Should the "Product Liability Loss" Deduction Be Calculated on a Consolidated Basis for an Affiliated Group?

Ralph C. Anzivino
Marquette University Law School, ralph.anzivino@marquette.edu

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Case at a Glance

A "product liability loss" incurred by a corporation may be carried back a maximum of 10 years from the loss year and used as a deduction in the carryback year(s). The question presented in this case is whether the availability of the "product liability loss" carryback for affiliated entities that file a consolidated return is to be determined by (i) aggregating the income and expenses of the consolidated entities or (ii) separately calculating the income and expenses of each entity.

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by Ralph C. Anzivino

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Ralph C. Anzivino is a professor of law at Marquette University Law School in Milwaukee, Wis.; rcanzivino@aol.com or (414) 288-5365.

ISSUE

Section 172(b)(1)(I) of the Internal Revenue Code of 1954 allows a taxpayer with a "product liability loss," as defined in section 172(j)(1), to carry that loss back up to a maximum of 10 years from the year in which the loss is incurred. The loss is then applied to income from those earlier years, which results in a refund to the taxpayer. The issue in this case is whether, in the case of an affiliated group of corporations filing a consolidated federal income tax return, the "product liability loss" is determined on a consolidated basis or on a separate company-by-company basis.

FACTS

During the years 1973 through 1986, United Dominion (Dominion) operated under the name of AMCA International Corporation (AMCA). During those years, AMCA filed consolidated income tax returns with its affiliated subsidiaries pursuant to section 1501 of the Internal Revenue Code and in accordance with the regulations issued by the IRS under the authority granted to it under section 1502. The Internal Revenue Code is silent with respect to the rules affecting affiliated groups of corporations. The primary rules in existence are those found in the extensive regulations issued under section 1502.

The consolidated return regulations allow the income of one or more members of the group to be offset by losses incurred by one or more other members of the group. Accordingly, the affiliated group computes its consolidated taxable income or calculates its net operating loss on a consolidated basis. Treas. Regs. § 1.1502-2 and § 1.1502-21. In essence, the affiliated group computes its taxable income or its net operating loss as if it were a single company and the members of the group were divisions of that company.

UNITED DOMINION INDUSTRIES, INC. v. UNITED STATES
DOCKET NO. 00-157

ARGUMENT DATE:
MARCH 26, 2001
FROM: THE FOURTH CIRCUIT

Under the language of section 172(j)(1), a taxpayer's "product liability loss" is the amount of its deductible product liability expenses for a given year limited by the amount of the taxpayer's net operating loss for that year. Thus, for example, if the taxpayer has a net operating loss of $100 and deductible product liability expenses of $80, the taxpayer has a "product liability loss" of $80. If the taxpayer does not have a net operating loss for a year, its "product liability loss" for the year is zero, regardless of the amount of the taxpayer's product liability deductions.

For the years 1983, 1984, 1985, and 1986, AMCA reported consolidated net operating losses of between $85 million and $140 million. These amounts far exceeded the annual product liability expenses of all of the members of the AMCA consolidated group during those years, which ranged from approximately $3.5 million to $6.5 million. Neither party disputes the size of these amounts or their characterization under section 172(j)(1)(B) as deductions attributable to product liability. This case focuses solely on whether the AMCA affiliated group can use certain product liability expenses in determining its "product liability loss" that is eligible for the 10-year carryback arising during the years 1983 through 1986. The dispute arises because, in each of those years in which the AMCA group had a consolidated net operating loss, all of the affiliated companies that had incurred product liability expenses generated positive separate taxable income when considered on a separate company-by-company basis.

In 1986 and 1987, Dominion filed with the IRS claims for refund with respect to its 1983 through 1986 consolidated tax returns. In its claims, Dominion asserted that it was entitled, under section 172(b)(1)(I) of the Code, to a 10-year carryback for the amount of its "product liability loss" incurred in 1983 through 1986. The amount of Dominion's claim for a refund is $1,618,306, plus statutory interest. The IRS agent assigned to review Dominion's claims for refund allowed the claims with respect to the consolidated return years. The agent allowed Dominion to carry back all of the product liability expenses it incurred during its 1983 through 1986 consolidated return years to offset its consolidated taxable income for the years 1973 through 1976. The agent concluded that the term "product liability loss" is determined on a consolidated, group-wide basis.

