as a corporation); Reg. § 1.1502-26 and I.R.C. §§ 615(c)(1)(B) (1969) and 617(h)(3)(B) (1986) (describing the taxpayer as the acquiring corporation under section 381); Reg. § 1.1502-25 (1993) and I.R.C. § 921 (1979) (describing the treatment of WHTCs, which are domestic corporations).

[256]The *Amtel* court seemed to accept this point. Because the court applied the CNOL allocation rules to limit a member's carryback to separate-return years, it must have concluded (although it did not state) that the consolidated SLL was limited to, and part of, the CNOL. The District Court and Tax Court have reached the same conclusion. *See* United Dominion Indus., Inc. v. United States, 98-2 U.S.T.C. ¶ 50,527, at 85,194, 82 A.F.T.R.2d 5037, 5190 (W.D.N.C. 1998) (endorsing the consolidated-first approach); Intermet Corp. v. Commissioner, 111 T.C. 294, 303-05 (1998) (endorsing a separate-first approach).

[257]*See* Reg. § 1.1502-21(e).

[258]*See supra* note 74.

[259]*See* 2 DUBROFF ET. AL., *supra* note 10, § 41.04[6][b][i], at 41-70; *see also* PEEL, *supra* note 14, § 9.01 (Cum. Supp. Sept. 1997); Collins, *supra* note 24, at 63.

ally reduced the DRD to seventy percent in 1987.[260] More dramatically, Regulation section 1.1502-24 still provides that charitable deductions are limited to a five-percent threshold, although the threshold was increased to ten percent in 1981.[261] The Service certainly does not intend (and no sensible court would find) that groups still benefit from an eighty-five percent DRD or suffer from the five-percent charitable deduction threshold.[262]

Further, faced with the rapid pace of legislative change and limited resources, the government fixes the squeaky wheel, and the relatively obscure SLL provision would not audibly squeak.[263] As a carryback controlled by a single filer (*i.e.*, the group), the consolidated SLL is unlikely to be deducted twice, since a court should require a group to account for the carryback consistently,[264] thereby reducing the need for specific guidance. Thus, the regulations' silence should not be read to advance either the consolidated-first or a separate-first approach.

e. *Computing and Combining Separate SLLs*

Yet, that silence leaves us no sure way to compute or combine separate SLLs. Separate SLLs could be computed by considering all or only a portion of each member's tax items, and those tax items could be characterized by each member separately or by the group as a whole. Whatever way we compute SLLs, we could combine them with other net member losses in one of several ways. These ambiguities favor the clear and certain consolidated-first approach.[265]

The following example illustrates four ways members could compute separate SLLs.[266]

[260]*See* Revenue Act of 1987, Pub. L. No. 100-203, § 10221(a)(1), 101 Stat. 1330-408.

[261]*See* Economic Recovery Act of 1981, Pub. L. No. 97-34, § 263, 96 Stat. 264.

[262]As another example, the regulations still describe section 615, which applies to certain pre-1970 mining deductions. *See* Reg. § 1.1502-16(b).

[263]In fact, the Service did not substantively amend the CNOL provisions between 1966, when the old regulations were first promulgated, and 1996, when the current version of the regulations was issued in temporary form. *Cf.* T.D. 7728, 1980-2 C.B. 236, 238 (changing a reference in CNOL regulations from "net capital gain" to "capital gain net income"); T.D. 8387, 1992-1 C.B. 306, 307 (adding a cross-reference to Temporary Regulation section 301.6402-7T); T.D. 8440, 1992-2 C.B. 306, 308 (slightly amending the cross-reference added by T.D. 8387).

[264]*See, e.g.*, Beltzer v. United States, 495 F.2d 211, 213 (8th Cir. 1974) (holding that when an estate beneficiary sold devised property, he could not claim that the property was valued incorrectly by the estate); Wichita Coca Cola Bottling Co. v. United States, 152 F.2d 6, 8 (5th Cir. 1945) (describing the duty of consistency); Cluck v. Commissioner, 105 T.C. 324, 331 (1995) ("The duty of consistency prevents the taxpayer from taking one position one year and a contrary position in a later year after the limitations period for the first year has run."); Unvert v. Commissioner, 72 T.C. 807, 814-15 (1979), *aff'd*, 656 F.2d 483 (9th Cir. 1981) (applying the duty of consistency).

In contrast, FELs may have been specially described to prevent whipsaw to the government. *See supra* pp. 694-96 for a description of FELs. Because an FEL was carried forward, it could have been attributed to a member filing a separate return after it left the group. Absent specific guidance, that member and the group, as different tax-return filers, were more likely to each claim the benefit of the same FEL, and the specific guidance on FELs limited the chance of that whipsaw.

[265]Under that approach, the consolidated SLL equals the lesser of the group's CNOL or its aggregate SL deductions.

[266]*See also* 2 DUBROFF ET. AL., *supra* note 10, § 41.04[6][b][i], at 41-73 n.192 (suggesting several of these methods, among others).

Example 11: Computing Separate SLLs. P, S1, and S2 are the members of a consolidated group. For the taxable year, P has a $300 ordinary loss, S1 has a $90 section 1231 gain and a $100 SL deduction, and S2 has an $80 section 1231 loss, $75 of ordinary income, and a $75 SL deduction. Thus, the group has a $390 CNOL.[267] In computing its CNOL (and CTI), its section 1231 amounts will be long-term capital amounts, because its total section 1231 gain (S1's $90 gain) exceeds its total section 1231 loss (S2's $80 loss).[268]

Only S1 and S2 have SL deductions, so only they could have separate SLLs. They could compute separate SLLs as follows:

STI Method. Each member's separate SLL could be limited to its negative STI. Under these facts, each item other than the section 1231 amount is included in a member's STI.[269] S1 has a $100 negative STI (*i.e.*, its SL deduction) and a $100 separate SLL, while S2 has a $0 negative STI (because its ordinary income equals its SL deduction) and a $0 SLL. Thus, the group has a $100 consolidated SLL.[270]

STI Method with Separate-Corporation Limit. Each member's SLL could be limited first by its negative STI and then by its net loss determined on a full separate-corporation basis.[271] After computing the STI limitation, only S1 could have a separate SLL. Because it has an overall $10 loss, S1's separate SLL would be limited to $10 and the consolidated SLL would be $10.

Pure Separate-Corporation Approach. A member could compute its separate SLL as if it were a corporation filing separate returns. Under this approach, S1 would have a $10 separate SLL,[272] S2 would have a $75 separate SLL,[273] and the group would have an $85 consolidated SLL.

Modified Separate-Corporation Approach. A member could compute its separate SLL as if it were a corporation filing separate returns, except that it would determine the character of consolidated items like section 1231 amounts[274] on a

[267]The CNOL is equal to P's $300 loss, minus S1's $90 section 1231 gain, plus S1's $100 SL deduction, plus S2's $80 section 1231 loss, minus S2's $75 ordinary income, plus S2's $75 SL deduction.

[268]*See* Reg. § 1.1502-23(a) (providing that the character of section 1231 amounts is determined by the group as a whole), I.R.C. § 1231(a)(1) (providing that all section 1231 amounts are long-term capital amounts when gains exceed losses).

[269]*See* Reg. § 1.1502-12.

[270]The consolidated SLL equals the sum of the members' separate SLLs, because each member has a loss on a separate-corporation basis, so that no member's separate SLL could offset any other member's income.

[271]The second netting would avoid some of the more troubling results otherwise occasioned by the STI limitation. *See supra* notes 138-46 and accompanying text.

[272]As a separate corporation, S1's $100 SL deduction would fully offset its $90 section 1231 gain, resulting in a $10 NOL treated entirely as an SLL.

[273]As a separate corporation, S2's section 1231 loss would be an ordinary loss. *See* § 1231(a)(2) (stating that when section 1231 losses equal or exceed section 1231 gains, all section 1231 amounts are ordinary). Thus, S2 would have a separate NOL of $80 ($80 section 1231 loss plus $75 SL deduction minus $75 income) of which $75 would be a separate SLL.

[274]Those consolidated items are described in Regulation section 1.1502-11(a)(3)-(5) and (7)-(8).

consolidated basis.[275] Under this approach, all of the section 1231 amounts would be capital amounts, S1 would still have a $10 separate SLL, S2 would have a $0 SLL,[276] and the group would have an $10 consolidated SLL.

Perhaps to avoid similar uncertainty, the Code and regulations generally define separate income or loss amounts when relevant for consolidated groups.[277] Neither the Code nor the regulations expressly defines separate SLLs, which is a strike against any separate-first approach.

