No. 00-157

In the Supreme Court of the United States

UNITED DOMINION INDUSTRIES, INC., PETITIONER

v.

UNITED STATES OF AMERICA

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

BRIEF FOR THE UNITED STATES

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QUESTION PRESENTED

A "product liability loss" incurred by a corporation may be carried back a maximum of ten years from the loss year and used as a deduction in the carryback year. 26 U.S.C. 172(b)(1)(I) (1988); see 26 U.S.C. 172(b)(1)(C), (f). The question presented in this case is whether, under the Treasury regulations that govern the years in which this case arose, 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, instead, (ii) separately calculating the income and expenses of each entity.

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a-24a) is reported at 208 F.3d 452. The opinion of the district court (Pet. App. 25a-41a) is unofficially reported at 98-2 U.S. Tax Cas. (CCH) ¶ 50,527.

JURISDICTION

The judgment of the court of appeals was entered on March 24, 2000. The petition for rehearing and for rehearing en banc was denied on May 19, 2000 (Pet. App. 42a). The petition for a writ of certiorari was filed on July 28, 2000, and was granted on November 27, 2000. The jurisdiction of this Court rests upon 28 U.S.C. 1254(1).

STATUTES AND REGULATIONS INVOLVED

1. The applicable provisions of Section 172 of the Internal Revenue Code, 26 U.S.C. 172 (1988), and of the regulations that govern the filing of consolidated returns for the years 1983 through 1986, 26 C.F.R. 1.1502 (1986), are set forth at Pet. 1-3 and Pet. App. 43a-59a. In addition to the regulations set forth in the petition, 26 C.F.R. 1.1502-80(a) provides in relevant part:

> The Internal Revenue Code, or other law, shall be applicable to the group to the extent the regulations do not exclude its application. Thus, for example, in a transaction to which section 381(a) applies, the acquiring corporation will succeed to the tax attributes described in section 381(c). * * *

2. 26 U.S.C. 11(a) provides:

> A tax is hereby imposed for each taxable year on the taxable income of every corporation.

3. 26 U.S.C. 1501 provides, in relevant part:

> An affiliated group of corporations shall, subject to the provisions of this chapter, have the privilege of making a consolidated return with respect to the income tax imposed by chapter 1 for the taxable year in lieu of separate returns. The making of a consolidated return shall be upon the condition that all corporations which at any time during the taxable year have been members of the affiliated group consent to all the consolidated return regulations prescribed under section 1502 prior to the last day prescribed by law for the filing of such return. The making of a consolidated return shall be considered as such consent. * * *

4. 26 U.S.C. 1502 provides:

> The Secretary shall prescribe such regulations as he may deem necessary in order that the tax liability of any affiliated group of corporations making a consolidated return and of each corporation in the group, both during and after the period of affiliation, may be returned, determined, computed, assessed, collected, and adjusted, in such manner as clearly to reflect the income-tax liability and the various factors necessary for the determination of such liability, and in order to prevent avoidance of such tax liability.

STATEMENT

1. a. The Internal Revenue Code imposes a tax each year "on the taxable income of every corporation." 26 U.S.C. 11(a). In calculating that tax during the years relevant to this suit, a corporation was allowed to carry back for a period of three years the amount of any "net operating loss" it incurred. 26 U.S.C. 172(b)(1)(A) (1988). If the corporation incurred a "product liability loss," however, the amount of that loss could be carried back a period of ten years from the loss year and used as a deduction in the carryback year. 26 U.S.C. 172(b)(1)(I) (1988).[1] The term "product liability loss" was defined for this purpose to mean the lesser of (i) the "net operating loss for such year" incurred by the corporation or (ii) the deductible expenses incurred by the corporation that were

[1] The provisions formerly located at Section 172(b)(1)(I) have been relocated at Section 172(b)(1)(C), (f). See 26 U.S.C. 172(b)(1)(C), (f). Unless otherwise noted, the statutory references hereafter set forth in this brief are to the Internal Revenue Code as in effect between 1983 and 1986.

attributable to the satisfaction or defense of product liability claims. 26 U.S.C. 172(j)(1).

b. Petitioner is the successor in interest to the common parent of an affiliated group of corporations that filed consolidated federal income tax returns for the taxable years 1983-1986. Pet. App. 3a. By filing consolidated returns, these corporations "consent[ed] to all the consolidated return regulations prescribed under section 1502 [of the Internal Revenue Code] prior to the last day prescribed by law for the filing of such return." 26 U.S.C. 1501. That statute broadly authorizes the Secretary to adopt such consolidated return regulations as he "may deem necessary in order that the tax liability of any affiliated group of corporations making a consolidated return and of each corporation in the group * * * may be returned, determined, computed, assessed, collected, and adjusted, in such manner as clearly to reflect the income-tax liability * * * and in order to prevent avoidance of such tax liability." 26 U.S.C. 1502.

