No. 00-157

IN THE
Supreme Court of the United States

UNITED DOMINION INDUSTRIES, INC.,

Petitioner,

v.

UNITED STATES OF AMERICA,

Respondent.

ON WRIT OF CERTIORARI TO THE
UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

BRIEF FOR PETITIONER

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QUESTION PRESENTED

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, to be deducted from income in the earlier year. The issue in this case is whether, in the case of an affiliated group of corporations filing a consolidated federal income tax return, a product liability loss is determined on a consolidated basis, as the petitioner contends, or on some type of a separate company-by-company basis, as the respondent contends.

LIST OF PARTIES AND CORPORATE DISCLOSURE STATEMENT

All parties to the proceeding in the court whose judgment is under review are named in the caption of the case in this Court. Petitioner's corporate disclosure statement was set forth at page *ii* of its Petition for a Writ of Certiorari, and there are no amendments to that statement.

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The opinion of the Court of Appeals (Pet. App. A[1]), *United Dominion Indus., Inc. v. United States*, is reported at 208 F.3d 452 (4th Cir. 2000). The District Court opinion (Pet. App. B), *United Dominion Indus., Inc. v. United States*, is unofficially reported at 98-2 U.S.T.C. (CCH) ¶ 50,527 (June 9, 1998).

STATEMENT OF JURISDICTION

The judgment of the Court of Appeals was entered on March 24, 2000. The Court of Appeals entered an order denying a timely petition for rehearing and suggestion for rehearing en banc on May 19, 2000. (Pet. App. C.) Petitioner filed its Petition for a Writ of Certiorari on July 28, 2000.

The jurisdiction of this Court is invoked under 28 U.S.C. § 1254(1).

STATUTORY AND REGULATORY PROVISIONS INVOLVED

This case involves sections 172(b)(1)(I), 172(c), and 172(j)(1) of the Internal Revenue Code of 1954, ("the Code"),[2] 26 U.S.C § 1 *et seq.*, and sections 1, 11, 12, 21, 75, and 79 of the consolidated return regulations,

1. All references to "Pet. App." are to the Appendix submitted by petitioner with its Petition for a Writ of Certiorari.

2. All references to the Code are references to the Internal Revenue Code of 1954, 26 U.S.C. § 1 *et seq.*, as in effect during the years 1983 through 1986, unless otherwise stated.

Treas. Reg. § 1.1502.[3] Because these regulations are lengthy, they are set forth separately in Pet. App. D.

For the years in question, section 172(b)(1)(I) provides the following:

> (I) PRODUCT LIABILITY LOSSES. — In the case of a taxpayer which has a product liability loss (as defined in subsection (j)) for a taxable year beginning after September 30, 1979 (referred to in this subparagraph as the "loss year"), the product liability loss shall be a net operating loss carryback to each of the 10 taxable years preceding the loss year.

Section 172(j)(1) defines the term "product liability loss" as follows:

> (1) PRODUCT LIABILITY LOSS. — The term "product liability loss" means, for any taxable year, the lesser of —
>
> (A) the net operating loss for such year reduced by any portion thereof which is attributable to a foreign expropriation loss, or
>
> (B) the sum of the amounts allowable as deductions under sections 162 and 165 which are attributable to —

3. All references to "Treas. Reg. §" are references to these regulations, 26 C.F.R. § 1502-1 *et seq.*, as in effect during the years 1983 through 1986, unless otherwise stated.

> (i) product liability, or
>
> (ii) expenses incurred in the investigation or settlement of, or opposition to, claims against the taxpayer on account of product liability.

Section 172(c) defines the term "net operating loss," in pertinent part, as follows:

> (c) NET OPERATING LOSS DEFINED. — For purposes of this section, the term "net operating loss" means the excess of the deductions allowed by this chapter over the gross income.

STATEMENT OF THE CASE

This case involves the interplay between the rules governing net operating losses under section 172 of the Internal Revenue Code of 1954 and the consolidated return regulations issued by the Internal Revenue Service ("IRS") under the authority of section 1502 of the Code.

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" (*see* section 172(c) of the Code) that it is entitled to carry back 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 ordinarily is permitted to carry its net operating loss back to the third year[4] preceding the year in which it incurred the loss, and then, if the loss is not fully absorbed in that year, to the second preceding year, the first preceding year (sec. 172(b)(1)(A) of the Code), and then forward for as many as 15[5] years (sec. 172(b)(1)(B) of the Code).

In the case of a "product liability loss," the statute extends the carryback period from the three years preceding the loss year to the 10 years preceding the loss year. (Sec. 172(b)(1)(I) and sec. 172(j)(1) of the Code.) 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. *See* Staff of the Joint Comm. On Tax'n, 95th Cong., General Explanation of the Revenue Act of 1978, 232 (Comm. Print 1979). 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. This case involves the application of this extended carryback provision to an affiliated group of corporations filing a consolidated federal income tax return.

In 1990, Congress reorganized section 172 and made the term "product liability loss" a subcategory of the term "specified liability loss" in section 172(b)(1)(C) and (f) of the Internal Revenue Code of 1986. *See* Omnibus Budget Reconciliation Act of 1990, Pub. L. No. 101-508, § 11811, 104 Stat. 1388, 1388-530. This reorganization did not change the meaning of the term "product liability loss," but simply brought under one subsection all types of expenses then entitled to the 10-year carryback. Although this change in the law has no specific application in this case, reference to it is made because of its applicability in *Intermet Corp. v. Commissioner*, 209 F.3d 701 (6th Cir. 2000) (Pet. App. E), the decision that is in direct conflict with the decision of the Court of Appeals in this case.

4. The carryback period was reduced to two years in 1990, after the years in issue in this case.

5. The carryforward period was extended to 20 years in 1990 when the carryback period was reduced from three years to two years.

Under section 1501 of the Code, a common parent corporation and its subsidiary corporations, referred to as an "affiliated group," may elect to file a single consolidated federal income tax return. The sole issue in this case is whether an affiliated group of corporations properly computes its product liability loss as if it were a single entity, as United Dominion contends, or whether each member of the group computes its product liability losses on some form of separate company basis, as the United States contends.