As a second strike, it is also unclear how we should combine separate SLLs to form the consolidated SLL. When a separate-return corporation computes its NOL, it first offsets income with loss amounts other than SL deductions.[278] If a group follows that priority in computing its CNOL, it would first offset net member income with net member losses other than separate SLLs.[279] As an alternative, it could use separate SLLs and other net member losses proportionately in offsetting net member income.[280] *Example 12* illustrates these methods, which I label the "last-use" and "proportionate" methods and which seem the likeliest ways to combine separate SLLs.[281]

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[275]Thus, a member would compute its separate NOL in the same way as under the apportionment rules. *See* Reg. § 1.1502-21(b)(2)(iv). Under those rules, a group may attribute part of its CNOL to a member to carry to the member's separate-return years. At least one court has used this method to compute a member's separate NOL in another context. *See* Allied Corp. v. United States, 685 F.2d 396, 406 (1982) (concluding that a loss should be attributed to a WHTC subgroup and carried over to first offset income of WHTC subgroup in subsequent year); *see also* Reg. § 1.1502-21(b)(2)(i), (ii) (1996) (providing that trade expansion losses and losses of regulated transportation corporations were computed using this separate-first approach).

[276]Because S2 would treat its section 1231 loss as a capital loss but would compute its NOL and SLL as a separate corporation, it would have an unused $80 capital loss and a $0 NOL and $0 SLL, since its ordinary income would equal its SL deduction.

[277]*See* I.R.C. § 1503(f)(2) (defining a member's separate income amount to include separate taxable income and other relevant items); Reg. §§ 1.1502-21(c)(1)(i) (defining a member's separate loss for the separate return limitation year restriction), -27(b) (determining the taxable income of a public utility on a separate corporation basis by adjusting separate taxable income to take consolidated items into account), -32(b)(3)(i) (determining the separate income of a member by including all of that member's items that are part of CTI), -42(e)(3) (providing that a thrift institution's tentative taxable income is determined on a separate-corporation basis by adjusting its separate taxable income to take consolidated amounts into account); *see also* Reg. §§ 1.1502-3(c)(2) (determining separate return limitation year restriction by taking into account all income and deductions of a member), -96(b)(2)(ii)(A) (determining the section 382 limitation for a subsidiary of a consolidated group in part by attributing the CNOL to that member); P.L.R. 96-38-003 (Sept. 20, 1996) (determining a separate income amount for a member by incorporating the special Code definition for taxable income under section 832 in applying the taxable income limitation under section 833(b)(2)). *But see* I.R.C. § 172(h) (implying that a commercial bank bad debt deduction is determined by using a separate-first approach; separate loss amount not defined).

[278]*See supra* note 47.

[279]Stated as a formula, the consolidated SLL would equal the lesser of (i) the aggregate separate SLLs and (ii) the CNOL.

[280]Stated as a formula, the consolidated SLL would equal the CNOL multiplied by a fraction, the numerator of which would be the aggregate separate SLLs and the denominator of which would be the aggregate net separate losses of all loss members.

[281]*Cf.* Reg. § 1.1502-21(b)(2)(i), (ii) (1996) (providing that trade expansion losses and losses of regulated transportation corporations were computed using a separate-first approach and taken into account proportionately).

Example 12. Combining Separate SLLs. P, S1, and S2 are the members of a consolidated group. For the taxable year, P has $50 of ordinary income, S1 has a $100 ordinary loss, and S2 has a $100 SL deduction. The group has a $150 CNOL,[282] and S2 has a $100 separate SLL.

Last-Use Method. If separate SLLs offset net member income only after other net member losses are absorbed, $50 of S1's net $100 loss would offset P's net $50 gain. Because S2's $100 separate SLL would be fully included in the CNOL, the group would have a $100 consolidated SLL.

Proportionate Method. If separate SLLs and other net member losses proportionately offset net member income, P's net $50 gain would be offset by $25 of S1's net loss and $25 of S2's separate SLL. Because only $75 of S2's separate SLL would be included in the CNOL, the group would have a $75 consolidated SLL.

In *Norwest Corp. v. Commissioner*, the Tax Court adopted the proportionate method in a loosely analogous situation, perhaps without even considering the last-use method.[283] In that case, the court determined the portion of a group's CNOL that was attributable to commercial bank bad debts and eligible for an extended carryback.[284] Rejecting the consolidated-first approach (advocated by the group), the court concluded that the group must compute its extended carryback using a separate-first approach. Without further discussion, it adopted the proportionate method to combine separate bad debt amounts and other net member losses.[285]

Unlike for SLLs, we can readily embrace a separate-first approach to compute the bad debt portion of a group's CNOL. The special bad debt rules in the Code apply to commercial banks,[286] and members qualify separately as commercial banks.[287] Thus, these rules should apply separately to members unless the consolidated return regulations provide otherwise. Because the regulations contain no rule for computing these bad debts,[288] we should first compute separate

[282]The CNOL will equal S1's $100 ordinary loss plus S2's $100 SL deduction minus P's $50 of ordinary income.

[283]111 T.C. 105, 169-70 (1998).

[284]If a commercial bank filed separate returns, it determined the bad debt portion of its NOL by first offsetting losses and deductions other than bad debts against its income. *See* I.R.C. § 172(g)(1). Thus, this bad debt portion and the SLL portion of an NOL are determined similarly. *Cf.* I.R.C. § 172(f)(2).

[285]*See Norwest*, 111 T.C. at 169-70; *see also* F.S.A. 1999-35-009, TAX NOTES TODAY (Sept. 7, 1999) (LEXIS, FEDTAX lib., elec. cit. 99 TNT 172-82) (following *Norwest*, the service concluded that separate SLLs should be accounted for using the proportionate method).

[286]*See* I.R.C. § 172(b)(1)(D).

[287]*See* Rev. Rul. 84-136, 1984-2 C.B. 193.

[288]Further, there may be less of a policy concern with adopting a separate-first approach to account for these bad debts, because commercial banks are heavily regulated and assets are less likely to be transferred to or from a commercial bank to manipulate any separate-first limitation. *See supra* pp. 680-86 (discussing policy concerns with adopting a separate-first approach for SLLs).

member amounts.[289] In contrast, the Code provision for SLLs need not apply to members separately and does not compel a separate-first approach.[290]

Although we may embrace the separate-first approach to compute separate member bank bad debts, it is less clear how we should combine these bad debt amounts (or how we should combine any separate SLLs). Despite the conclusion in *Norwest*, the last-use method appears to reach the better policy result and also draws greater support from the consolidated return regulations. Because of *Norwest*, however, it is difficult to choose between the last-use and proportionate methods.

We can fashion no more than a weak policy case for either method because each builds on the separate-first approach, a rather shaky foundation.[291] Although the proportionate method might better protect any separate-first limitation,[292] the method would make it more likely that otherwise identical groups could be treated differently based solely on asset placement within each group. It also would be more burdensome, requiring a group to compute separate loss amounts for every member, not just for members with SL deductions as under the last-use method. Although reasonable people may differ, the policy case for the last-use method seems better.

We can also construct the better technical case for the last-use method, at least under the current regulations. Under Regulation section 1.1502-21(b)(1), the carryover and carryback of a CNOL is "determined under the principles of [section] 172," including section 172(f) (for SLLs) and section 172(g) (for commercial bank bad debts). Thus, when we combine separate loss amounts to compute the CNOL, we should use the section 172(f) or (g) priority; that is, we should adopt the last-use method.

The result should be the same under the old regulations, although the case is less compelling. Under those regulations, the CNOL was carried over and back under the "principles of [section] 172(b)," not section 172 generally.[293] Al-

[289]The *Norwest* court seemed to imply as much when it stated that the bad debt section "is a special rule that prioritizes a bank's losses. Nothing in that section leads us to believe that Congress intended to give a priority to a bank member's bad debt losses as against a nonbank member's losses in the context of a consolidated return." *Norwest*, 111 T.C. at 170-71.

[290]*See supra* pp. 700-03.

Currently, under Code section 172(g)(2), the bank bad debt portion of an NOL is treated like an SLL for purposes of section 172(b)(2). Before the FEL provision was repealed, that portion was treated like an FEL. *See* I.R.C. § 172(g)(2) (1990). Those references mean that the bank bad debt portion should be treated as a separate NOL for purposes of section 172(b)(2); they do not require FELs, SLLs, and bad debt amounts to be computed or combined by consolidated groups in the same way. *See* I.R.C. § 172(f)(5) (stating that for purposes of section 172(b)(2), an SLL is treated as a separate NOL); *see also* I.R.C. § 172(b)(2) (1990) (flush language) (stating that an FEL is treated as a separate NOL for purposes of section 172(b)(2)).

[291]*See supra* pp. 680-86 (discussing policy concerns with a separate-first approach).