The affiliated corporations that joined in the consolidated returns for 1983-1986 included Jesco, Inc., Cherry-Burrell Corporation, Amtel, Inc., The Litwin Corporation and Litwin Panamerican Corporation, each of which incurred product liability expenses during these years.[2] Pet. App. 3a, 26a. Although petitioner reported consolidated net operating losses when combining *all* of its affiliated corporations for each of the years from 1983 to 1986,[3] the affiliates named above

[2] Petitioner formed Cherry-Burrell in 1975. Petitioner acquired the other corporations at various times after 1976. Pet. App. 4a n.5.

[3] Petitioner reported consolidated net operating losses of $140,402,175 for 1983, $114,134,256 for 1984, $ 85,521,645 for 1985,

that had product liability expenses each generated positive net income during some or all of these years. *Id.* at 26a-27a.[4] The issue in this case is whether the product liability expenses incurred by the affiliates that had *positive* separate incomes during these years constitute "product liability *losses*" under 26 U.S.C. 172(b)(1)(I) (emphasis added) that may be carried back ten years and deducted from petitioner's taxable income for the years 1973-1976.

2. The Internal Revenue Service determined that the product liability expenses incurred by the affiliates that generated a positive separate net income during 1983-1986 did not give rise to product liability "losses"

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and $101,221,077 for 1986. J.A. 8. The following amounts of product liability expenses were incurred by these affiliates during the 1983-1986 taxable years (Pet. App. 27a):

Corporation	Product Liability Expenses			
	1983	1984	1985	1986
Jesco	$166,042	$1,402,931	$1,292,733	$127,682
Cherry-Burrell	34,608	192,287	8,642	87,760
Amtel	0	12,135	13,218	7,549
Litwin	5,250	0	14,139	8,909
Panamerican	19	1,987	5,056	502
Total	$205,919	$1,605,342	$1,333,788	$232,402

[4] Jesco, Cherry-Burrell and Panamerican had positive "separate taxable income" (under 26 C.F.R. 1.1502-12) for each year between 1983 and 1986. Pet. App. 27a. Amtel had positive separate taxable income for 1984, 1985 and 1986, and negative separate taxable income (of $3,017,912) only for 1983. *Ibid.* Litwin had positive separate taxable income for 1983, 1985 and 1986, and negative separate taxable income (of $399,300) only for 1984. Litwin claimed $4198 in product liability deductions during 1984, a year in which it computed negative separate taxable income. *Ibid.* As explained at note 7, *infra*, the tax consequences of Litwin's 1984 deductions are not at issue in this case.

that could be carried back ten years under Section 172. Because these affiliates each generated positive incomes—rather than "losses"—during those years, no "product liability losses" were incurred under the plain text of the statute. Pet. App. 28a.

Petitioner thereafter brought two separate refund suits to challenge the Service's determination. In the first suit, which was commenced in the United States Court of Federal Claims, petitioner asserted that the product liability expenses incurred during 1985 by the group of profitable affiliates that petitioner acquired after 1976 (see note 2, *supra*) generated a "product liability loss" that could be carried back ten years and deducted from the gross income reported on the separate returns filed by those affiliates in 1975.[5] Petitioner argued that this group of affiliates was entitled to this carryback on the theory that "a consolidated group is treated as a single entity with respect to the product liability loss provisions." *Amtel, Inc.* v. *United States*, 31 Fed. Cl. 598, 599 (1994), aff'd, 59 F.3d 181 (Fed. Cir. 1995) (Table). The Court of Federal Claims rejected petitioner's claim. The court held that petitioner's affiliates "cannot carry back a product liability loss from 1985 to 1975 because [they] had no net operating loss in 1985." 31 Fed. Cl. at 600. Relying on the consolidated return regulations adopted by the Treasury under Section 1502, the court concluded that these affiliates had no "separate net operating loss" (26 C.F.R. 1.1502-

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[5] In 1975, Amtel was the common parent of an affiliated group of corporations that included Litwin and Panamerican. Those corporations were not members of petitioner's affiliated group in that year. The consolidated return regulations accompanying Section 1502 of the Code denominate the 1975 taxable year a "separate return year" for Amtel, Litwin and Panamerican. See 26 C.F.R. 1.1502-1(e).