During the years 1973 through 1986, United Dominion operated under the name of AMCA International Corporation ("AMCA"). (Pet. App. A at 2a, n.1.) During these years, AMCA filed consolidated income tax returns with its affiliated subsidiaries pursuant to section 1501 of the Code, and in accordance with the regulations issued by the IRS under the authority granted to it under section 1502. (Pet. App. A at 3a.) The Code is largely silent with respect to the rules affecting affiliated groups of corporations, and these rules are primarily 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 federal income tax on the basis of its consolidated taxable income or calculates its net operating loss on a consolidated basis. Treas. Regs. § 1.1502-2 and § 1.1502-21. In short, the affiliated group essentially computes its taxable income or its net operating loss as if it were a single company, and as if the members of the group were divisions of that company.

For the years 1983, 1984, 1985 and 1986, AMCA reported consolidated net operating losses of between $85 million and $140 million (Pet. App. B at 26a.) These amounts far exceeded the annual product liability expenses of all of the members of the AMCA consolidated group during these years, which ranged from approximately $3.5 million to $6.5 million. This case involves five members of the AMCA affiliated group that contributed the following combined amounts of product liability expenses to the group's total in each year in issue, all of which the Court of Appeal's decision excluded from AMCA's product liability loss:

YEAR	AMOUNT DISALLOWED
1983	$ 205,919.00
1984	$ 1,609,340.00
1985	$ 1,333,788.00
1986	$ 250,550.00

(Pet. App. B at 25a.[6])

6. The $1,618,306 figure used by the Court of Appeals (Pet. App. A at 3a) actually represents the total income tax refund in issue, not the amount of the product liability expenses which are in dispute, the amount of which was correctly stated in the opinion of the District Court.

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 these amounts 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 these years in which the AMCA group had a consolidated net operating loss, each one of the five companies in question,[7] when considered on a separate company basis, generated positive separate taxable income, as that term is defined under Treas. Reg. § 1.1502-12.*

The pivotal facts of this case (Pet. App. E at 61a-62a), thus are:

> 1. An affiliated group of corporations filing a consolidated federal income tax return has a large consolidated net operating loss resulting from the fact that the total deductible expenses of all members of the group exceed the total gross income of all members of the group;
>
> 2. Various members of the affiliated group incur expenses attributable to product liability that, in total, are less than the group's consolidated net operating loss for the year; and
>
> 3. Some members of the group incurring expenses attributable to product liability have positive separate taxable income for the year in which the product liability expenses are incurred.

7. There are two minor exceptions of no consequence to this case. (Pet. App. A at 4a.)

Under the plain 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. The identical mechanism applies to specified liability losses.

In 1986 and 1987, petitioner filed with the IRS claims for refund with respect to its 1983 through 1986 consolidated tax returns. (Pet. App. B at 27a-28a.) In its claims, petitioner asserted that it was entitled, under section 172(b)(1)(I) of the Code, to carry back up to 10 years the amount of its product liability expenses incurred in 1983 through 1986. The amount of petitioner's claim at issue in this case is $1,618,306 of income tax, plus statutory interest.

The IRS agent assigned to review petitioner's claims for refund allowed the claims with respect to petitioner's consolidated return years. The agent allowed petitioner 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 agreed with petitioner that, for consolidated return years, the term "product liability loss" is determined on a consolidated, group-wide basis. (Pet. App. B at 28a.)

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 petitioner's claims. (Pet. App. B at 28a.) 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 that petitioner had no "product liability loss" to the extent the individual group members that incurred petitioner's product liability expenses did not have negative separate taxable income (even though the negative taxable income of a single group member is not equivalent either mechanically or in substance to a "net operating loss," as defined in section 172(c) of the Code).

As a result of the Joint Committee's denial of its claims for refund, petitioner filed a suit for refund of federal income taxes in the United States 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 and filed June 19, 1998 (Pet. App. B), the District Court granted petitioner's motion for summary judgment and denied respondent's motion. The District Court correctly concluded that, with respect to consolidated return years, the amount of any 10-year carryback should be determined on a consolidated basis. (Pet. App. B at 38a-39a.) On September 14, 1998, the United States filed a notice of appeal.

On March 24, 2000, the Court of Appeals rejected the consolidated return approach of the District Court and reversed its judgment. Instead, the Court of Appeals determined that petitioner's entitlement to the ten-year carryback for consolidated return years should be determined on a separate, company-by-company basis. The Court of

Appeals based its erroneous conclusion largely upon Treas. Reg. § 1.1502-79(a) (Pet. App. at 21a), a provision having no function other than that of apportioning a consolidated net operating loss to separate return years of group members.[8] No separate return years are involved in this case.

On April 20, 2000, the Sixth Circuit Court of Appeals issued its opinion in the *Intermet*[9] case. (Pet. App. E.) 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, as the taxpayer in *Intermet* had argued. The Sixth Circuit rejected the argument of the United States that a specified liability loss had to be determined on a separate company basis, and specifically noted that it was "unpersuaded by the Fourth Circuit's approach." (Pet. App. E at 74a.)

SUMMARY OF THE ARGUMENT

During the years in issue, the AMCA affiliated group filed consolidated federal income tax returns reflecting net operating losses for the entire group. Because there is no such thing as a separate net operating loss for any separate member of an affiliated group, the group's net operating losses were calculated only on a group-wide, consolidated basis, in accordance with the regulations.

8. A separate return year of a member of a particular affiliated group is a year when the member filed a separate federal income tax return either for a year before or after it joined that particular group, or a year when such member joined in the filing of a consolidated return with another affiliated group.

9. *Intermet* involved specified liability expenses rather than product liability expenses, but that distinction is without legal significance because product liability expenses are identical to specified liability expenses with respect to the issue in this case.

Section 172 of the Code provides that a taxpayer with a net operating loss may carry that loss back 10 years to the extent that the loss does not exceed the taxpayer's product liability deductions for that year. The portion of the taxpayer's net operating loss that may be carried back 10 years is called a "product liability loss." Because there is only one taxpayer with a net operating loss in this case — the AMCA affiliated group — this group is the only "taxpayer" which has (or could have) relevant product liability deductions.

This result flows from a number of sources. First, it follows logically and directly from both the plain language, as well as the technical operation, of the consolidated return regulations.