The Joint Committee on Internal Revenue Taxation of the United States Congress (which has jurisdiction over refunds exceeding a certain threshold, as set forth in section 6405(a) of the Code) reversed the agent's decision and denied Dominion's refund claim. The Joint Committee determined that an affiliated group's "product liability loss" must be calculated at the level of each individual group member as if it had filed a separate corporate income tax return. Accordingly, the Joint Committee found Dominion had no "product liability loss" to the extent that the individual group members that incurred the product liability expenses did not have net operating losses.

As a result of the Joint Committee's denial of its claims for refund, Dominion filed a suit for refund of federal income taxes in the U.S. District Court for the Western District of North Carolina on August 24, 1995. In light of the absence of any factual dispute, the parties submitted cross-motions for summary judgment. In an order dated June 19, 1998, the District Court granted Dominion's motion for summary judgment and denied the government's motion. The district court concluded that, with respect to consolidated return years, the amount of any 10-year carryback should be determined on a consolidated basis. *United Dominion v. United States,* 1998 WL 725813, 98-2 USTCP 50,527 (W.D. N.C. June 19, 1998)

On Sept. 14, 1998, the United States filed a notice of appeal. On March 24, 2000, the court of Appeals rejected the consolidated return approach approved by the district court, and reversed its judgment. *United Dominion v. United States,* 208 F.3d 452 (4th Cir. 2000). Rather, the court of appeals determined that Dominion's entitlement to the ten-year carryback for the consolidated return years should be determined on a separate, company-by-company basis.

On April 20, 2000, the Sixth Circuit Court of Appeals issued its opinion in the case of *Internet Corp. v. Commissioner,* 209 F.3d 701 (6th Cir. 2000). The Sixth Circuit held that the amount of an affiliated group's specified liability loss qualifying for the 10-year carryback is properly determined on a consolidated basis. The Sixth Circuit rejected the argument of the United States that a specified liability loss had to be determined on a separate company-by-company basis. In light of the conflicting decisions between the Sixth and Fourth Circuits, the Supreme Court granted the petition for a writ of certiorari. *United Dominion v. United States,* 121 S.Ct. 562 (2000).

Case Analysis

As a general matter, if a taxpayer properly claims deductions in a year that exceed the gross income it generates, it is said to have a "net operating loss." The Internal

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Revenue Code permits a taxpayer with a net operating loss to carry that loss to preceding taxable years as an offset to the taxable income generated in those years, thereby yielding a refund of taxes. The main reason for this provision is to smooth the taxpayer's income and loss over multiple tax-accounting periods. A taxpayer is ordinarily permitted to carry its net operating loss back to the third year preceding the year in which it incurred the loss, and then, if the loss is not fully absorbed in that year, the second preceding year, the first preceding year, and then forward for as many as 15 years.

In the case of a "product liability loss," the code extends the carryback period from the three years preceding the loss year to the 10 years preceding the loss year. Congress provided this extended carryback period primarily because it understood that the latent cost of product liability can take years to emerge, rendering the normal three-year matching period insufficient. The 10-year carryback has been a part of the federal income tax law since 1979. *See* Revenue Act of 1978, Pub. L. No. 95-600, § 371, 92 Stat. 2763, 2859.

Dominion argues that the mechanics of the consolidated return regulations require that the product liability losses of an affiliated group be determined on a consolidated or single entity basis. Section 172(j)(1) of the code unequivocally requires that a "taxpayer" have a "net operating loss" before it can have a "product liability loss" eligible for the 10-year carryback. Under the consolidated return regulations in force during the years in dispute, a corporation that is a member of an affiliated group filing a consolidated federal income tax return can never have its own "net operating loss." The concept simply does not exist in the consolidated return context. Only the affiliated group, as a single entity, can have a "net operating loss." According to Dominion, the attempt of the Fourth Circuit to apply section 172(j)(1) at the separate corporate member level is an unreasonable interpretation of that provision.