79(a)(3)) for 1985 to carry back to their 1975 separate return year. 31 Fed. Cl. at 601. Because, as the affiliates acknowledged, their "separate net operating loss * * * was zero," the court held that there was no product liability "loss" to be carried back. *Ibid.*

The Court of Federal Claims expressly rejected petitioner's argument that a "consolidated" product liability loss occurred merely because *other* reporting entities included on petitioner's 1985 consolidated return–-entities that themselves had no product liability expenses—incurred losses that were sufficient to create an aggregate net operating loss on the consolidated return. The court explained that the governing "regulations do not use the term 'consolidated product liability loss' or incorporate such a concept by directing that product liability loss be treated on a consolidated basis." 31 Fed. Cl. at 602. The Federal Circuit affirmed the decision of the Court of Federal Claims in an unpublished opinion. 59 F.3d 181 (1995) (Table).

3. After the Federal Circuit issued its opinion in *Amtel*, petitioner filed this second refund suit in the United States District Court for the Western District of North Carolina. In this second suit, petitioner contended that the product liability deductions claimed by its affiliates during 1983, 1984, 1985 and 1986 created product liability "losses" that could be carried back ten years and deducted from *petitioner's* consolidated taxable income for 1973, 1974, 1975 and 1976.[6] The

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[6] Those years were all *before* the date on which these affiliates had become part of petitioner's consolidated group. See note 2, *supra*.

complaint sought a refund of $1,618,305 plus statutory interest. J.A. 15.[7]

The district court granted summary judgment to petitioner. Pet. App. 25a-41a. The court agreed with the argument that the Court of Federal Claims had rejected in the *Amtel* case, and concluded that an affiliated group's product liability "loss" is to be determined on a consolidated basis. *Id.* at 38a-39a.[8] The district court held that, so long as the consolidated return reflects an *aggregate* net operating loss, the product liability expenses incurred by *profitable* affiliates may be employed to generate "product liability *losses*" that may be carried back and set off against any earnings of the consolidated entities for a period of up to ten years. *Ibid* (emphasis added).

4. The court of appeals reversed. Pet. App. 1a-24a. The court concluded that the consolidated return regulations "make[] clear * * * that a comparison of the group members' aggregated product liability expenses to the consolidated net operating losses in order to derive a consolidated 'product liability loss' is not intended." *Id.* at 16a. The court observed that, under the consolidated return regulations, "product

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[7] The refund claim included the product liability deductions claimed by Litwin in 1984. Petitioner conceded in the court of appeals, however, that under 26 C.F.R. 1.1502-79(a)(3), Litwin's 1984 product liability loss could not be carried back to petitioner's 1974 consolidated return year because Litwin was not a member of petitioner's affiliated group in that year. See Pet. App. 4a n.4.

[8] The district court held that the decision in *Amtel* did not collaterally estop petitioner from asserting, in the context of this case, that product liability losses must be accounted for on a consolidated basis. Pet. App. 39a-40a. The United States did not challenge that collateral estoppel determination in the court of appeals, and the issue is not now presented in this case.

liability expenses are linked to the consolidated net operating loss only through their nexus to the group member" (*ibid.*) and "that an interpretation removing the close nexus between such expenses and whether the affected company operated at a loss is inconsistent with the regulations." *Id.* at 17a. The court concluded "that determining 'product liability' loss separately for each group member is correct and consistent with the regulations." *Ibid.* The court explained the proper method under the regulations for determining product liability loss on a consolidated return (*id.* at 21a):

> 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."

SUMMARY OF ARGUMENT

I. Because product liability expenses are often incurred by businesses in an unforeseen and unpredictable manner, Congress has provided a special tax rule for losses resulting from such expenses. When a taxpayer incurs product liability expenses, it must first deduct them in the year they are incurred as "ordinary and necessary" business expenses under Section 162 of the Internal Revenue Code. If any portion of such product liability expenses is *not* effectively employed as deductions in that year—because there is insufficient taxable income that year to set them against—then that unconsumed portion of those expenses (and only that portion) constitutes a "product liability loss" that, under Section 172 of the Code, may be carried back as many as ten years and be set off against previously earned taxable income.

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 the statute, 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." Instead, each of these profitable entities obtained a full and effective current use of its product liability expenses by deducting them in the year the expenses were incurred.

II. Petitioner concedes that its affiliates with product liability expenses had positive separate incomes and therefore would not qualify for a "product liability loss" carryback as individual corporations. Petitioner nonetheless asserts that the fact that these profitable affiliates filed a consolidated return with *other* entities —entities that had operating losses but *no* product liability expenses—somehow requires a different result. That contention is incorrect because, under the governing consolidated return regulations, 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 is *positive*, then all of the product liability expenses have been fully utilized in reducing taxable income at that level. As a consequence, there are no unconsumed or unutilized product liability expenses—or "product liability losses"—to carry to the consolidated level of the group.