[292]Under the last-use method, the limitation might be avoided through appropriate asset transfers to increase the losses of members with SL deductions. The proportionate method could require additional asset transfers to decrease the loss for other loss members, a requirement that makes it less likely the limitation would be avoided.

[293]*See* Reg. § 1.1502-21(b)(1) (1996).

though section 172(f) and (g) establish the last-use priority for SLLs and commercial bank bad debts, the priority is relevant only if the SLL or bad debt portion is carried back under section 172(b). Because those priorities are integral to the section 172(b) carryback, they should be considered an aspect of that carryback included under section 172(b) principles.[294] Because the regulations do not expressly describe any method to combine those separate loss amounts, we should look to the Code (*i.e.*, sections 172(f) and (g)) to establish the priority.[295] In other words, we should adopt the last-use method.

Despite the points in favor of the last-use method, *Norwest* may upset the balance by adopting the proportionate method, making it unclear which method groups should adopt. The confusion favors the consolidated-first approach.

f. *Apportionment*

In our extended tour of the Code and regulations, we have yet to find any provision that requires a separate-first approach for SLLs, but we have one final stop—the apportionment rules of Regulation section 1.1502-21(b)(2). Because those rules do not require such an approach, we should adopt the consolidated-first approach.

The apportionment rules apply when a group's CNOL (and thus its consolidated SLL) might be carried to either the group's consolidated-return year or a member's equivalent separate-return year.[296] Under those rules, the member carries back its "attributable" portion of the CNOL to its separate-return year, and the attributable portion equals the following amount:

CNOL x A/B, where —

A = the separate net operating loss of the member and

B = the sum of the separate net operating losses of all members.[297]

The separate net operating loss of a member is the CNOL computed by including only the member's tax items.[298]

These rules leave much to the reader's ingenuity, never mentioning the SLL and non-SLL components of a CNOL. Despite the lack of specific guidance, those components should be separately apportioned among members. For separate-return corporations, section 172(f)(5) treats the SLL as a separate net oper-

[294]Moreover, the results should not differ under the current and old regulations, because the regulations are generally intended to be the same in substance. *See* CO-78-90, 1991-1 C.B. 757, 760. When the current regulations were proposed, the preamble stated that the regulations were "generally intended to simplify, but not change, the [old regulations]." *Id.* The proposed regulations were made final without significant, relevant changes.

[295]*See* Reg. § 1.1502-80(a) (providing that the Code applies to the group to the extent the regulations do not exclude its application).

[296]*See* Reg. § 1.1502-21(b)(2); Reg. § 1.1502-79(a)(3) (1996) (describing essentially equivalent apportionment rules under the current and prior regimes).

[297]*See* Reg. §§ 1.1502-21(b)(2)(iv); Reg. § 1.1502-79(a)(3) (1996).

[298]*See id.*; *see also supra* notes 248-49 and accompanying text (discussing why the regulatory reference to separate NOLs does not require a separate-first approach).

ating loss,[299] and that principle should apply to the consolidated group.[300] Thus, the SLL and non-SLL components of the CNOL should be apportioned as separate net operating losses among the group and its members.[301]

We could apportion those components in four ways that appear consistent with the regulations.[302] One would divide losses into SLL and non-SLL components at the member level only, a second would do so at the group level only, and a third and fourth would do so at both levels.

We should adopt the fourth method. The first two methods could attribute a portion of the consolidated SLL to a member without SL deductions. The third method could attribute more of the CNOL to a member than its separate loss. The fourth method avoids each of these missteps. Whatever method we adopt, the apportionment rules contemplate the consolidated-first approach, leaving us no reason to adopt a separate-first approach.

i. *The First and Second Methods*

We should reject the first two methods, because either might include non-SL deductions in an SLL. The first method mistakenly presumes that the SLL and non-SLL components of the CNOL are used proportionately, and the second that a loss member is attributed the consolidated SLL in proportion to its overall net loss.[303]

Under the first method, the group would attribute the CNOL to a member by considering the SLL and non-SLL components of the member's separate net operating loss, together with the CNOL as a whole. In the attribution formula —

CNOL = The total CNOL for the group —

A = The member's SLL or non-SLL component of its separate net operating loss, as appropriate, and

B = The sum of the separate net operating losses of all members.

Example 13 illustrates how the first method may include non-SL deductions in the consolidated SLL.

> *Example 13: First Method May Include Non-SL Deductions in the Consolidated SLL.* P, S1, and S2 are the members of a consolidated group and have been members for more than 10 years. P has always been the common parent. In the current taxable year, P has no tax items, S1 has a $900 SL deduction, and

[299]Code section 172(f)(5) states, in part, "For purposes of applying [the carryback provision, an SLL] for any taxable year shall be treated as a separate net operating loss to be taken into account after the remaining portion of the net operating loss for such taxable year."

[300]*See supra* notes 293-95 and accompanying text (explaining why a group should apply section 172(f) principles in carrying its CNOL over and back).

[301]Thus, the regulations cannot be applied literally.

[302]There may be many more models if we depart more dramatically from the regulatory formula. *See, e.g.*, 2 DUBROFF ET. AL., *supra* note 10, at § 41.04[6][b][ii] (suggesting ways that do not track the regulatory formula as closely).

[303]We would have these concerns for each method, whether we use the consolidated-first or any separate-first approach.

S2 has an $1,800 non-SL deduction. Thus, the group has a $2,700 CNOL, $900 of which is a consolidated SLL. The group carries back $600 of the SLL 10 years and offsets group income in that carryback year but uses none of the remaining CNOL in any carryback year.

At the end of the current year, S1 leaves the group. At that time, the group has an unused $2,100 CNOL.[304] Under the first method, S1 would be attributed $700 of that CNOL for carryforward to its separate-return years,[305] leaving the group with a $1,400 carryforward.[306] Thus, only $200 of S1's SL deductions must have been included in the $600 SLL carryback, since S1 retains the benefit of $700 of its $900 separate loss. Because S2 was the only other member to contribute to the CNOL, the remainder of the SLL carryback must have included $400 of S2's non-SL deductions.

Mechanically, the first method may include a member's non-SL deductions in the consolidated SLL because it fails to divide the CNOL into SLL and non-SLL components.

The second method makes that division. In the attribution formula for the second method –

CNOL = The SLL or non-SLL component of the group's CNOL,[307]

A = The entire separate net operating loss for the member,[308] and

B = The sum of the separate net operating losses of all members.

Example 14 illustrates how the second method may shift an SLL to a member without SL deductions:

Example 14: The Second Method May Shift SL Deductions. The facts are the same as in *Example 13*, except that S2 joined the group at the beginning of the taxable year in which the group generates the $2,700 CNOL, $900 of which is a consolidated SLL.

Under the second method, S2 would be attributed the SLL and non-SLL components of the CNOL in the proportion that its entire separate loss bears to the aggregate separate loss of all loss members. Thus, S2 would be allocated two-

[304]It used $600 of the consolidated SLL, reducing the consolidated SLL from $900 to $300 and the overall CNOL from a $2,700 to $2,100.

[305]In the allocation fraction, the numerator would be $900, S1's separate SLL, and the denominator would be $2,700, the sum of the separate net operating losses for all members ($900 for S1 and $1,800 for S2). Thus, the allocation fraction would equal $900/$2,700 or one-third, and S1 would be allocated one-third or $700 of the group's $2,100 CNOL.

[306]The portion of a CNOL carried over to a separate-return year may not be carried over to an equivalent, or later, consolidated return year. *See* Reg. § 1.1502-21(b)(2)(i).

[307]Note that when the CNOL has both SLL and non-SLL components, the formula would be applied twice to attribute a portion of both components to each member. These components could be computed using a separate-first or consolidated-first approach. For the reasons discussed below, the second method is flawed under either approach.

[308]Thus, the separate net operating loss would not be broken down into its SLL and non-SLL components.

thirds of each component of the CNOL,[309] or $600 of the consolidated SLL and $1,200 of the remaining CNOL. Consequently, the second method would convert $600 of S2's carryback to an SLL, even though it had no SL deductions.

ii. *The Third and Fourth Methods*

The third and fourth methods avoid the concerns of the first two by dividing both the separate net operating loss of a member and the CNOL into SLL and non-SLL components.[310] In the attribution formula for the third method –

CNOL = The SLL or non-SLL component of the group's CNOL, as appropriate,

A = The member's SLL or non-SLL component of its separate net operating loss, as appropriate, and

B = The sum of all members' separate SLL or non-SLL components, as appropriate.[311]

The fourth method's formula is exactly the same as the third's, except that the SLL component for "CNOL" cannot exceed the sum of all members' separate SLL components. Although the third method has the intrinsic appeal of attributing the entire CNOL among members, we need the fourth method (or one like it) to account for specialty losses.[312] Because of those losses, the method we choose must accommodate the consolidated-first approach.