Second, it flows directly from the fundamental goal of the consolidated return regime to tax a family of affiliated corporations as if those corporations were one company, particularly with respect to the computation of net operating losses. The IRS has previously acknowledged as much in both a Private Letter Ruling (Priv. Ltr. Rul. 8816002) and in a notice the IRS released to the public in 1991 as it introduced proposed amendments to the consolidated return regulations.

Third, Congress plainly intended that the 10-year carryback rule of section 172 liberally benefit taxpayers by enlarging the number of years (from the normal three years to a total of 10 years) for which taxpayers could seek tax refunds as a result of incurring product liability losses.

The respondent's narrow reading of section 172(b)(1)(I) and (j)(1), as applied to an affiliated group of corporations, obstructs Congressional intent, and wrongly encourages corporate taxpayers to elevate tax planning over business planning when selecting the optimal organizational structures for their corporate families. If the respondent's position is adopted by the Court, corporate taxpayers will face little choice but to rearrange their corporate structures so that assets or operations that may potentially result in product liability expenses are placed within "unprofitable" corporate group members, because (according to the respondent) only product liability expenses of unprofitable members count toward the product liability loss of an affiliated group. Nothing in the Code or Regulations can be construed as supporting this manifestly undesirable result.

Fourth, as the Sixth Circuit correctly noted in *Intermet*, the reference in section 172(b)(1)(I) to a "taxpayer" is logically interpreted in the consolidated return context to mean the affiliated group itself, rather than individual members of the group. This conclusion follows irrefutably from the numerous group-oriented requirements set forth in the consolidated return regulations, including, among others, the rules requiring that (1) an affiliated group file a single tax return each taxable year (rather than the individual members filing separate returns); (2) the group's members each operate on an identical taxable year; and (3) the group, as a whole, computes a single annual tax liability or loss that takes into account a blended total of profitable members' incomes and unprofitable members' losses. The respondent's position that "taxpayer" means something other than the affiliated group in the consolidated return regulations is not supportable.

Fifth, the Court of Appeals below erroneously attached legal significance to the absence of an explicit reference to "consolidated product liability expenses" in the consolidated return regulations. Because the amount of an affiliated group's consolidated income or loss is the same whether one views product liability deductions on a group basis (as does petitioner) or on an individual member basis (as does respondent), there would never be a need under any circumstances for the consolidated regulations to reference a consolidated product liability expense item. Because the parties have no dispute over the amount of the AMCA group's consolidated net operating loss in any of the years in question, the only issue at stake concerns what portion of this agreed-upon loss can be carried back 10 years instead of the normal three years. The answer depends solely on the manner in which the group's product liability expenses are compared with AMCA's consolidated net operating loss, and Petitioner respectfully asserts that the only rational manner in which such expenses can be compared to an affiliated group's consolidated net operating loss is on a similar, consolidated basis.

Sixth, the Court of Appeals erroneously relied upon Treas. Reg. § 1.1502-79(a), a regulation which applies only to "separate return years," even though no such years are at issue in this case. By applying this inapplicable regulation, the Court of Appeals wrote a new judicial regulation which is at odds with the consolidated regulations' purpose and structure, the effect of which (if upheld) would be to distort the operation of section 172(b)(1)(I) and (j)(1), and to add unnecessary complications to an already complex area of tax law.

For the foregoing reasons, the AMCA group must be treated as a single taxpayer, both for the purpose of calculating its net operating loss, and also for the purpose of determining the amount of its 10-year product liability loss carrybacks. Because the AMCA group's consolidated net operating loss for each of the years 1983 through 1986 was larger than its total deductions attributable to product liability, the affiliated group's product liability loss for each of those years was equal to the sum of the deductions attributable to product liability incurred by all the members of its group. The affiliated group's product liability loss then became "a net operating loss carryback to each of the 10 taxable years preceding the loss year" under section 172.

A straightforward, logical application of the Code and the consolidated return regulations demonstrates that the decision of the Court of Appeals below should be vacated and the District Court's entry of summary judgment in favor of the Petitioner should be reinstated. Affirmance of the Court of Appeals' decision below not only would be incorrect as a technical matter, but it would encourage taxpayers to engage in inefficient, tax-motivated behavior that runs counter to sound tax policy.

ARGUMENT

A. The Mechanics Of The Consolidated Return Regulations Require That The Product Liability Losses Of An Affiliated Group Be Determined On A Single Entity Basis.

Section 172(j)(1) of the Code, the provision principally at issue in this case, 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 (as well as under the current regulations), 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. In that context, only the affiliated group, as a single entity, can have a "net operating loss," which is defined as a "consolidated net operating loss" in Treas. Reg. § 1.1502-21(f). The attempt of the Fourth Circuit and the respondent to apply section 172(j)(1) at the separate corporate member level — despite the fact that no individual member of an affiliated group can ever have a net operating loss — is an unreasonable interpretation of that provision that should be rejected by this Court.

In order to understand the fundamental unsoundness of the Fourth Circuit's and the respondent's positions, one must carefully track through the related consolidated return regulations. Under Treas. Reg. § 1.1502-2, the tax liability of an affiliated group for a consolidated return year is determined by adding together a number of tax components, the first of which is

> The tax imposed by section 11 [of the Code] on the consolidated taxable income for such year (see § 1.1502-11 for the computation of consolidated taxable income).

Consolidated taxable income for a consolidated return year is determined under Treas. Reg. § 1.1502-11 by taking into account eight separate items. The first of these is

> [t]he separate taxable income of each member of the group (see § 1.1502-12 for the computation of separate taxable income).

The term "separate taxable income" is defined in Treas. Reg. § 1.1502-12 to include cases in which deductions exceed gross income. For this reason, this Brief uses the term "positive separate taxable income" to describe the separate taxable income of a member of an affiliated group with prescribed items of income in excess of prescribed deductions, and the term "negative separate taxable income" to describe the separate taxable income of a member of an affiliated group with prescribed deductions in excess of prescribed items of income. The unmodified term "separate taxable income" is used, as it is used in the consolidated return regulations, to describe either or both of these situations.

Under Treas. Reg. § 1.1502-11, items such as net operating loss carryovers, capital gains and losses, section 1231 losses and charitable deductions are taken into consideration on a consolidated basis only, separate and apart from the separate taxable income of each member of the group.