By contrast, under these controlling regulations, if an individual affiliate has a negative separate income for the current year *and* unconsumed product liability expense deductions for that year, those unutilized product liability expenses are properly carried to the consolidated level. They are then first applied to offset any net operating profit from other affiliates at the consolidated level—thereby providing an immediate tax benefit from the deductions. If, after application of such deductions, the consolidated entity realizes a positive net operating income, then all of the product liability expenses have (by definition) been consumed as deductions in that year and there is nothing left to carry to other years. Alternatively, if a consolidated net operating *loss* results in the current year, then any product liability expenses that have not either been utilized by the individual entity that incurred them or been consumed at the consolidated level may be carried back for as many as ten years as "product liability losses" for the consolidated entity. On the facts of this case, however, *all* of the product liability expenses were fully deducted in determining the separate income of the profitable individual affiliates that incurred those expenses. There are thus no unutilized deductions, or "product liability losses," in this case.

Petitioner is incorrect in asserting that, as applied to a consolidated group of corporations, the "taxpayer" to whom the "product liability loss" provisions apply is exclusively the consolidated group. Even though separate affiliated taxpayers may join in filing a consolidated return, "each of [the] corporations joining * * * in a consolidated return is none the less a taxpayer." *Woolford Realty Co.* v. *Rose*, 286 U.S. 319, 328 (1932). The text and history of Section 172(j) both make clear that the "taxpayer" referred to in that statute is the corporation that has *itself* incurred product liability expenses and is unable fully to 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 product liability expenses. The statute is not designed to provide tax benefits for affiliated entities that (either by conscious corporate design or by historical accident) have kept themselves and their assets free from any liability for these expenses.

Moreover, Congress did not intend to provide any tax benefit to a *profitable* corporation—such as the affiliates involved in this case—even though that corporation might have had large product liability expenses. When, as here, a profitable corporation employs its product liability expense deductions to reduce its net income in the current period, there are no remaining unused deductions—or "product liability losses"—for it to pass to its affiliates on a consolidated return either as current deductions or as a carryback to prior years under Section 172(j).

The rule that petitioner advocates would permit significant tax avoidance abuses. Under petitioner's approach, a corporation that is currently unprofitable but that 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. As this Court emphasized in a case that involved a similar abuse, "[t]he mind rebels against the notion that Congress in permitting a consolidated return was willing to foster an opportunity for juggling so facile and so obvious." *Woolford Realty Co.* v. *Rose*, 286 U.S. at 330. The result advocated by petitioner thus would not only contravene the text and intent of the governing statute and regulations, it would also defeat the directive of Congress that consolidated returns not be employed as an artifice for "avoidance of such tax liability." 26 U.S.C. 1502.

ARGUMENT

Whether reported on a separate or consolidated return, product liability expenses are to be deducted by each individual corporation in determining the net income attributable to that individual entity. When, as in this case, the resulting net income of each individual corporation with product liability expenses is positive, there are no unused product liability deductions—or "product liability losses"—to be carried back and deducted from income in prior years under section 172 of the Internal Revenue Code.

I. 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.

A. The Internal Revenue Code imposes a tax each year "on the taxable income of every corporation." 26 U.S.C. 11(a). In calculating that taxable income, a corporation was allowed by Section 172 of the Code to carry back for a period of three years, or carry forward for a period of 15 years, the amount of any "net operating loss" it incurs. 26 U.S.C. 172(b)(1)(A), (B).[9] Section 172(c) generally defines a "net operating loss" as "the excess of the deductions allowed by this chapter over the gross income." 26 U.S.C. 172(c). 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." *United States* v. *Foster Lumber Co.*, 429 U.S. 32, 47 (1976). By providing for the carryforward and carryback of net operating losses, Section 172 "permit[s] a taxpayer to set off its lean years against its lush years, and to strike something like an average taxable income computed over a period longer than one year." *Lisbon Shops, Inc.* v. *Koehler*, 353 U.S. 382, 386 (1957).

Although the general carryback period for a net operating loss is three years from the year in which the loss is incurred, Congress adopted a special ten-year carryback period for a "product liability loss" incurred by a "taxpayer." 26 U.S.C. 172(b)(1)(I).[10] The term "product liability loss" is defined to mean, for any taxable year, "the lesser of" the "net operating loss for

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[9] Unless otherwise noted, the statutory references in this brief are to the Internal Revenue Code and Treasury regulations as in effect between 1983 and 1986. See note 1, *supra*. In the Taxpayer Relief Act of 1997, Pub. L. No. 105-34, § 1082(a)(1)-(2), 111 Stat. 950, Congress amended Section 172(b)(1)(A) to shorten the general carryback period to two years and to enlarge the carryforward period from fifteen years to twenty years.