The third method fails to accommodate that approach, because a member could be attributed a portion of the CNOL greater than its separate loss. *Example 15* illustrates this point.

Example 15: Third Method Does Not Accommodate the Consolidated-First Approach. P, S1, and S2 are the members of a consolidated group. In a taxable year, P has no tax items, S1 has $600 of section 1231 gain and a $1,500 SL deduction, and S2 has an $1,800 non-SL deduction. Thus, the P group has a $2,700 CNOL.[313]

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[309]In the allocation fraction, the numerator would be $1,800 (S2's separate loss) and the denominator would be $2,700, or the sum of the separate net operating losses of all members ($900 for S1 plus $1,800 for S2). Thus, S2's allocation fraction would equal $1,800/$2,700 or two-thirds.

[310]Although the regulatory formula does not divide the CNOL into components, that division necessarily follows from Code section 172(f)(5), which requires that each component be treated as a separate NOL. *See supra* notes 293-95 and accompanying text (discussing why this principle should apply to CNOL carryovers and carrybacks by a consolidated group).

[311]In applying this formula, the SLL and non-SLL components of the CNOL are separately allocated among members. For example, in allocating the SLL component of the CNOL to a member, "A" equals the member's SLL component of its separate net operating loss and "B" equals the sum of all members' separate SLL components.

[312]In United Dominion Industries, Inc. v. United States, 98-2 U.S.T.C. ¶ 50,527, at 85,194, 82 A.F.T.R.2d 5037, 5190 (W.D.N.C. 1998), the District Court appeared to endorse a method similar to the fourth but did not adequately explain how the consolidated SLL would be attributed among members when aggregate SL deductions exceeded the consolidated SLL.

[313]Its CNOL equals S1's $1,500 SL deduction, plus S2's $1,800 non-SL deduction, minus S1's $600 section 1231 gain.

The group would have a $900 SLL component if it computed the SLL component using any likely separate-first approach (other than the STI method)[314] and a $1,500 SLL component if it used the STI method[315] or consolidated-first approach.[316]

Under the third method, S1 would be attributed the entire consolidated SLL.[317] Thus, it would be attributed $900 under a separate-first approach (other than the STI method) and $1,500 under the STI method or the consolidated-first approach. The latter amount exceeds $900, S1's net loss determined on a separate-corporation basis.

Unlike the third method, the fourth method would allow no member to carry back an amount greater than its separate net loss. However, if the consolidated SLL exceeded the aggregate separate SLL components, the excess would be a "pure" consolidated attribute.[318] *Example 16* illustrates the fourth method.

Example 16: The Fourth Method Accommodates the STI Method and Consolidated-First Approach. The facts are the same as *Example 15*, and the results and analysis are the same unless the group used the STI method or consolidated-first approach to compute its SLL component. Then, the CNOL would include a $1,500 SLL component,[319] but S1 would be attributed only $900 of that component,[320] an amount equal to its $900 separate loss. Because no other member would have a separate SLL, no member other than S1 could be attrib-

[314]Only S1 would have a separate SLL, which under these facts would equal $900, the amount of its net loss determined as if it were a separate corporation. Because the CNOL exceeds $900, the group would have a $900 consolidated SLL. See Example 11, *supra* p. 710 for description of the likely separate-first approaches.

[315]Under the STI method, a member's separate SLL component is determined by taking into account only those amounts included in STI. Because STI excludes section 1231 amounts, S1's separate SLL under this method would be $1,500. If the last-in method is used, the group would have a $1,500 consolidated SLL, because its CNOL exceeds $1,500. If the proportionate method is used, the group would have a $1,227.27 consolidated SLL, because $272.73 of S1's SL deductions would offset its section 1231 gain. In either case, the consolidated SLL would be greater than S1's separate loss, creating the problem illustrated by Example 15. For convenience, the example assumes the consolidated SLL is $1,500.

[316]Under the consolidated-first approach, the group's SLL equals the lesser of (i) the aggregate SL deductions of all members and (ii) the CNOL. Only S1 has SL deductions, and those deductions equal $1,500. Because the CNOL is greater, the consolidated SLL would equal $1,500.

[317]S1's allocation fraction (A/B) equals 1, because A equals $900 (S1's separate SLL component) and B equals $900 (the sum of all members' separate SLL components). Thus, S1 is allocated the entire consolidated SLL under this method.

[318]If the group terminated, that consolidated attribute apparently could not be used by any former member of the group. If the regulations explicitly adopted the fourth method, they could also provide that the common parent succeeded to that attribute. *Cf.* Reg. § 1.1502-20(g) (providing that a loss could be reattributed from a subsidiary to the common parent).

[319]*See supra* notes 315-16.

[320]In the attribution formula, "A" would equal $900, which is the portion of S1's separate NOL that would be an SLL, "B" would equal $900, which is the sum of the separate SLL components for all members ($900 for S1's separate SLL component), and "CNOL" would equal $900, which is the lesser of (i) the sum of the separate SLL components for all members ($900) and (ii) the portion of the CNOL that is an SLL ($1,500). Thus, S1 would be attributed $900 of the SLL (i.e., $900/$900 times $900).

uted any portion of the consolidated SLL.[321] Thus, $600 of the $1,500 consolidated SLL would be a pure consolidated attribute.

Because the entire CNOL can be attributed among members when the CNOL is not broken into components,[322] we might question the fourth method, which is the only one that accommodates the consolidated-first approach. If we rejected the fourth method, we might conclude that the consolidated SLL must be computed using a separate-first approach.[323]

Although the regulations never discuss how to attribute CNOL components, they should anticipate the fourth method (or one like it) because of three specialty losses which use the consolidated-first approach.[324] Those losses are corporate equity reduction ("CERT") losses,[325] foreign expropriation capital losses ("FECLs"),[326] and foreign expropriation losses ("FELs").[327]

[321]It is at least somewhat ironic that the STI method, a separate-corporation approach, might produce a pure consolidated attribute.

[322]The following proves that proposition:

Assume that the number of group members having separate net operating losses is *n*. Let loss member 1's separate net operating loss equal NOL_1, loss member 2's separate net operating loss equal NOL_2, and so on. The sum ("SUM") of the separate net operating losses of all loss members equals

$$NOL_1 + NOL_2 + \ldots + NOL_n.$$

When the CNOL is not divided into components, the portion of the CNOL attributable to loss member 1 equals CNOL x (NOL_1/SUM), the amount attributable to loss member 2 equals CNOL x (NOL_2/SUM), and so on. *See* Reg. §1.1502-21(b)(2)(iv). If Y equals the total amount of the CNOL that could be attributable to all members

$$\begin{aligned} Y &= (CNOL \times (NOL_1/SUM)) + (CNOL \times (NOL_2/SUM)) + \ldots + (CNOL \times (NOL_n/SUM)) \\ &= CNOL \times (1/SUM) \times (NOL_1 + NOL_2 + \ldots + NOL_n) \\ &= CNOL \times (1/SUM) \times SUM \\ &= CNOL. \end{aligned}$$

Thus, when the CNOL is not broken into components, the total amount attributable to members equals the CNOL.

[323]We would also reject the STI method, because only the fourth method accommodates that method.

[324]As a necessary incident to that approach, a member's contribution to a CNOL component may exceed its separate loss, and no member should be attributed that excess. If it were attributed to the "contributing" member, that member could be attributed more than its separate loss, the concern illustrated by Example 15. If it were attributed to another member, the member could be attributed more than its separate loss (the same concern) or more than its separate contribution to the CNOL component, the concern illustrated by Examples 13 and 14. *Cf.* Amorient, Inc. v. Commissioner, 103 T.C. 161, 169 (1994) (concluding that a member could not use its attributable portion of the group's CNOL in a separate-return year because it was an S corporation in that year; the group also could not use that portion in the equivalent consolidated-return year).

[325]Section 172(b)(1)(E) limits the carryback of a CERT loss. For a corporation filing separate returns, its CERT loss equals the lesser of its NOL or its interest deductions attributable to certain major stock acquisitions. *See* I.R.C. § 172(h)(2).

[326]FECLs are capital losses resulting from a foreign government's expropriation, seizure, or similar taking of property. *See* I.R.C. § 1212(a)(2)(A). The Code first provided special rules for these losses in 1964, four years before special rules were added for the predecessor to the SLL. *See* Pub. L. No. 88-571, § 7(a), 78 Stat. 857 (1964). Under Code section 1212(a)(1) and (2), a corporate taxpayer is afforded an extended carryforward period for the portion of its net capital loss attributable to FECLs. For a corporation filing a separate return, that portion equaled the lesser of the corporation's FECLs or its net capital loss. *See* I.R.C. § 1212(a)(2)(B).