Under Treas. Reg. § 1.1502-12, each member of an affiliated group computes its own separate taxable income in much the same manner as a separate corporation would compute its taxable income, but with a number of important modifications. Thus, a member of the group, in computing its separate taxable income, does not take into account the net operating loss carryovers, capital gains and losses, § 1231 gains and losses, and charitable deductions that Treas. Reg. § 1.1502-11 requires to be computed on a consolidated basis only.

A consolidated net operating loss of an affiliated group is computed under Treas. Reg. § 1.1502-21(f) in a manner analogous to the computation of consolidated taxable income. *Treas. Reg. § 1.1502-21(f) is of the greatest significance in this case because it provides the exclusive definition in the regulations (there is no definition in the Code) of a net operating loss for an affiliated group of corporations.* Treas. Reg. § 1.1502-21(f) provides that "the consolidated net operating loss shall be determined by taking into account" six separately enumerated items. The first of these items is

> the separate taxable income (as determined under § 1.1502-12) of each member of the group. . . .

After taking into consideration the separate taxable income of each member of the affiliated group, the remaining items to be taken into consideration under Treas. Reg. § 1.1502-21(f), including capital gains and losses, section 1231 losses and charitable deductions, are all calculated on a consolidated basis only, wholly apart from "separate taxable income."

The fact that capital gains and losses, section 1231 losses and charitable contributions are excluded from the computation of "separate taxable income" necessarily means that "separate taxable income" can never reflect what an affiliated group member's taxable income or net operating loss would be if it filed a tax return as a separate company that was not part of an affiliated group. *Thus, when the calculation of a group member's "separate taxable income" under Treas. Reg. § 1.1502-12 produces a negative amount (prescribed deductions exceed prescribed income), that negative amount cannot, and does not, meet the definition of a net operating loss.* This is clear from the definition of "net operating loss" in section 172(c) of the Code, which provides that

> the term "net operating loss" means the excess of the deductions allowed by this chapter over the gross income.

Inasmuch as capital losses, section 1231 losses and charitable deductions fall within the definition of "deductions allowed by this chapter," and capital gains are included in gross income, an amount computed without these items taken into account cannot be the equivalent of a net operating loss. In other words, a corporation that is a member of an affiliated group is incapable of having its own net operating loss under the consolidated return regulations, as recognized by the Court of Appeals. (Pet. App. A at 19a-20a.)

Section 172(b)(1)(I) of the Code provides that a taxpayer with a product liability loss may treat such loss as a net operating loss carryback to each of the 10 taxable years preceding the loss year. In order to determine the taxpayer's product liability loss, section 172(j)(1) requires that two items be compared. The first is a "net operating loss," and the second is "deductions . . . attributable to product liability." For an affiliated group, there is only a *consolidated* net operating loss; no individual member of the group can have its own net operating loss. It must follow that, if an affiliated group has only a consolidated net operating loss, and no member of the group can have a separate net operating loss, the thing to be compared with a net operating loss, namely, deductions attributable to product liability, can only be determined on a group-wide basis if the required comparison is to be made in a consistent and logical manner.

If, as the respondent maintains, deductions attributable to product liability are to be computed on a separate company basis, there would be nothing to compare them with because no separate company in an affiliated group can have its own net operating loss.

B. Consistency Requires That All Provisions Of Section 172 Be Applied On A Single Entity Basis.

Petitioner's position is perfectly in harmony with the position of the IRS, as discussed in a 1987 private letter ruling (Priv. Ltr. Rul. 8816002, December 31, 1987),[10] which considered net operating losses in the consolidated return context. The IRS made clear that the separate loss of any member of a consolidated group was not a net operating loss:

> The underlying concept behind the sections of the consolidated return regulations which deal with the CNOL [consolidated net operating loss] deduction is the application of the *single entity approach*. For example, net operating losses of members of an affiliated group are used to offset income generated by other members of the group in determining the consolidated taxable income of the group for the taxable year under sections 1.1502-11 and 12 of the regulations. Consolidated taxable income is determined, in part, by taking into account the separate taxable income (loss) of each member of the group. The computation

10. Although technical advice memoranda and private letter rulings are not official precedent, courts have found such materials useful in determining the scope of a particular regulation, as well as the manner in which the IRS has applied the regulation in other cases. *Xerox Corp. v. United States*, 656 F.2d 659, 660, n.3 (Ct. Cl. 1981).

of the separate taxable income (loss) of each member is made without taking into account any net operating loss carryovers or carrybacks. Section 1.1502-12(h). As each member's separate net income (loss) is combined, current losses of members offset current income of other members. *Thus net operating losses are aggregated as a "group" item. An individual member may not independently carryover or carryback a net operating loss to itself to a year in which it has income. . . . Because the single entity approach is the underlying basis for the application of the net operating loss deduction in the context of 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.* [Emphasis added.]

Private Letter Ruling 8816002 is not an isolated statement of the IRS position with respect to entity characterization. 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 February 4, 1991, 56 Fed. Reg. 4,228), the IRS asserted unequivocally (in a discussion of an approach to separate return limitation year losses known as fragmentation) that:

> Fragmentation is in many ways inconsistent with the single entity approach to the use of losses under the consolidated return regulations. The single entity approach reduces the tax distinctions between separate affiliated corporations and separate divisions within a single corporation, and reflects two principles. *First, 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.* Second, the tax laws should be neutral with respect to changes in ownership so that losses arising among members of a group are able to be used among the members following an ownership change, subject only to the restrictions imposed on a single entity in similar circumstances.

1991-1 C.B. 757, 759 (emphasis added). Clearly, the IRS has endorsed the single entity approach with respect to the use of losses generated by an affiliated group.

C. Congressional Intent Mandates A Liberal Interpretation Of The Product Liability Rules.

Following enactment of the Revenue Act of 1978 (P.L. 95-600), which introduced into the Code 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, 95th Cong. (Comm. Print 1979), in which it stated:

> The Congress believed 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 would reduce the likelihood that a large product liability

> claim would give rise to a net operating loss in excess of taxable income during the carryback period. Furthermore, the extended carryback period makes it more likely that businesses which suffer product liability losses will obtain a current economic benefit from a tax refund rather than have to speculate on possible future tax reductions due to carryovers of operating losses. (at p. 232.)