[10] The product liability loss is carried back a maximum of ten years to the earliest taxable year for which the taxpayer reported taxable income. 26 U.S.C. 172(b)(2). In the event any portion of the loss remains after application in the earliest taxable year, the remainder is carried forward to the next taxable year for which the taxpayer reported taxable income. *Ibid.* The process continues until the loss is used up.

such year" or the deductible expenses incurred by that entity that are "attributable to" the satisfaction or defense of product liability claims. 26 U.S.C. 172(j)(1).[11] 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 (*i.e.*, its total deductions exceed its gross income) *and* (ii) that net operating loss is attributable in whole or in part to deductions for product liability or product liability expenses.

In adopting this provision, Congress was concerned that product liability expenses are often incurred in cycles that are not clearly reflected under normal tax accounting principles. Although income is earned upon the sale of a product, associated liability expenses may not be incurred for many years thereafter. And, when such liability expenses are incurred, they are often "large and sporadic." Staff of Joint Comm. on Taxation, 96th Cong., 1st Sess., *General Explanation of the Revenue Act of 1978 (H.R. 3511, 95th Cong., Pub. L. 95-600)* 232 (1979). The extended carryback period for product liability losses under Section 172 is designed to "allow businesses to use previous taxable income as at least a partial reserve" against product liability expenses subsequently incurred by that company. 124 Cong. Rec. 34,733 (1978) (Sen. Culver).

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[11] The term "product liability" is defined as (26 U.S.C. 172(j)(2)):

> liability of the taxpayer for damages on account of physical injury or emotional harm to individuals, or damage to or loss of the use of property, on account of any defect in any product which is manufactured, leased, or sold by the taxpayer, but only if such injury, harm, or damage arises after the taxpayer has completed or terminated operations with respect to, and has relinquished possession of, such product.

To accomplish this goal, Congress established the following method for accounting for product liability expenses. When a taxpayer incurs product liability expenses, it must first deduct them in the year they are incurred as "ordinary and necessary" business expenses under Section 162 of the Code. 26 U.S.C. 162. If any portion of such product liability expenses is *not* effectively employed as deductions in that year—because there is insufficient taxable income that year to set them against—then that *unconsumed* portion of those expenses (and only that portion) constitutes a "product liability loss" that may be carried back as much as ten years and be set off against previously earned taxable income.

Section 172 is plainly not designed to provide the taxpayer with a *double* deduction. The extended carry-back of losses permitted under that Section allows a corporation that incurs product liability expenses only *one* effective use of a deduction for these expenses—by permitting the deduction to be carried back to a prior year when, due to an insufficient amount of income from current operations, the corporation is not able fully to utilize the expense as a deduction in the current year.

If all of the product liability expenses are consumed in determining the taxable income of the liable corporation, and the corporation thus has no net operating loss, it cannot have a "product liability loss" under this statute. 26 U.S.C. 172(j)(1). And, if the corporation *does* have a net operating loss, the amount of its "product liability loss" is defined as the *lesser* of the amount of that loss or the amount of the product liability expenses incurred in that year by the corporation—in other words, it is the portion of the product liability expenses that are not *effectively utilized* as deductions to reduce the taxable income of the corporation in the current year. See *ibid.*

B. The various possible applications of the "product liability loss" provisions to individual corporations are all encompassed within the following three examples.

1. If the corporation has product liability expenses for a particular tax year but has sufficient income that it does not incur a net operating loss for that year, it has no "product liability loss," for Section 172(j)(1) defines that term as the *lesser* of the net operating loss for the taxable year or the amount of product liability deductions claimed by the taxpayer during that year. 26 U.S.C. 172(j)(1). Since the product liability expenses were fully and effectively utilized in that year as current deductions under Section 162, there are no unconsumed product liability expenses—or "product liability losses"—to carry back to other years.

2. If the corporation incurs a net operating loss for the taxable year but has no product liability expense deductions during that year, there are necessarily no unconsumed product liability deductions in that year and thus no "product liability losses" to carry back to other years under 26 U.S.C. 172(j)(1). The corporation does, however, have a "net operating loss" for the year that may be carried back a maximum of three years under 26 U.S.C. 172(b)(1)(A).

3. If the corporation incurs a net operating loss for the taxable year and has product liability expenses in that year, two situations may arise. First, if the product liability expenses incurred in that year are *less* than the net operating loss for that year, the corporation has a "product liability loss" (with a ten-year carryback) only for the amount of the product liability expenses; the remaining portion of the net operating loss may be carried back only for the three-year period

allowed by Section 172(b)(1)(A). Second, if the product liability expenses are *greater* than the amount of the net operating loss, only the unconsumed portion of the product liability expenses—which is then equal to the amount of the net operating loss—constitutes a "product liability loss" for which a ten-year carryback is permitted. 26 U.S.C. 172(j)(1).