Each loss is struck from the same mold as the SLL. For a separate-return corporation, the portion of its NOL attributable to each loss is the lesser of the NOL or the loss.[328] That portion is treated as a separate NOL to be applied after the remaining portion of the NOL.[329] Consolidated groups compute each of those losses using the consolidated-first approach.[330]

Only a method like the fourth can accommodate that computation. The other methods are flawed for the same reasons illustrated by *Examples 13* through *16*; under the first two, the specialty loss could be shifted to a member that did not recognize such a loss, while under the third, a member could be allocated a loss greater than its separate loss.

Whatever method we adopt, the apportionment rules contemplate the consolidated-first approach, and our extended tour of the Code and regulations offers no good reason to adopt a separate-first approach. We should compute the consolidated SLL using a consolidated-first approach, because it better meets our policy goals, is clear and certain, and follows a readily accessible reading of the Code and regulations.

V. CONCLUSION

The consolidated return regulations should clearly reflect the income tax liability of the consolidated group and prevent the avoidance of that liability.[331] To advance these goals, the regulations adopt a hybrid of the single-entity and separate-corporation approaches.[332] Although combining these approaches promotes tax neutrality,[333] it also creates an inevitable tension, typified by the quandary surrounding how a group should compute and use its SLL, issues the regulations never directly address.

Net capital losses (including the FECL portion) are attributed among members under the principles of Regulation section 1.1502-21(b)(2) (*i.e.*, the same rules that apply to the attribution of the CNOL). *See* Reg. § 1.1502-22(b)(3); *see also* Reg. § 1.1502-22(b)(1) (1996) (providing an equivalent rule under prior regulations). For convenience in discussing the attribution rules from this point forward, the article generally refers to an FECL or consolidated FECL as an NOL or CNOL, respectively.

[327]Until 1990, a taxpayer could elect to extend the carryforward period for any portion of its NOL attributable to FELs. *See* I.R.C. § 172(b)(1)(D), (3)(A) (1990). For a corporation filing a separate return, that portion equaled the lesser of the corporation's FELs or its NOL. *See* I.R.C. § 172(h)(2) (1990). For a more extended discussion of FELs, see *supra* pp. 694-96.

[328]*See supra* notes 327-29.

[329]*See* I.R.C. §§ 172(h)(4)(B)(i), (f)(5) (for CERT losses), 1212(a)(2)(C) (for FECLs), 172(b)(2) (1990) (for FELs).

[330]*See* I.R.C. § 172(h)(4)(C) (treating the group as one taxpayer in applying the CERT loss provision); Reg. § 1.1502-22(b)(1) (1996) (for FECLs); § 1.1502-21(b)(2)(iii) (1996) (for the now-repealed FELs).

The current regulations do not describe these specialty losses but merely restate the attribution rules found in the old regulations. *See* CO-078-90, 56 Fed. Reg. 4228, 4230 (1991). Thus, if the old regulations accommodated the consolidated-first approach, the current regulations should as well.

[331]*See* I.R.C. § 1502.

[332]Under the single-entity approach, the group is treated like one corporation, while under the separate-corporation approach group members are treated as separate corporations.

[333]The regulations promote neutrality in the group's choices to form, acquire, or sell members and to transfer assets between members.

To carry its SLL back to consolidated-return years, a consolidated group should use a single-entity approach. The regulations provide no mechanism for a group or its members to absorb members' losses or deductions separately, instead directing the group as a whole to offset its gross income and deductions in computing its CTI or CNOL.

However, a group should use a separate-corporation approach to carry any portion of its SLL back to a member's separate-return year. Otherwise, a member with positive separate income could be attributed a portion of the group's CNOL.

It is less certain how a group should compute its SLL.[334] Possible methods include the consolidated-first or a separate-first approach. Under the consolidated-first approach, the group would compute its SLL as if it were a single corporation. Under a separate-first approach, a group would compute and combine separate member SLLs to form its SLL.

Although the Service and at least one court support a separate-first approach, a textual analysis slightly favors the consolidated-first approach, and the balance becomes more pronounced when we read the regulations in context. Any separate-first approach would impede the group's non-tax economic choices to form or acquire new members or transfer assets between members, because the location of assets within the group would matter. It would also create more administrative headaches for the government and taxpayers. A loss group would have to compute a notional net operating loss amount and separate SLLs for each member with SL deductions, and the approach would spark more tax disputes.

The consolidated-first approach neatly sidesteps these and similar concerns by making the location of tax items within the group irrelevant, and the approach fits comfortably with the Code and consolidated return regulations. The Code limits the SLL for any taxable year to the net operating loss for that year,[335] and, under the regulations, a group's net operating loss is its CNOL.[336] The group computes its CNOL by taking into account each members' losses and other tax items.[337] As part of this computation, the group determines its SLL, and neither the Code nor regulations expressly require that members first compute separate SLLs. The most accessible reading favors the consolidated-first approach,[338] and we should adopt that approach.

[334]Too often, debate on the SLL's computation has centered on a textual, rather than contextual, interpretation of regulatory language. If generally followed, this wooden approach invites a winding, technical foray through the consolidated return regulations for any consolidated question not directly answered by the Code or regulations.

[335]*See* I.R.C. § 172(f)(2).

[336]*See* Reg. § 1.1502-21.

[337]*See* Reg. § 1.1502-21(e).

[338]Ockham's razor trims Plato's beard.

Appendix

The appendix identifies strategies a consolidated group may currently employ to maximize the benefit of SL deductions following the group's acquisition of the stock or assets of a target corporation. It also sketches possible regulatory responses to those strategies.

The regulatory responses should extend beyond merely adopting a separate-first or the consolidated-first approach. Neither approach is tax-neutral,[339] either can be manipulated through stuffing,[340] and neither addresses broader loss trafficking concerns.[341]

The appendix illustrates these concerns by example.[342] Except as otherwise provided, the facts in each example are as follows: Since January 1 of Year 1, P, S1, and S2 have been the members of a calendar-year, consolidated group. Each member is an accrual-basis taxpayer. On December 31 of Year 11, the P group acquires the stock or assets of T, an unrelated corporation and accrual-basis taxpayer. In Year 12, the P group has a $1,000 CNOL, all of which is attributable to P.[343]

Examples A-1 and *A-2* illustrate that neither the consolidated-first nor any separate-first approach is tax-neutral. Although the consolidated-first approach makes more tax-neutral a group's choice to form a new member or transfer assets among historic members,[344] either approach may make federal income tax considerations a factor in a group's acquiring a target corporation.

> *Example A-1: Consolidated-First Approach Not Tax-Neutral.*[345] P acquires the T stock on December 31 of Year 11, anticipating that, in Year 12, T will incur, pay, and deduct a $100 SL deduction and the P group will have a $1,000 CNOL. Both turn out to be true. Using any separate-corporation measurement, T has positive net income in Year 12 and will be attributed no portion of the P group's CNOL.[346] No member other than T has SL deductions in Year 12.
>
> If the P group uses the consolidated-first approach and its use of the SL deductions is not otherwise limited,[347] $100 of the group's $1,000 CNOL would be treated as an SLL.[348] If the group uses a separate-first approach, none of the

[339]*See infra* Examples A-1 and A-2.

[340]*See infra* Examples A-3 through A-5.

[341]*See infra* Example A-6.

[342]*See infra* Examples A-3 through A-6.

[343]Also assume for convenience that S1 and S2 have no net income or loss.

[344]*See supra* pp. 680-82.

[345]Example A-1 is substantially the same as Example 4, which begins at page 682.

[346]*See* Reg. § 1.1502-21(b)(2)(iv) (providing that the CNOL is attributable to a member only if the member has a separate net operating loss, as defined in that section).

[347]*Cf.* I.R.C. §§ 269, 382. Except as otherwise stated, assume that section 382 does not apply in the examples in this appendix.

[348]Under a consolidated-first approach, the group's SLL would equal the lesser of its members' aggregate SL deductions or its CNOL. Thus, the P group's SLL would equal $100, *i.e.*, the lesser of $100 (its members' aggregate SL deductions) or $1,000 (its CNOL).

CNOL would be an SLL, because no member would have a separate SLL.[349]

Accordingly, under the consolidated-first approach, the P group could extend $100 of its CNOL carryback from 2 to 10 years and may have a tax motivation to acquire T.

Example A-2: Separate-First Approach Not Tax-Neutral.[350] The facts are the same as in *Example A-1*, except that P acquires the T stock on December 31 of Year 4 before P (or T) anticipates that T will incur SL deductions. T incurs and pays the SL deductions in Year 12 (or more than seven years after the group acquired the T stock). The results are the same as in *Example A-1* even if P contributed the business to T that generated the SL deductions.