Dominion further notes that its single entity approach is consistent with prior pronouncements by the IRS. Although technical advice memoranda and private letter rulings are not official precedent, courts have found such pronouncements useful in determining the scope of a particular regulation. *Xerox Corp. v. United States,* 656 F.2d 659 (Ct. Cl. 1981). In a 1987 private letter ruling (Priv. Ltr. Rul. 8816002, Dec. 31, 1987), which considered net operating losses in a consolidated return context, the IRS made clear that the separate loss of any member of a consolidated group is not a net operating loss. The IRS stated that the underlying concept behind the consolidated return regulations, which deal with the consolidated net operating loss deduction, is the application of the single entity approach.

Further, Dominion indicates that the Private Letter Ruling is not an isolated statement of the IRS's position. In a Notice of Proposed Rulemaking related to the use of certain losses, deductions, and credits under the consolidated return regulations (published in the Federal Register on Feb. 4, 1991, 56 Fed. Reg. 4,228), the IRS asserted unequivocally that corporations 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. Clearly, the IRS has endorsed the single entity approach with respect to the use of losses generated by an affiliated group.

Dominion asserts that Congress intended a liberal interpretation of the "product liability loss" rules. Following enactment of the Revenue Act of 1978 (P.L. 95-600), which established the carryback rules for product liability losses, the Staff of the Joint Committee on Taxation issued its General Explanation of the Revenue Act of 1978. The Joint Committee stated its intent that an extended carryback period should be available to taxpayers who suffer product liability losses because such losses may tend to be large and sporadic. It was believed that the extended carryback period made it more likely that businesses that suffer product liability losses would obtain a current economic benefit from a tax refund rather than have to speculate on possible future tax reductions due to carry forwards of operating losses. Clearly Congress intended taxpayers with product liability losses to benefit by accelerating the time when they could recover taxes attributable to product liability losses.

Significantly, under the government's restrictive interpretation, if a member of an affiliated group incurred expenses attributable to product liability during a consolidated return year but did not have its own negative separate taxable income in the same year, the group would not be able to carry back any deductions attributable to product liability of that member even though the affiliated group, as a whole, had both a consolidated net operating loss and deductions attributable to product liability. The government's interpretation ascribes overwhelming tax significance to the organizational structure of the taxpayer's business. Such an interpretation is completely at odds with the underpinnings of the consolidated tax return system promulgated by Congress. If it makes a tax difference to a family of commonly owned corporations whether a particular business is put into one corporation rather than another, the benefit to be gained by allowing that family of companies to file a single return is lost.

Dominion believes that a fair reading of section 172(b)(1)(I) and the related Treasury regulations indicates that all net operating losses, including "product liability losses," are to be calculated on a consolidated basis. Section 172(b)(1)(I) of the code applies to "a taxpayer." In the consolidated return context, the affiliated group is the taxpayer. Treas. Reg. § 1.1502-75(h) provides that an affiliated group of corporations files a single federal income tax return each year. Treas. Reg. § 1.1502-76(a)(1) states that all members of the affiliated group must have the same taxable year. And finally, Treas. Reg. § 1.1502-2 provides that the affiliated group's tax liability for any year is computed on a consolidated basis after the income of profitable members of the group has been offset by losses of the unprofitable members. The thrust of the code and related regulations is clear. Losses for an affiliated group are calculated on the basis of a single entity theory, not to each member of the group individually.

Despite the government's claims to the contrary, Dominion posits that the failure of the consolidated return regulations to provide specifically for the calculation of product liability deductions on a consolidated basis has no legal significance. The Fourth Circuit determined that Dominion's single entity theory had to be rejected because the consolidated return regulations, although providing for a single consolidated net operating loss, did not explicitly incorporate a reference to "consolidated product liability expenses." This, Dominion argues, is faulty reasoning that loses sight of what the consolidation regulations seek to accomplish.

In both the case of taxable income and net operating loss, the consolidation of certain items serves the very necessary purpose of offsetting or combining particular types of income or deductions of one group member with those of other members so that the net numbers can be incorporated into a consolidated income or loss on a basis deemed appropriate by the IRS. Whether product liability expenses are taken into consideration on a separate company basis or on a consolidated basis has no bearing whatsoever on the computation of taxable income or net operating loss, which is the sole focus of the consolidation regulations. Accordingly, Dominion contends that the Fourth Circuit was simply in error when it concluded that the consolidation of product liability expenses is not permitted because such consolidation is not expressly approved in the regulations. To the contrary, it was not necessary to include a provision for the calculation of "consolidated product liability expenses" when calculating an affiliated group's taxable income or net operating loss.