C. 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. Pet. App. 27a; see page 7, *supra*. 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." 26 U.S.C. 172(j)(1). 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 these expenses were fully utilized as deductions in the year they were incurred, there were no unconsumed product liability expenses—or "product liability losses"—for these corporations to carry back to set off against their taxable income in prior years. See *Amtel, Inc.* v. *United States*, 31 Fed. Cl. at 601. Indeed, petitioner concedes that none of these entities had a negative taxable income "when considered on a separate company basis" (Pet. Br. 7 (emphasis omitted)). It therefore follows that none of these corporations would be able to claim a "product liability loss" under Section 172 if it had filed a separate return. See also *Amtel, Inc.* v. *United States*, 31 Fed. Cl. at 601.

II. WHEN PROFITABLE CORPORATIONS WITH PRODUCT LIABILITY EXPENSES FILE A CONSOLIDATED RETURN WITH AFFILIATES THAT GENERATE LOSSES BUT HAVE NO PRODUCT LIABILITY EXPENSES, THE RESULTING CONSOLIDATED NET OPERATING LOSS IS NOT A "PRODUCT LIABILITY LOSS" UNDER SECTION 172(j) OF THE CODE

While conceding that its affiliates with product liability expenses had positive separate incomes and therefore would not qualify for a "product liability loss" carryback as individual corporations, petitioner nonetheless asserts that the fact that these profitable corporations joined in filing a consolidated tax return with *other* entities—entities that had operating losses but *no* product liability expenses—somehow requires a different result.[12] The court of appeals correctly held, however, that petitioner may not use product liability expenses incurred by a profitable affiliate to generate "product liability losses" to be carried back ten years on petitioner's consolidated return. Under Section 172 and the consolidated return regulations, product liability losses must be calculated "separately for each group member." Pet. App. 17a.

A. *The Consolidated Return Regulations Require The Accounting For Product Liability Expenses To Occur First At The Separate Entity Level*

1. The Internal Revenue Code vests ample authority in the Treasury to adopt consolidated return regulations to effect a binding resolution of the question

[12] The losses incurred by these other entities would represent "net operating losses" for which a three-year carryback would be permitted if they had filed separately. 26 U.S.C. 172(b)(1)(A).

presented in this case. Section 1501 of the Code specifies that affiliated corporations may file a consolidated income tax return, "in lieu of separate returns," only "upon the condition that * * * the affiliated group consent to all the consolidated return regulations prescribed under Section 1502 prior to the last day prescribed by law for the filing of such return." 26 U.S.C. 1501.[13] In turn, Section 1502 authorizes the Secretary of the Treasury to:

> prescribe such regulations as he may deem necessary in order that the tax liability of any affiliated group of corporations making a consolidated return and of each corporation in the group, both during and after the period of affiliation, may be returned, determined, computed, assessed, collected, and adjusted, in such manner as clearly to reflect the income-tax liability and the various factors necessary for the determination of such liability, and in order to prevent avoidance of such tax liability.

26 U.S.C. 1502. Any taxpayer that files a consolidated return is bound by the regulations that are in effect on the date the return was due (26 U.S.C. 1501), and the tax on the consolidated return is to "be determined, computed, assessed, collected, and adjusted in accordance with the[se] regulations * * * ." 26 U.S.C. 1503(a).

2. a. The consolidated return regulations promulgated by the Secretary under Section 1502 arrive at a single figure of "consolidated taxable income" for the

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[13] The Internal Revenue Code generally defines an "affiliated group" as "1 or more chains of includible corporations connected through stock ownership with a common parent corporation." 26 U.S.C. 1504(a)(1)(A).

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 regulation, "*[t]he 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. 1.1502-12 (emphasis added). 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" under this regulation. See *ibid.*; pages 22-23, *infra*. 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 unutilized product liability loss to carry to the consolidated level.[14]

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[14] "The term 'separate taxable income' * * * include[s] a case in which the determination * * * results in an excess of deductions over gross income." 26 C.F.R. 1.1502-12(q). As we discuss in further detail below (pages 24-27, *infra*), the "separate taxable income" computed by a member of an affiliated group is not necessarily equivalent to the income or net operating loss figure that the corporation would have computed if it had filed a separate return. It is possible for a corporation to compute positive separate taxable income even though the corporation would

b. Under the regulations, the following items are excluded from the computation of the "separate taxable income" of each member and are instead treated as "consolidated items" that flow through directly to the "consolidated taxable income" of the affiliated group: (1) the consolidated net operating loss deduction (computed under 26 C.F.R. 1.1502-21); (2) any consolidated capital gain net income; (3) any consolidated Section 1231 net loss; (4) any consolidated charitable contributions deduction; (5) any consolidated Section 922 deduction; (6) any consolidated dividends received deduction; and (7) any consolidated Section 247 deduction. 26 C.F.R. 1.1502-12 (a)-(n). The net operating profit or loss of the consolidated entity is determined by