Accordingly, under a separate-first approach, none of the P group's CNOL would be an SLL even if the P group bore the full economic cost of the SL deductions,[351] and the P group may be reluctant for tax reasons to acquire T. The consolidated-first approach would not affect that choice.

To make target acquisitions more tax-neutral, the regulations could combine the consolidated-first and separate-first approaches.[352] The regulations could provide that a group's consolidated SLL would equal the lesser of its qualified SL deductions and its CNOL. Reflecting that the consolidated-first approach generally is tax-neutral, all of a member's SL deductions should be qualified SL deductions except in a case like *Example A-1* in which the acquiring group anticipates target SL deductions.[353] The "anticipated" deductions would be treated as qualified SL deductions only to the extent they did not exceed the target's separate SLL.[354]

As *Examples A-3* and *A-4* illustrate, however, this "combined" approach would not limit all tax-motivated transactions.

[349]Under a separate-first approach, the group's SLL cannot exceed the aggregate separate SLLs of its members. No member other than T could have a separate SLL, because only T has SL deductions, and T does not have a separate SLL because it has positive net income determined on a separate-corporation basis.

[350]This example is similar to Example 5, which begins on page 683.

[351]*See supra* notes 115-21 and accompanying text (discussing why a group should benefit from the extended carryback of SL deductions if it bears their economic cost).

[352]The combination would be consistent with the hybrid approach. *See supra* notes 12-44 and accompanying text.

[353]To be administrable, the combined approach must clearly identify when a member must compute a separate SLL (*i.e.*, when the group "anticipates" SL deductions) and which of the member's SL deductions may be limited. We could provide that the deductions are limited only if they are built-in deductions, determined under Code section 382(h)(6)(B) by treating the date the target joins the consolidated group as the "change date." (The target would not have to undergo an ownership change.) Further, the group could compute a separate SLL only for those members with SL deductions that may be limited. The Appendix discusses how we may compute built-in deductions under section 382(h)(6)(B) beginning at page 728.

[354]The regulations would also have to define a separate SLL and presumably would not use the STI limitation because of the odd outcomes it may produce. *See supra* notes 188-200 and accompanying text. Further, if a member acquires a target's assets in a section 368 reorganization, we would measure any limitation using the acquiring member's separate SLL. *See infra* Example A-5.

Example A-3: Stuffing of Loss Assets; Creating a Separate-Return Carryback.[355] The facts are the same as in *Example A-1*, except that P contributes a business to T. Assume that because of the contribution, T generates a $100 separate loss in Year 12 under any separate-corporation measurement and would be attributed $100 of the group's CNOL.

Under the consolidated-first, any separate-first, or the combined approach, $100 of the group's $1,000 CNOL would be an SLL.[356] The entire SLL would be attributed to T and carried back to its separate-return year.

Example A-4: Stuffing of SL Deductions; Creating a Separate-Return Carryback. The facts are the same as in *Example A-1*, except that P holds the business that will generate the SL deductions (the "SL business"). The P group cannot benefit from an extended carryback of its CNOL if its SLL is carried back to a consolidated-return year. P contributes the SL business to T at the beginning of Year 12. Assume that because of the contribution, T generates a $100 separate loss in Year 12 under any separate-corporation measurement and would be attributed $100 of the group's CNOL.

Under the same analysis as in *Example A-3*, $100 of the group's CNOL would be an SLL, and the entire SLL would be attributed to T and carried back to its separate-return year.

To address concerns with stuffing, the combined approach could be supplemented with an anti-avoidance rule. The rule could apply if the group transfers assets to the target with a sufficient intent to increase the carryback of its SLL to the target's separate-return years.[357] If the rule applied, the carryback could be limited to an amount calculated by disregarding the asset transfers[358] and the group could have the burden to prove that the carryback should be greater than $0.

Although the stuffing concern illustrated by *Examples A-3* and *A-4* extends beyond consolidated groups,[359] it may merit a targeted consolidated response like the anti-avoidance rule, because consolidated groups may more easily en-

[355]This example illustrates the same problem as Example 7, which begins on page 685.

[356]The analysis for the consolidated-first approach is the same as in Example A-1. Under a separate-first approach, the group's SLL would equal $100, the lesser of the aggregate separate SLLs (T's $100 separate SLL) or the $1,000 CNOL.

[357]The rule's application could be conditioned on the group's transferring assets with a "principal purpose" or a "view" to increase the target's carryback. *Compare* Reg. § 1.1502-13(h)(1) *and* -32(e) (looking to a principal purpose) *with* Reg. § 1.1502-20(e) (looking to a view); *see also* I.R.C. § 269 (an anti-avoidance rule using "the" principal purpose). To limit its administrative burden, the rule could also provide that groups generally disregard asset transfers within some stated time before the SL deductions economically accrue. *Cf.* Reg. § 1.1502-20(e)(2) (adopting a two-year window to connect an asset transfer and subsequent stock disposition).

[358]*Cf.* Reg. § 1.1502-20(e)(2)(ii) (for a comparable rule).

[359]For example, we may have similar concerns if the P group were an affiliated, non-consolidated group.

gage in that kind of stuffing.[360] When a stuffing technique is not uniquely available to consolidated groups, however, it should not justify a targeted response. *Example A-5* illustrates a more generally available technique.

> *Example A-5: Extending the Carryback to a Consolidated-Return Year.*[361] The facts are the same as in *Example A-1,* except that P acquires the T assets in a section 368 reorganization and P incurs and pays the $100 SL deduction. P is entitled to deduct the $100 SL deduction in Year 12.[362] Assume that under any separate-first approach P would have a $100 separate SLL. Assuming the entire $1,000 CNOL is attributable to P, the group would have a $100 SLL, eligible for a 10-year carryback, no matter what approach is used to compute SLLs.[363]
>
> P could use the same technique to extend its loss carryback if it were a non-consolidated corporation.

Example A-6 also illustrates a broader loss trafficking concern and may merit a broader response.

> *Example A-6: Loss Trafficking—A Broader Concern.* The P group anticipates that it will generate $1,000 of CTI in Year 12. Because the group pays tax at a thirty-five percent rate, it would pay a $350 tax.[364] T anticipates incurring, paying, and deducting a $100 SL deduction in Year 12 and generating a $100 separate loss. Assume that because of past losses, T could absorb none of the net loss as a carryback.
>
> P buys the T stock on December 31 of Year 11. If the group's use of T's excess loss is not restricted,[365] the group would reduce its CTI from $1,000 to $900 and reduce its tax from $350 to $315.[366] If the P group paid more for T because of the anticipated deduction, the purchase would result in a form of loss trafficking.

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[360]In applying Code section 351, a member is treated as owning any stock the group owns. *See* Reg. § 1.1502-34(a). As a consequence, when a member exchanges assets for another member's stock, the exchange is often described in section 351, no matter how much stock the transferor member actually owns in the transferee member. Because section 351 more readily applies, it is more likely that a group can shift loss to the acquired target. *See* I.R.C. § 362(a) (providing that the transferee corporation takes a carryover basis in assets received in section 351 transfer). *But see* Rollins v. Commissioner, 66 T.C.M. (CCH) 1869, 1896, 1993 T.C.M. (RIA) ¶ 93,643, at 3431 (concluding that the loss on a transferred asset was not shifted to the transferee corporation when the transfer and sale were part of an overall plan).

[361]This example is similar to Example 6, which begins at page 685.

[362]*See* Reg. §§ 1.381(c)(4)-1(a)(1), 1.381(c)(16)-1(a)(1)-(2); *see also* Rev. Rul. 83-73, 1983-1 C.B. 84; G.C.M. 38,977 (Apr. 8, 1982) (each concluding that the acquiring corporation steps into the "tax shoes" of the target).

[363]*See* I.R.C. § 381(b)(3) (stating that the acquiring corporation cannot carry back its NOL to a taxable year of target). The carryback may be limited under section 269(a)(1), which applies when a corporation acquires control of another corporation with "the principal purpose" to evade or avoid "Federal income tax by securing the benefit of a deduction, credit, or other allowance which such . . . corporation would not otherwise enjoy." I.R.C. § 269(a). The "principal purpose" standard appears to be a difficult threshold for the Service to overcome, and it rarely attempts to apply section 269 to limit deductions.

[364]The $350 tax equals 35% of $1,000.

[365]*See* I.R.C. § 382.

[366]The reduced tax would equal 35% of $900.