Finally, Dominion attacks the Fourth Circuit's reliance on Treasury Regulation 1.1502-79(a) as misguided. The Fourth Circuit reasoned that the Treasury regulation, which is captioned "carryover and carryback of consolidated net operating losses to separate return years" evidences congressional intent to calculate the "product liability loss" on a separate return basis rather than a consolidated basis. Dominion maintains that the Treasury regulation supports no such conclusion. Dominion points out that the Treasury regulation only applies where a consolidated net operating loss is carried back to a separate return of a corporation in a year in which that member was not a part of the consolidated group. Dominion notes that no separate return years are at issue in this case, and all operating loss carrybacks are being applied on a consolidated basis only. Therefore, Treasury Regulation 1.1502-79 has no application to this case.

The government counters that none of the individual corporations involved in this case incurred a "product liability loss" within the meaning of section 172 of the Internal Revenue Code. Section 172(c) generally defines a "net operating loss" as the excess of the deductions allowed over the gross income. Thus, a taxpayer does not have a net operating loss for a particular year unless its deductions exceed its ordinary income and its capital gains. The term "product liability loss" is defined to mean the lesser of the net operating loss for such year or the deductible expenses incurred by that entity that are attributable to the satisfaction or defense of product liability claims. A "taxpayer" thus has a "product liability loss" for a particular taxable year only if (i) the taxpayer has a net operating loss for the year and (ii) that net operating loss is attributable in whole or in part to deductions for product liability or product liability expenses.

In the present case, it is undisputed that each of the affiliated corporations that incurred product liability expenses in the tax years at issue would have reported positive net income—rather than a net operating loss—for those years if it had filed a separate return that reflected its individual operations. Under the plain text of section 172, none of these entities would have been entitled to a "product liability loss" deduction on a separate return, for none of them incurred a "loss."

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Instead, each of these entities obtained a full and effective use of its product liability expenses by deducting them in the year the expenses were incurred. Because those expenses were fully utilized as deductions in the year they were incurred, there were no unconsumed product liability expenses—or "product liability losses"—for those affiliates to carry back to set off against their taxable income in prior years. Therefore, it follows that none of those profitable affiliates would be able to claim a "product liability loss" under section 172.

The government also argues that the consolidated return regulations require the accounting for product liability expenses to occur first at the separate entity level. The consolidated return regulations promulgated under section 1502 arrive at a single figure of "consolidated taxable income" for the affiliated group by starting first at the individual entity level. 26 C.F.R. 1.1502-11(a). Section 12 of the regulations provides that, subject only to the specific modifications set forth in the regulations, "the separate taxable income of a member is computed in accordance with the provisions of the code covering the determination of taxable income of separate corporations." 26 C.F.R. 1.502-12. Product liability expenses are not included among the specific items for which modified treatment is provided in computing the "separate taxable income of a member." As a result, the product liability expenses of each affiliate must be netted against the income of that affiliate in determining the "separate taxable income" of that member of the group.

When, as in this case, the "separate taxable income" of the affiliates with product liability expenses is positive, then all of the product liability expenses have necessarily been consumed and utilized in reducing taxable income at that level. As a consequence, there are no unconsumed or unutilized "product liability losses" to carry to the consolidated level of the group. It is only when the separate taxable income of the individual member is negative that there will be an unused product liability loss to carry to the consolidated level.

The government believes that Dominion is incorrect in asserting that, as applied to a consolidated group of corporations, the "taxpayer" to whom the section 172 scheme applies is the consolidated group. Section 7701(a)(14) of the code generally specifies that the term *taxpayer* as used in the code means any person subject to any internal revenue tax. Even though separate affiliated taxpayers may join in filing a consolidated return, the resulting tax liability is not a liability of the "group." Instead, it attaches directly to each of the individual taxpayers that are members of the group, who are severally liable for the tax incurred. 26 C.F.R. 1.1502-6(a). As the Supreme Court has emphasized, while a consolidated group files a return that aggregates information developed from the various separate affiliates, it is not to be ignored that each of the corporations joining in a consolidated return is nonetheless a taxpayer. *Woolford Realty Co. v. Rose,* 286 U.S. 319 (1932).