Without question, Congress intended the change in section 172, as it related to taxpayers with product liability losses, to benefit taxpayers by accelerating the time when they could recover taxes attributable to product liability losses. The respondent's restrictive reading of section 172 in the consolidated return context completely thwarts Congressional intent.

Significantly, under the respondent's theory in this case, if a member of an affiliated group incurred expenses attributable to product liability during a consolidated return year but did not have 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.

This theory ascribes overwhelming tax significance to the organizational structure of the taxpayer's business, a result that is completely at odds with the underpinnings of the consolidated tax return regime. 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 tax return is lost.

To illustrate, consider two different affiliated groups, *A* and *B*. Both group *A* and group *B* have a number of separate businesses, one of which is occasionally subject to very large product liability losses. For non-tax, business reasons, it is advantageous for *A* to operate this business as part of a corporation that also happens to operate a separate, highly profitable business. Group *B*, by contrast, has devoted more resources than *A* to tax avoidance planning and, in order to be well situated should the respondent's theory in this case become law, has chosen to operate the product liability business in another corporation that, when looked at on a separate company basis, almost always generates a loss. Thus, in a year in which the *A* and *B* groups generate identical consolidated net operating losses, even if their two product liability businesses result in identical product liability deductions for the year, group *B* will be able to take advantage of the special ten year carryback, whereas group *A* will not. Thus, the respondent's theory of the law results in a world where affiliated groups that enter into tax-motivated organizational structures will prevail over their more straightforward, business-motivated competitors. As a policy matter, given a choice, a sound tax system should not elevate tax planning over common sense, and the respondent's theory of the case, which would do just that, therefore should be rejected.

D. The Opinion Of The Sixth Circuit In The *Intermet* Case Correctly Analyzes The Issue In This Case.

In the *Intermet* case, the Sixth Circuit essentially adopted the petitioner's position, as presented in Sections A and B of petitioner's Argument. (Pet. App. E at 69a-72a.) The Sixth Circuit, in addition, referred to Treas. Reg. § 1.1502-80, which states, "The Code, or other law, shall be applicable to the group to the extent the regulations do not exclude its application," and concluded that there was nothing in this regulation that was inconsistent with its opinion because section 172(b)(1)(I) applied to a "taxpayer" and, in the world of consolidated tax returns, the taxpayer was properly regarded as the affiliated group. (Pet. App. E at 74a.)

In its Brief in response to petitioner's Petition for a Writ of Certiorari in this case, respondent first asserted (p. 14) that the Sixth Circuit in *Intermet* relied on Treas. Reg. § 1.1502-80 to resolve the issue in that case. Respondent went on to state, as a second proposition, that the Sixth Circuit "erred in its construction of this regulation" which provides "that every separate corporation [joining in the filing of a consolidated tax return] is to be treated as a separate taxable entity (unless the consolidated return regulations otherwise provide)," the implication clearly being that the regulation somehow requires computing an affiliated group's product liability loss on a separate company basis.

Respondent is mistaken on both counts. First, the Sixth Circuit did not rely on Treas. Reg. § 1.1502-80 to resolve the issue before it. That Court reasoned that the arguments made by the taxpayer in that case, which are the same as those made by petitioner in Sections A and B above, were valid (Pet. App. E at 64a-70a), and then went on to point out that those arguments were not inconsistent with, or trumped by, Treas. Reg. § 1.1502-80 (Pet. App. E at 74a).

Second, the cited regulation does not have the implication urged by respondent, and the cases cited by respondent in its aforementioned brief (pp. 14-15) do not support that implication. *Moline Properties v. Commissioner*, 319 U.S. 436 (1943), and *In re Chrome Plate, Inc.*, 614 F.2d

990 (5th Cir. 1980), have nothing to do with consolidated income tax returns. Both cases deal with the general rule against disregarding a corporate entity in totally different contexts.

While the two cited Tax Court cases, *Gottesman & Co. v. Commissioner*, 77 T.C. 1149, 1156 (1981), and *H Enterprises International, Inc. v. Commissioner*, 105 T.C. 71, 85 (1995), both suggest that corporations filing consolidated returns are to be treated as separate entities to the extent that the consolidated return regulations do not require otherwise, this is not tantamount to saying that product liability losses must be determined on a separate company basis because the consolidated return regulations do not contain specific words requiring that such losses be computed on a consolidated basis.

The reality is that the structure of the consolidated return regulations does require that product liability losses be computed on a consolidated or single entity basis for the reasons set forth in Section A. Inasmuch as that structure does not provide a method for making the product liability loss computation on a separate company basis, apart from the Fourth Circuit's erroneous application of a regulation that was designed for a situation not present in this case (see discussion below in Section F), the consolidated return regulations do mandate that product liability losses be computed on a consolidated basis, as the Sixth Circuit correctly concluded in *Intermet*.

The Sixth Circuit correctly pointed out that section 172(b)(1)(I) of the Code applies to "a taxpayer" and, in the consolidated return context, most particularly with respect to net operating losses, the affiliated group is properly regarded as the taxpayer. (Pet. App. E at 74a.) A general reading of the consolidated return regulations makes clear that this is, in fact, the case. For example:

1. An affiliated group of corporations files a single federal income tax return each year. Treas. Reg. § 1.1502-75(h).

2. All members of the affiliated group must have the same taxable year. Treas. Reg. § 1.1502-76(a)(1).

3. 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. Treas. Reg. § 1.1502-2.

4. Section 38 of the Internal Revenue Code of 1986 currently provides a business credit, which section 38(c) limits to the excess of "the *taxpayer's* net income tax over the greater of — (A) the tentative minimum tax for the taxable year, or (B) 25 percent of so much of the taxpayer's net regular tax liability as exceeds $25,000." I.R.C. § 38(c)(1) (emphasis added). Although never brought up to date, the parallel provision of the current consolidated return regulations requires an affiliated group to make this computation on a consolidated basis. Treas. Reg. § 1.1502-3(a)(3)(i).

5. Section 901(a) of the Code allows each "taxpayer" to elect to claim a foreign tax credit (in lieu of a deduction for foreign taxes), but Treas. Reg. § 1.1502-4(a) provides that any election of the common parent is also binding on every other member of the group.