A response to the loss trafficking illustrated by *Example A-6* may begin with section 382.[367] If a target undergoes an ownership change,[368] section 382 may restrict the target's (or its successor's) use of pre-change losses following the ownership change.[369] In an appropriate case,[370] pre-change losses include "built-in deductions," which are amounts allowable as deductions during the five-year period following the change date but "attributable to periods before [that] date."[371] If T's SL deductions in *Example A-6* are built-in deductions, section 382 and certain consolidated provisions may limit the P group's use of those amounts.[372]

We may read section 382(h)(4) to prohibit the carryback of the SL deductions in *Example A-3* or *A-5* if those amounts are built-in deductions. Under section 382(h)(4)(A), when the use of built-in deductions and other amounts is restricted by section 382, the restricted portion "shall be" carried forward to subsequent years.[373] From that direction, we might conclude that built-in deductions cannot be carried back.

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[367]Section 382 suffers from great operational and technical complexity. For a description of some of the issues under section 382, *see* BORIS I. BITTKER & JAMES S. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS, ¶¶ 14.42-44 (6th Ed. 1993). Because of that complexity, the appendix does not describe section 382 in detail, but instead focuses on aspects of section 382 relevant to limit the extended carryback of a consolidated SLL.

[368]*See* I.R.C. § 382(g) (defining ownership change); *see also* I.R.C. § 382(l)(3) (stating that constructive ownership rules apply to determine if an ownership change occurred), (8) (treating an entity and its successor or predecessor as one entity).

[369]*See* I.R.C. § 382(a) (providing the general rule that the amount of pre-change loss that can be used is annually limited to the section 382 limitation). In any post-change year, the pre-change losses that may be used equal a fraction of the target's value. *See* I.R.C. § 382(b) (defining section 382 limitation as product of the value of the loss corporation and the long-term tax-exempt rate), (f) (defining the long-term, tax-exempt rate); *see also* Reg. § 1.1502-94(b)(1) (applying section 382 in this circumstance on a separate-corporation basis).

[370]*See* I.R.C. § 382(h)(1)(B) (rule for a net unrealized built-in loss); *see also* I.R.C. § 382(h)(3)(B) (treating the net unrealized built-in loss as zero unless it exceeds certain threshold amounts); 2 DUBROFF ET. AL., *supra* note 10, § 42.05[2][ii], at 42-175 (discussing the net unrealized built-in loss in more detail).

[371]I.R.C. § 382(h)(6)(B), (7)(A).

[372]Under the consolidated return regulations, use of the built-in deductions may be limited by separate return limitation year ("SRLY") rules. Under those rules, when a target becomes a group member, the use of its pre-group losses is limited to the aggregate positive CTI attributable to the target while it was a member of the group. *See* Reg. § 1.1502-21(c)(1) (describing the SRLY limitation); *see also* Reg. § 1.1502-21(c)(2) (applying the SRLY limitation to a target subgroup by treating the subgroup like one corporation). *But see* Reg. § 1502-21(g) (providing a section 382 limitation in lieu of the SRLY limitation in certain cases). For this purpose, built-in losses and deductions may be treated as pre-group losses. *See* Reg. § 1.1502-15(b) (treating certain built-in losses under section 382(h)(2)(B), as slightly modified, as SRLY losses). *See* 2 DUBROFF ET. AL., *supra* note 10, § 42.02, at 42-6 (discussing the SRLY limitation generally) and § 42.03, at 42-99 (discussing the SRLY limitation as it applies to built-in deductions).

Somewhat ironically, another anti-abuse provision, section 461(h), may facilitate a modest avoidance of section 382 (and the consolidated provisions). Because of section 461(h), an economically accrued deduction could be postponed more than five years beyond the change date, and it would not be treated as a built-in deduction. Therefore, it could avoid the reach of section 382 (and the consolidated provisions). *See* Reg. § 1.461-1(g) (often requiring payment as a condition for the deduction).

[373]Applicable legislative history states that those amounts "must be carried forward (not carried back) under rules similar to the rules applicable to net operating loss carryforwards and will be subject to the special limitations [in the carryforward years] in the same manner as pre-change loss." H.R. CONF. REP. NO. 99-841, II-191 (1986).

That conclusion would make the deduction's timing vital, inconsistent with the neutrality goal section 382 appears to implement.[374] To advance that goal, we should read section 382(h)(4)(A) not to prohibit carrybacks but merely to authorize a carryforward when section 172 (or another carryover provision) would not otherwise apply.[375] Thus, if section 172 applied, the restricted portion might be carried back and used in an earlier year just as if it were recognized in that year, consistent with neutrality. If the earlier year were a pre-change year, section 382 would not restrict the carryback's use because of the ownership change.[376]

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[374] *See* Daniel L. Simmons, *Net Operating Losses and Section 382: Searching for a Limitation on Loss Carryovers*, 63 TUL. L. REV. 1045, 1069-83 (1989) (discussing how section 382 imperfectly implements neutrality). Under the neutrality principle, the acquisition of a target loss corporation should be neither motivated nor impeded by the prospective tax use of the target's losses. *See id.* at 1070. Furthermore, a target should have no tax incentive or disincentive to accelerate or postpone its income or deduction items because of the acquisition. *See* Arthur W. Needham, *The "Item of Income" Exclusion of Section 382(h)(6)(A)—An Expansion of the Built-in Gain Rule*, 51 TAX NOTES 373, 375 (1991) (stating that companion built-in gain rules "implement 'neutrality' by ensuring the coextensive use of losses against gain recognized on the sale of an asset, whether before or after the change date"); *see also* James L. Dahlberg & Michael B. Miles, *Built-in Gain of Foreign Corporations*, 47 TAX NOTES 1217, 1221 (1990) (stating that "the neutrality principle [underlies] all of section 382, including section 382(h)").

[375] *See* 2 DUBROFF ET. AL., *supra* note 10, § 42.03[1], at n.304 (advocating that reading). For example, in the year of the deduction the target may have positive taxable income, so that section 172 would not authorize use of the restricted amount in another year. Section 172 would apply only if the target had a net operating loss.

[376] To further neutrality, we might adopt a targeted consolidated rule that in an appropriate case would deny the carryback of a built-in loss or deduction following a taxable target stock disposition. The rule could apply if (i) the target was a subsidiary member of a consolidated group immediately before the disposition and (ii) the selling group would have had no net tax benefit if the target had taken the loss or deduction into account immediately before the disposition.

An earlier loss or deduction might have produced no net tax benefit, because the group would have reduced its basis in the target stock and *might* have recognized a correspondingly greater gain on the target disposition. *See generally* Reg. § 1.1502-32(b)(3)(i) (providing that a deduction results in a negative adjustment); *cf.* Reg. § 1.1502-32(b)(3)(i)(B) (providing that a deduction carried back and absorbed in an earlier year results in a basis adjustment in the later year); *see also* 2 DUBROFF ET. AL., *supra* note 10, § 42.03[1], at n.304 (noting that an earlier deduction may produce no net tax benefit to the selling group).

Note that in many cases an earlier loss or deduction would have produced some benefit either absolutely or on a present-value basis. For example, the basis reduction might have eliminated a stock loss otherwise disallowed under Regulation section 1.1502-20(a). *See* 2 DUBROFF ET. AL., *supra* note 10, § 42.03[1], at n.304. Further, the group might have an unused capital loss that could have offset any increased capital gain on the target stock disposition. *See id.* Finally, if the target had minority common shareholders, the group's basis in the target stock would have been reduced by less than the loss or deduction. *See* Reg. § 1.1502-32(c)(2)(i)(5), Ex. 1 (providing that a negative adjustment is allocated equally among shares). The earlier loss or deduction would also have produced at least a net present-value benefit if the target was disposed of in a non-recognition exchange, even if the group took a correspondingly lower basis in the qualified property received in the exchange.

It would be difficult, if not administratively infeasible, to adopt a targeted consolidated response for these other cases. Each case may deserve a selective, sometimes complex, response, and in certain instances it may be difficult to gauge the response because the extent of any net benefit may be unclear at the time of the carryback.

However the section 382(h)(4) debate is resolved, we must still answer what amounts qualify as built-in deductions under section 382.[377] It is not clear how we should answer this question, because the Service has yet to issue applicable guidance.[378] We could follow the regulatory approach taken for a similar S corporation provision or chart a new course.

The similarly worded S corporation provision is found in section 1374. Under that section, after a C corporation converts to an S corporation, the corporation may have to pay a corporate-level tax on certain net gain recognized after, but accrued before, the conversion.[379] The gain subject to tax may be reduced by built-in deductions,[380] which are amounts deducted by the corporation during the ten-year period following the conversion but "attributable to periods before [the conversion]."[381]

Under the regulations, an amount is attributable to a pre-conversion period if it would have been allowed as a pre-conversion deduction for an accrual-method taxpayer.[382] This determination is made by disregarding the economic performance requirement for liabilities relating to torts and taxes, among other things.[383] At a minimum, then, a built-in deduction must generally meet the all-events test before the conversion date.[384]

We may define built-in deductions under section 382 in a similar way. The operative language under sections 382 and 1374 is practically identical,[385] as is

[377]We need to know how to compute these amounts to resolve how section 382 applies in some of the examples and also to compute the consolidated SLL.