Also, when Congress has decided to apply a particular provision of the code that refers to a "taxpayer" directly to an affiliated group of corporations, it has done so expressly. In at least three separate code sections, Congress references the consolidated group filing the return as the taxpayer. Congress has not enacted similar language in section 172 to provide for the carryback of "product liability losses" on a consolidated, rather than an individual "taxpayer," basis. Thus, the "taxpayer" referred to in section 172(j) is the corporation that incurred the product liability expenses and is unable to fully utilize them due to an insufficient amount of current income. Congress was concerned with smoothing the accounting of the income and expenses of the individual entity that is liable for the product liability expenses. The statute was not designed to provide tax benefits for affiliated entities that had no liability for these expenses.

The government also refutes Dominion's assertion that its approach in this case is in perfect "harmony" with positions taken by the Internal Revenue Service in prior agency rulings. Dominion fails to acknowledge that, in Technical Advice Memorandum 97-15-002 (Apr. 11, 1997), the Service addressed the very issue presented in this case and specifically rejected the approach advocated by Dominion.

Moreover, the authorities that Dominion cites are simply unrelated to the issues presented in this case. The Notice of Proposed Rulemaking cited by Dominion merely makes the unremarkable observation that, under the governing regulations, corporations that file a consolidated return are to combine their separate income and losses to arrive at a single consolidated income (or loss) for the group. 56 Fed. Reg. 4229 (1991). These same regulations, however, require each individual corporation with product liability expenses first to claim and utilize those deductions in computing its "separate taxable income." The "separate taxable income" calculated independently for each of the several affiliates is thereafter combined to derive a consolidated income figure. When, as in this case, the product liability expenses are fully utilized as deductions at the separate entity level, there are no remaining deductions—or "product liability losses"—to be passed on and employed at the consolidated level.

Finally, the government postulates that the single entity rule advocated by Dominion would permit significant tax avoidance abuses. Under Dominion's approach, a corporation that is currently unprofitable but had substantial income in prior years could (i) acquire a profitable corporation with product liability expense deductions in the year of acquisition, (ii) file a consolidated return, and (iii) thereby create an otherwise nonexistent "product liability loss" for the new affiliated group that would allow the acquiring corporation to claim refunds of the tax it paid in prior years. Neither the terms nor the purpose of the consolidated return regulations authorize this sort of "juggling" and trading of corporate tax attributes. According to the government, the result advocated by Dominion thus contravenes the text and intent of the product liability loss provisions in Section 172(j). It also contravenes the clear admonition of Congress and the Supreme Court that consolidated returns should not be employed as an artifice to evade taxes.

Significance

In 2000, a record number of business bankruptcies were filed. A new record of business failures is expected in the year 2001. An increasingly larger percentage of these business failures and losses is attributable to product liability claims, expenses and losses. The range of product liability claims is almost limitless. Some recent examples include defective tires, breast implants, asbestos-related products, defective IUDs, etc.

In light of these product liability claims, which are extraordinary in amount and timing, Congress has extended the carryback of a "product liability loss" to 10 years as compared to the normal three-year carryback for net operating losses of a business. The problem, however, is that the Internal Revenue Code and companion regulations are not clear on how to calculate the "product liability loss" for an affiliated group that files a consolidated return.

The taxpayer supports the single entity theory that calculates the "product liability loss" at the consolidated level by combining the income and expenses for all the affiliates in one calculation. In other words, does the group have a net "product liability loss"? On the other hand, the government claims the law anticipates a two-step process when calculating "product liability loss." First, calculate the "product liability loss" at each separate affiliate level, and second, if an affiliate has an amount of "product liability loss," add those affiliate losses together to arrive at the group's "product liability loss." The different approaches net vastly different results. In this case, the difference is $1,618,306. In light of the escalating trend of business failures in this country and proliferating product liability litigation, the financial and tax ramifications of this decision are huge.

Attorneys for the Parties

For United Dominion Industries, Inc. (Eric R. Fox (202) 393-7600)

For the United States (Barbara D. Underwood (202) 514-2217)

Amicus Briefs

In Support of United Dominion Industries, Inc.

National Association of Manufacturers et al. (Richard E. Zuckerman (313) 465-7480)