6. Section 6655 of the Code, which refers to "the taxpayer" several times (*see, e.g.*, sec. 6655(e)(2)(C) and (e)(4)), requires every corporation to pay estimated income tax according to certain prescribed rules applicable to that corporation's facts, but Treas. Reg. § 1.1502-5 applies the section 6655 rules to the affiliated group on a consolidated basis, not to each member of the group individually.

E. 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 unequivocally agreed with petitioner that no member of an affiliated group can have its own net operating loss, and it also agreed that the IRS was incorrect in comparing a group member's product liability deductions with its separate taxable income to determine whether the member could contribute to the group's product liability loss. (Pet. App. A at 18a-21a.) The Court, nonetheless, determined that petitioner'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." (Pet. App. A at 14a-16a.) This conclusion is based on a faulty premise.

Treas. Reg. § 1.1502-11(a) and Treas. Reg. § 1.1502-21(f) provide, respectively, that "consolidated income" and "net operating loss" "shall be determined by taking into account" certain items. These items are the "separate taxable income" of each member of the group, and then a variety of items that must be taken into consideration on a consolidated basis. In the case of both of the cited regulations, there is no reference to the computation of product liability deductions on a consolidated basis, which both the respondent and the Fourth Circuit erroneously found fatal to petitioner's case.

The flaw in this position is that both the respondent and the Fourth Circuit have lost sight of what the regulations seek to accomplish by having certain items computed on a consolidated basis. In both the case of taxable income and net operating loss, 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 in a bottom line amount of income or loss on the basis deemed appropriate by the IRS. *On the other hand, whether product liability deductions 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.*

No one in this case is arguing about the size of the AMCA consolidated net operating loss in any year. These are agreed upon amounts. The only issue to be determined is the portion of these agreed upon amounts that can be carried back 10 years instead of the normal three. To make this determination in the manner urged by petitioner is not in the slightest inconsistent with the failure of Treas. Reg. § 1.1502-11(a) or Treas. Reg. § 1.1502-21(f) to provide for the computation of product liability deductions on a consolidated basis because to have done so would have served no rational purpose. *Accordingly, the respondent and the Fourth Circuit are simply in error when they conclude that the consideration of product liability deductions on a consolidated basis is not permitted because the consolidation of product liability deductions is not called for expressly in the cited regulations. To the contrary, it would have been incongruous to have included such a provision in the regulations.*

This same refutation is applicable to the Fourth Circuit's reliance on the absence of a reference to product liability deductions as one of the modifications to the computation of separate taxable income under Treas. Reg. § 1.1502-12 as justification for its determination that product liability deductions must be determined on a separate company basis. This regulation provides directions for the computation of an income number. Once again, the issue in this case has nothing at all to do with the computation of income, be it separate or combined. Thus, one would never expect to find a reference to product liability deductions in Treas. Reg. § 1.1502-12.

The fundamental error made by the Court of Appeals is that it appeared to think of the issue in this case as involving the taxpayer's right to a deduction. Deductibility is not at issue here. There is no dispute as to the amount of AMCA's consolidated net operating losses. There is no dispute that these losses may be carried to other years and deducted against income of the AMCA affiliated group in other years. The only question before this Court is whether these undisputed losses can be carried back 10 years or three years, and the answer turns not on whether any member of the AMCA affiliated group can deduct product liability expenses, but only on the manner in which they are compared with AMCA's consolidated net operating loss.

F. The Fourth Circuit Erroneously Relied On A Regulation That, By Its Own Explicit Terms, Is Not Applicable In This Case.

Having rejected both the IRS method of comparing product liability deductions with separate taxable income and the petitioner's single entity theory, the Court of Appeals found itself in somewhat of a dilemma, which it attempted to resolve on two pillars; first, the Court asserted that petitioner's position resulted in a windfall tax benefit (Pet. App. A at 16a-17a) and second, the court asserted that Treas. Reg. § 1.1502-79(a) provided the appropriate method for allocating an affiliated group's consolidated net operating loss among its members for the purpose of determining whether any particular member could contribute product liability deductions to the group to be included in the computation of the group's product liability loss (Pet. App. A at 21a-23a).

The windfall conclusion is a classic "bootstrap" argument. First decide that the IRS is correct, and then conclude that the opposite result therefore would create a windfall. Of course, this position begs the question of whether the IRS is right in the first instance. If petitioner is correct that the taxpayer to which section 172(b)(1)(I) is applicable is properly the affiliated group, then there is certainly no windfall because the result that flows from that conclusion is the intended result.

The substantive effort made by the Fourth Circuit to buttress its windfall conclusion reflects a lack of understanding as to the operation of both the consolidated return regulations and section 172:

> We agree that, were the taxpayer's reasoning to prevail, the parent corporation could obtain the extended ten-year carryback for losses incurred by individual group members (that are reflected in the parent's "consolidated net operating loss"), although the losses were not the result of product liability expenses (and thus could not be "product liability loss").

(Pet. App. A at 17a.)

An affiliated group's consolidated net operating loss is made up of all of the income and deductions of every member of the group. This loss, of necessity, includes the product liability deductions of every member of the group, whether or not the member itself has positive or negative separate taxable income. In every case, the group's consolidated net operating loss is the direct result of every member's product liability deductions. For example, if an affiliated group has a consolidated net operating loss of 100 while all the members of the group have product liability deductions of 10, the 10 is reflected dollar for dollar in the 100. If the 10 were increased to 15, the net operating loss would be increased to 105; if the 10 were decreased to 5, the net operating loss correspondingly would be decreased to 95.

The fact that money is fungible and the affiliated group's consolidated net operating loss can be said to be attributable to deductions other than those related to product liability is irrelevant because the same statement can be made in the case of a single corporation filing a separate federal income tax return. For instance, a single company filing a separate income tax return might have income of 15 and deductions of 30, attributable to 10 of interest, 10 of depreciation and 10 of product liability. This company has a net operating loss of 15, of which 10, without question, will be properly characterized as a product liability loss. The fact that one might argue that the loss of 15 is attributable in whole or in part to the 10 of interest plus the 10 of depreciation carries no weight because section 172(j)(1) unequivocally states that the product liability loss is the lesser of the taxpayer's net operating loss or its product liability deductions. The statute does not permit the IRS to limit the taxpayer's product liability loss to 5 on the theory that the company's product liability deductions properly accounted for only one-third of the 15 net operating loss after pro rating the various deductions contributing to the taxpayer's loss.