[378]Two private letter rulings consider section 382(h)(6)(B), but neither defines built-in deductions. *See* P.L.R. 98-52-013 (Dec. 25, 1998) (concluding that an amount was not a built-in deduction apparently because it was recognized before the change date); P.L.R. 94-44-035 (Nov. 4, 1994) (treating a deduction relating to an employee stock option as a built-in deduction apparently because it was economically accrued as of the change date).

[379]*See* I.R.C. § 1374(a) (imposing tax on net recognized built-in gain), (d)(2) (providing that net recognized built-in gain cannot exceed the excess of recognized built-in gain over recognized built-in loss); *see also* I.R.C. § 1374(d)(3), (4) (generally defining recognized built-in gain and losses).

Generally, an S corporation does not pay tax at the corporate level. *See* I.R.C. § 1363(a). Instead, each S corporation shareholder takes into account a pro rata share of the S corporation tax items for any year on the shareholder's tax return. *See* I.R.C. § 1366(a)(1).

[380]*See* I.R.C. § 1374(d)(5)(B) (treating built-in deductions as net recognized loss).

[381]*See also* I.R.C. § 1374(d)(7) (defining the ten-year recognition period).

[382]*See* Reg. § 1.1374-4(b)(2).

[383]*See id.*

[384]*See* Reg. § 1.461-1(a)(2) (providing that a liability for an accrual-basis taxpayer is incurred when the all-events test is met and economic performance has occurred); *cf.* Reg. § 1.1374-4(b)(2), (3) *Ex. 3* (applying the all-events test to determine built-in deductions under section 1374). "The all-events test is met [for] any item if all events have occurred which determine the fact of the liability and the amount of such liability can be determined with reasonable accuracy." I.R.C. § 461(h)(4).

[385]*Compare* I.R.C. § 382(h)(6)(B) (providing for purposes of section 382 that the applicable loss amount includes deductions "attributable to" periods before ownership change date) *with* I.R.C. § 1374(d)(5)(B) (providing for purposes of section 1374 that the applicable loss amount includes deductions "attributable to" periods before the S corporation election). The language was also implemented in the same section of the Technical and Miscellaneous Revenue Act of 1988 (the "1988 Act") but as technical amendments to different sections of the Tax Reform Act of 1986 (the "1986 Act"). Section 382(h)(6) was refined by section 1006(d)(22) of the 1988 Act, which amended section 621 of the 1986 Act. Section 1374(d)(5) was added by section 1006(f)(5)(A) of the 1988 Act as an amendment to section 632 of the 1986 Act.

the applicable legislative history.[386] Further, both sections 382 and 1374 key on the value of a corporation, a value that would include the present value cost of those deductions.

Nonetheless, we could justify different definitions, in part because the provisions apply in dramatically different settings.[387] Section 1374 generally applies to smaller corporations,[388] while section 382 more often applies to larger ones. The Service may have justified a narrow limitation under section 1374 for administrative reasons that focused on the likely audience, less-sophisticated taxpayers. Those same considerations may not apply in implementing the built-in deduction provisions under section 382.[389]

Further, a narrow definition under section 382 may undercut neutrality, because a group may be able to acquire a target with reasonably anticipated losses free of a section 382 taint. *Example A-7* illustrates this point.

> *Example A-7: Loss Trafficking—Deduction Not Accrued.* The facts are the same as in *Example A-6*. T anticipates incurring, paying, and deducting a $100 SL deduction in Year 12, because it has negotiated an agreement to pay a tort victim $100 in that year. Assume that as of December 31 of Year 11, T has not executed the agreement, but the victim will keep the offer open until January 15 of Year 12.
>
> The $100 liability would not satisfy the all-events test before Year 12, because T did not execute the settlement offer before that year.[390] Thus, if we adopt substantially similar definitions for built-in deductions under sections 382 and 1374, the SL deduction would not be a built-in deduction under section 382. Nevertheless, the P group should readily anticipate a $100 SL deduction in Year 12 and may pay more for T because of the deduction, resulting in a form of loss trafficking.

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[386]That legislative history describes built-in deductions similarly as amounts "attributable to" prechange or conversion periods. *See* S. Rep. No. 100-445, at 48-49 (1988), *reprinted in* 1988 U.S.C.C.A.N. 4515, 4571 (describing the section 382 amount); S. Rep. No. 100-445, at 65 (1988), *reprinted in* 1988 U.S.C.C.A.N. 4515, 4588 (describing the section 1374 amount).

[387]In fact, the Service has implied that the two sections may be applied differently. The preamble to the proposed regulations under section 1374 described the limited approach to determine built-in deductions for purposes of section 1374 but added that "[t]he Treasury Department and the Internal Revenue Service intend no inference regarding rules they may adopt in other regulations, such as under section 382(h)(6) . . ., which contain language similar to section 1374(d)(2)." CO-80-87, 57 Fed. Reg. 57971, 57973 (Dec. 8, 1992), 1992-2 C.B. 594, 595. The Service adopted substantially the same limited approach in finalizing the regulations. *See* Reg. § 1.1374-4(b)(2) (using an accrual approach to determine built-in deductions); *see also* P.L.R. 94-44-035 (Nov. 4, 1994) (appearing to adopt a broader approach under section 382 than under section 1374).

[388]An S corporation can have significant assets, although it is limited in the number of shareholders it may have. *See* I.R.C. § 1361(b)(1)(A) (for the 75-shareholder limitation).

[389]Consistent interpretations would have polar effects. When the Service adopted the relatively narrow definition of built-in deductions for section 1374, it reduced the available deductions, increased the net gain subject to tax, and likely *increased* the tax paid under section 1374. A similarly narrow construction of section 382(h)(6)(B) would increase the deductions free of a section 382 taint, increase currently available deductions, and probably *decrease* the collectible tax (or at least its present value).

[390]The all-events test for a liability is met only if the "fact of the liability" is established. *See* Reg. § 1.461-1(a)(2)(i). Because T establishes the fact of the tort liability by executing the settlement agreement, it cannot meet the all-events test for that liability before it executes the agreement.

As *Example A-7* hints, the practical effect of similar rules for section 382 and 1374 could be quite different, because taxpayers could time a conversion or acquisition to maximize tax benefits.[391] For example, a corporation might postpone its S corporation conversion until a significant deduction was incurred or met the built-in test. A loss corporation could postpone a deduction's accrual beyond the change date, possibly freeing it from the section 382 taint. To have comparable effects, the section 382 and section 1374 built-in deduction rules should be different.

We should adopt the broader rule for section 382 because taxpayers may time an acquisition more freely than a conversion,[392] although it is not clear how we should craft the rule. If we required a built-in deduction to be "anticipated" or "economically accrued" when the acquisition occurred, the rule seems too vague.[393]

As an alternative, we could use the section 1374 rule for some deductions[394] but adopt a presumption that would treat as built-in deductions other amounts that accrue within a stated time after the acquisition. For example, we may presumptively treat a post-acquisition SL deduction as a built-in deduction if it accrues within two years after the acquisition.[395] The acquiror could rebut any presumption by presenting proof clearly establishing that neither it nor the target anticipated the deduction as of the acquisition date.[396]

Even carefully drawn presumptions would preserve some difficult cases, but they should eliminate many otherwise troubling ones. This Article leaves to others the time-consuming and delicate task of identifying appropriate presumptions.

Whether or not the Service adopts an approach outlined in this appendix, it should clearly define built-in deductions under section 382(h)(6)(B). We may then develop regulatory responses that will not only make the combined consolidated-first/separate-first approach more tax-neutral but also minimize stuffing and broader loss trafficking concerns.

[391] If we adopt similar rules, courts may still interpret them differently to prevent abuse, making them more difficult for the Service to administer and taxpayers to apply.

[392] A conversion becomes effective on the first day of the corporation's taxable year. *See* I.R.C. § 1362(b)(1). An acquisition typically can occur at any time.

[393] It brings to mind the often baffling task of identifying contingent liabilities as of an acquisition date. *But see* I.R.C. § 381(c)(16) (requiring a similar finding that a target obligation was reflected in consideration paid in the acquisition).

[394] For example, it may be appropriate to treat a post-acquisition account payable as a built-in deduction only if it has accrued as of the acquisition date.

[395] *Cf.* Reg. § 1.707-3(c) (stating that a transfer within two years is presumed to be a sale).

[396] *Cf. id.* (providing that a presumption could be rebutted by facts that "clearly establish" that transfers did not constitute a sale).