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have reported a net operating loss if it had filed a separate return. For example, if a corporation made a charitable contribution during a particular year, it conceivably could have had a "net operating loss" under Section 172 even though it computed positive separate taxable income under the consolidated return regulations, because the charitable contribution deduction is not taken into account in the computation of separate taxable income. See 26 C.F.R. 1.1502-12(*l*). Conversely, it is possible for a corporation to compute negative separate taxable income even though it would have reported positive income if it had filed a separate return. That would occur if the corporation had capital gains that, along with the other income it earned, exceeded the corporation's deductions, since capital gains are not taken into account in the computation of separate taxable income. See 26 C.F.R. 1.1502-12(j). The record of this case, however, reflects that no member of petitioner's affiliated group that computed positive separate taxable income and claimed product liability deductions would have had a "net operating loss" under Section 172 if it had filed a separate return. Petitioner has acknowledged that its profitable affiliates had positive separate taxable income and incurred no separate net operating losses in the years relevant to this case. Pet. Br. 7; *Amtel, Inc.* v. *United States*, 31 Fed. Cl. at 601.

adding these "consolidated items" to the aggregated amount of "separate taxable income" calculated for each of the individual affiliates. 26 C.F.R. 1.1502-11. See also 26 C.F.R. 1.1502-21(f) ("[t]he consolidated net operating loss shall be determined by taking into account * * * [t]he separate taxable income of each member of the group").[15]

Under these provisions, if an individual affiliate had a separate operating loss for the current year (a negative "separate taxable income") and had unconsumed product liability expenses for that year, the unutilized

[15] The consolidated net operating loss deduction, for which a three-year carryback is permitted under Section 172(b), is defined in the regulations as "an amount equal to the aggregate of the consolidated net operating loss carryovers and carrybacks to the taxable year," which consists "of any consolidated net operating losses (as determined under paragraph (f) of this section) of the group, plus any net operating losses sustained by members of the group in separate return years, which may be carried over or back to the taxable year under the principles of section 172(b)." 26 C.F.R. 1.1502-21(a),(b). Paragraph (f) of the regulation, in turn, provides that the "consolidated net operating loss" of the group is determined by aggregating "[t]he separate taxable income * * * of each member of the group" along with the consolidated items (such as capital gains and charitable deductions) that are dealt with directly at the consolidated, rather than the individual corporate, level. 26 C.F.R. 1.1502-21(f); see page 21, *supra*.

The "consolidated net operating loss" of an affiliated group of corporations is thus determined in the same manner as the group's consolidated taxable income. Each member of the group computes its separate taxable income or loss, the separate taxable income or loss figures are aggregated into a single figure, and this figure is adjusted by taking into account the consolidated items set forth in the regulation. The resulting consolidated net operating loss may then be carried back (or forward) to other taxable years for which the group reported taxable income and be deducted as part of the group's consolidated net operating loss deduction for those years.

product liability expenses would then be applied to offset any net operating profit from *other* affiliates at the consolidated level—thereby providing an immediate tax benefit from the deduction. If, after application of such deductions, the consolidated entity realizes a net operating profit, then all of the product liability expenses have (by definition) been consumed as deductions in that year and there is nothing left to carry to other years. If, however, the consolidated entity realizes a net operating loss in the current year, then any product liability expenses that had not (i) first been utilized by the individual entity that incurred them, or (ii) thereafter been consumed at the consolidated level may then be carried back for as many as ten years as "product liability losses" for the consolidated entity.

c. Even in this situation, however, the carryback will not be allowed if the corporations have not been members of the same affiliated group throughout the carryback period. See *Amtel, Inc.* v. *United States*, 31 Fed. Cl. at 601; pages 6-7, *infra*. In providing for consolidated returns, Congress directed the Treasury to adopt regulations to ensure that such returns are not employed as an artifice for "avoidance" of taxes or to distort the clear reflection of income. 26 U.S.C. 1502. Acting under this directive, the Treasury has promulgated detailed rules that limit the ability of affiliated corporations to carry consolidated losses back to their separate return years. 26 C.F.R. 1.1502-79A. By limiting the carryback of losses to separate return years, these rules forestall the trading in tax losses that could occur through the acquisition of profitable corporations by corporations with losses, or vice versa. As this Court stated in *Woolford Realty Co.* v. *Rose*, 286 U.S. 319, 329 (1932), rules of this type are required to avoid "the mischiefs certainly to be engendered" by permitting such abuse to occur. Without such restrictions on the use of loss carrybacks on consolidated returns, "a prosperous corporation could buy the shares of one that had suffered heavy losses and wipe out thereby its own liability for taxes." *Id.* at 329-330. As the Court emphasized in *Woolford Realty*, "[t]he mind rebels against the notion that Congress in permitting a consolidated return was willing to foster an opportunity for juggling so facile and so obvious." *Id.* at 330.