The other justification offered for the Fourth Circuit's decision is Treas. Reg. § 1.1502-79(a), concerning which it makes the following statement:

> The regulations governing consolidated returns provide a simple and direct method for determining the portion of a group member's product liability expenses that are "product liability loss." The regulations define a group member's "separate net operating loss," *see* Treas. Reg. § 1.1502-79(a)(3), which is analogous to an individual's "net operating loss" on a separate return. By comparing each member's product liability expenses to its "separate net operating loss," that member's "product liability loss" may be properly calculated. The parent's "product liability loss" is then calculated as the total of the members' "product liability loss."

(Pet. App. A at 21a.)

There are three fundamental flaws with this reasoning. First, on its face, the regulation cited by the Fourth Circuit simply does not apply. Treas. Reg. § 1.1502-79 is captioned "Separate return years." Paragraph (a) of that section is captioned *"Carryover and carryback of consolidated net operating losses to separate return years."* Treas. Reg. § 1.1502-79(a)(1), by its terms, only applies "[i]f a consolidated net operating loss can be carried . . . *to a separate return year* of a corporation . . . which was a member in the year in which such loss arose. . . ." (Emphasis added.) In the event a consolidated net operating loss can be carried to a separate return year, the portion of the loss that can be so carried is determined under Treas. Reg. § 1.1502-79(a)(3), as explicitly stated in Treas. Reg. § 1.1502-79(a)(1). Contrary to the Fourth Circuit's conclusion, Treas. Reg. § 1.1502-79(a)(3) is accorded no other purpose in the consolidated return regulations. As noted above, *no separate return years are at issue in this case* (or in the *Intermet* case). All net operating loss carrybacks in issue apply only within the single affiliated group litigating this case. Accordingly, the Fourth Circuit's application of Treas. Reg. § 1.1502-79(a) can be construed only as a new consolidated return regulation which imposes *separate return* concepts and provisions on the determination of *consolidated return* items. The Fourth Circuit cited no technical or policy support for creating this regulation and applying it in a manner that is directly at odds with its plain language.

In *Intermet*, the Sixth Circuit considered the Fourth Circuit's approach and expressly rejected it as unpersuasive. After agreeing with an IRS statement in a related 1997 Technical Advice Memorandum, that no portion of an affiliated group's consolidated net operating loss could be attributed to a member of the group with positive separate taxable income, the Court of Appeals pointed out that the Memorandum's further conclusion that Treas. Reg. § 1.1502-79(a)(3) could be relied on as the basis for denying petitioner's single entity approach was "entirely misplaced:"

> Section 1.1502-79(a) (redesignated as Treas. Reg. § 1.1502-79A by T.D. 8677) establishes a method for allocating CNOL to an individual member if a member seeks to carry back a loss to a "separate return year," *i.e.*, a year in which the member was not part of the consolidated group. The IRS contends that this allocation method may also apply in cases such as this one that involve carrybacks to a consolidated return year, pointing out that section 1.1502-79(a)(3) does not explicitly limit its application to separate return years. Tech. Adv. Memo. 9715002.
>
> The IRS's interpretation ignores a "fundamental rule of statutory construction that statutory language is to be read in pertinent context rather than in isolation." *Oates v. Oates*, 866 F.2d 203 (6th Cir. 1989). When reading section 1.1502-79A(a) as a whole, there is no question that it applies only to the separate return scenario. . . . We note that the Fourth Circuit recently held that a consolidated taxpayer is entitled to a "product liability loss" carryback — comparable to the [specified liability loss] carryback — for that portion of an individual member's product liability expenses that does not exceed the member's "separate net operating loss" as calculated under section 1.1502-79A(a)(3). . . . *The court offered no analysis to support its conclusion* that Treas. Reg. § 1.1502-79A(a)(3) dictates a method for calculating a member's "separate net operating loss" outside of the separate return context. . . . *For the reasons outlined above, we are unpersuaded by the Fourth Circuit's approach.*

(Pet. App. E at 72a-74a) (emphasis added).

Petitioner's case provides a good example of why courts must not take it upon themselves to write their own regulations, because the second flaw in the Fourth Circuit's reasoning is that its method of apportioning the consolidated net operating loss to individual group members completely distorts the operation of section 172(b)(1)(I), and adds undue complexity to an already complex area of the law. Petitioner asserts that the 10-year carryback amount is the lesser of an affiliated group's consolidated net operating loss or the group's total product liability expenses. The IRS, by contrast, contended below that the 10-year carryback amount is the lesser of the group's consolidated net operating loss or the sum of the product liability expenses of each member of the affiliated group, to the extent that the member had negative separate taxable income. The Fourth Circuit, however, limited the 10-year carryback amount to the lesser of the affiliated group's consolidated net operating loss or the sum of the product liability expenses of each member of the affiliated group, to the extent that amount did not exceed the member's share of the group's consolidated net operating loss, allocated under Treas. Reg. § 1.1502-79(a)(3). This convoluted calculation produces arbitrary and capricious results.

Take the following illustration. A consolidated group consists of a parent corporation and three wholly-owned subsidiaries. The parent has no income or loss. Subsidiary A has a separate taxable loss of $500, of which $100 is attributable to product liability deductions. Subsidiary B has a separate taxable loss of $10,000. Subsidiary C has separate taxable income of $10,400. Neither B nor C has any deductions attributable to product liability. Thus, the taxpayer group has a consolidated net operating loss of $100 ($10,400-$10,000-$500).

If Subsidiary A had filed a return as a separate taxpayer, it would have had a product liability loss of $100 (the lesser of what would be, in a separate return context, a $500 net operating loss, or the $100 product liability deduction), which it could carry back 10 years. Under the taxpayer's methodology, the taxpayer affiliated group would have a product liability loss of $100 (the lesser of the $100 consolidated net operating loss or the $100 product liability deduction). Even under the IRS approach, misguided as it is, the taxpayer group would have a product liability loss of $100, because the member with the $100 product liability deduction had negative separate taxable income of $500, and the affiliated group had a consolidated net operating loss of $100.

Under the Fourth Circuit's approach, however, the group would have a product liability loss of only *$4.76* (the lesser of Subsidiary A's $100 product liability deduction or, under Treas. Reg. § 1.1502-79(a)(3), the $100 group loss, multiplied by Subsidiary A's loss of $500, divided by the sum of all separate losses, $10,500). This unwarranted result occurs solely because the bulk of the group's loss happens to have been incurred by a member with no product liability deductions. No policy rationale exists for determining the ten-year carryback in this arbitrary manner.

Clearly, the method relied on by the Fourth Circuit does not produce a result that is anything like the result that would be obtained if the member of the group with the product liability deductions had filed a separate return, which the IRS has contended was its goal, and which the Fourth Circuit indicated it was attempting to achieve by stating that "a group member's 'separate net operating loss,' [defined under] Treas. Reg. § 1.1502-79(a)(3), . . . is analogous to an individual's [presumably, the Court meant "member's"] 'net operating loss' on a separate return." (Pet. App. A at 21a.) In the example given above, the group member with the product liability deductions would have a net operating loss on a separate basis of $500 whereas the Fourth Circuit has reduced this to $4.96.

What has happened here is that the Fourth Circuit has taken a regulation that makes perfectly good sense when apportioning an affiliated group's consolidated net operating loss to separate return years and used it in a situation with which it is incompatible. When apportioning an affiliated group's consolidated net operating loss to separate return years, it makes sense to apportion that loss among the members of the group based on the portion of that loss contributed by each member incurring a loss. Thus, in the example above, if Subsidiary B's share of the affiliated group's consolidated net operating loss were properly apportioned to a separate return year, it would be appropriate for its share of the loss to be $95.24 because B contributed 95.24% of the consolidated net operating loss. The portion of the group's net operating loss remaining to be used by the group would be $4.96, thus producing a total net operating loss equal to the group's $100.

When dealing with a product liability loss, however, if one applies the allocation formula favored by the Fourth Circuit, the share of the consolidated net operating loss contributed by a member of the group has no rational relationship to the amount of product liability deductions it can contribute to the group's product liability loss, as demonstrated above. At the very least, if the Court of Appeals' view were correct, one would expect to find some correlation between what a group member's product liability loss would be on a separate company basis with what it would be within the affiliated group, a correlation that will almost never exist under the Fourth Circuit's decision or, for that matter, under any method of applying the product liability loss rules to an affiliated group on a separate company basis.

For instance, one can mathematically derive the equivalent of a net operating loss for a member of an affiliated group if one is of a mind to create yet another rule, but any assertion that this will permit calculation of the product liability loss of an affiliated group in a manner consistent with the results one would obtain if the members of the group filed separate income tax returns is without foundation.

Two simple examples will demonstrate this. First, assume a two-member affiliated group with one member, A, having the mathematical equivalent of a net operating loss of 100 that includes product liability deductions of 50. The other member, B, has net income of 200 and no product liability deductions. If A had filed a separate income tax return, A would have properly claimed a product liability loss of 50 that it could carry back 10 years. Because the affiliated group of which it is a member, however, has consolidated taxable income of 100 (B's income of 200 less A's loss of 100), neither the group nor A is entitled to a product liability loss.

Assume next, an affiliated group having three members, A, B and C. A and B each have the mathematical equivalent of a net operating loss of 100, including product liability deductions of 50. C has taxable income of 175. On a separate basis, both A and B would be entitled to claim a product liability loss of 50 each. The affiliated group of which they are members, however, has a consolidated net operating loss of only 25 which establishes the maximum product liability loss to which the entire group is entitled. Thus, instead of A and B having a combined product liability loss of 100 on a separate basis, they are limited to a product liability loss of 25 on a consolidated basis.

In short, any form of separate company approach is a "heads, I win, tails you lose" solution for the IRS. When treating a member of an affiliated group on a separate company basis would result in a product liability loss that is greater than it would be on a consolidated basis, as in the case of the two examples above, the consolidated return rules require disregarding the equivalent separate return results. On the other hand, when treating a group member as if it had filed a separate return would work to increase the returns to the fisc, as it would in the present case if respondent prevails, the IRS is adamant that only separate return accounting will do.

Clearly, only the method of determining product liability losses approved by the Sixth Circuit in the *Intermet* case, the method favored by petitioner in this case, is capable of being consistently and fairly applied in a manner that does not produce arbitrary results favoring one side or the other because, in all cases, the consolidated net operating loss, the only net operating loss that exists for an affiliated group of corporations, will always set the upper limit of the group's product liability loss while, at the same time, the consolidated approach will permit all of the product liability deductions of the group to be taken into consideration, subject to that limitation. In short, the rule urged by petitioner recognizes that, for net operating loss purposes, an affiliated group of corporations is a single taxpayer. If this were not the case, there could be no justification for allowing the income of one member of an affiliated group to be offset by the losses of others, as prescribed by the consolidated return regulations.

The third flaw in the Fourth Circuit's opinion is that the IRS has acknowledged that, "although the consolidated net operating loss is apportioned to individual members for purposes of carry backs to separate return years, *the apportioned amounts are not separate NOLs [net operating losses] of each member.*" Preamble to Prop. Treas. Reg. § 1.1502-21(g), 49 Fed. Reg. 30,528, 30,530 (1984) (emphasis added). Thus, even if by some stretch of the imagination, Treas. Reg. § 1.1502-79(a)(3) might be applicable, the number derived by application of that regulation, in the words of the IRS itself, is not a separate net operating loss of any member of the group.

Thus, as petitioner noted in Section A of this Argument, the only net operating loss an affiliated group can conceivably have is a consolidated net operating loss. Inasmuch as section 172(j)(1) directs a comparison of a taxpayer's net operating loss with its product liability deductions, consistency can be obtained only by aggregating all of the product liability deductions of every member of the affiliated group to determine whether the resulting number is greater than, or less than, any consolidated net operating loss the group may have.

CONCLUSION

For the reasons stated above, the Court is respectfully requested to reverse the decision below of the United States Court of Appeals for the Fourth Circuit and to reinstate the decision of the United States District Court for the Western District of North Carolina, Charlotte Division, which would result in the refund to petitioner of $1,618,306 of income tax, plus interest according to law.

Respectfully submitted,

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