Under the anti-abuse regulations adopted by the Treasury, a corporation may carry back to its "separate return years" only the portion of the consolidated loss that is attributable to its own operations. 26 C.F.R. 1.1502-79A(a)(1). That amount is determined in a two-step process. First, the entity's "separate net operating loss" is determined by adding to that entity's "separate taxable income" its share of the consolidated items that are treated directly on the consolidated return under the regulations described above. 26 C.F.R. 1.1502-79A(a)(3); see 26 C.F.R. 1.1502-12. Second, a ratio is applied to the amount of the entity's "separate net operating loss" to allocate to that entity the portion of the entire consolidated loss that is attributed to the separate operations of the individual entity. 26 C.F.R. 1.1502-79A(a)(3).[16]

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[16] That ratio may be expressed as a fraction, the numerator of which is the consolidated loss of the entire group and the denominator of which is the sum of the "separate net operating losses" of the entities that had such losses. 26 C.F.R. 1.1502-79A(a)(3). Because the separate net operating losses of the affiliates that have losses may be used to offset positive income of other affiliates, this fraction will never be greater than one but will often be less than one.

In rejecting the contention advanced by petitioner that "there is no such thing as a separate net operating loss for any separate member of an affiliated group" (Pet. Br. 10-11), the court of appeals correctly pointed out that this anti-abuse regulation utilizes the exact concept of a "separate net operating loss" (26 C.F.R. 1.1502-79A(a)(3)) in directing application of the net operating loss carryback provisions in the consolidated return context. Pet. App. 21a. We agree with the court of appeals that the regulatory definition of the term "separate net operating loss" "is analogous to an individual's 'net operating loss' on a separate return." *Ibid.* We also agree that, if a situation arose in which a taxpayer had items that were excluded in the calculation of "separate taxable income" under 26 C.F.R. 1.1502-12(a), then application of the regulatory concept of "separate net operating loss" from the anti-abuse provisions of 26 C.F.R. 1.1502-79A(a)(3) by analogy would not be inappropriate.[17] But neither this case, nor

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Contrary to the suggestion of petitioner (Pet. Br. 35-36), however, the government has not advocated that this allocation formula, which was specifically developed in the anti-abuse regulation to address the special problem of separate return years (see *Amtel, Inc.* v. *United States*, 31 Fed. Cl. at 601), would apply outside that context. The court of appeals also did not apply that ratio in this case. Instead, it denied petitioner's claim expressly because the profitable affiliates in this case had no "separate net operating loss," and thus no unutilized "product liability losses" to carry to the consolidated level of petitioner's return. Pet. App. 21a-23a.

[17] The rationale applied by the court of appeals in this case appears to be a sensible way to harmonize the product liability loss provisions of Section 172 of the Code with the consolidated return regulations. The "separate net operating loss" described in 26 C.F.R. 1.1502-79(a)(3) adds the excluded consolidated items (under 26 C.F.R. 1.1502-12(a)) back to the separate taxable income of the

any other pending case of which we are aware, presents such a factual scenario.[18] See note 14, *supra*.

It is sufficient to resolve the present case to note that under both (i) the direct text of the regulations that were in fact in place in the relevant years (26 C.F.R. 1.1502-21(f)) and (ii) the analogous principles set forth in the anti-abuse rule for application of consolidated losses to separate entities (26 C.F.R. 1.1502-79A(a)(3)), product liability expenses must *first* be applied in determining the separate income of the affiliate to which the product liability has attached. Only the portion of that amount that remains *after* applying those expenses against the current income of that affiliate then passes to the consolidated entity, where it is then set off against items of current income of *other* affiliates before any then-remaining amount is eligible for carryback to prior years. Because, as petitioner concedes, none of the affiliates involved in this case that had product liability expenses had either a negative "separate taxable income" or a "separate net operating loss" (see notes 14, 18, *supra*), it is a mathematical fact that none of those affiliates had any unutilized product

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affiliate and is thus analogous to the "net operating loss" that would be computed if that entity filed a separate return. Because those two measures of separate income yield identical results in this case, however, whether the anti-abuse provisions should apply here should be left for resolution by the Treasury in prospectively applicable regulations adopted under the broad authority provided by Section 1502. See pages 28-29, *infra*.

[18] This issue could arise only if there were "consolidated items" derived from a particular affiliate—an affiliate with product liability expenses in that period—that were sufficient to alter a *positive* "separate taxable income" for that affiliate into a "separate net operating *loss*." This unusual factual combination has not been presented in any pending case.

liability loss deductions to carry to the consolidated return. Because these entities had no unused deductions, there were no "product liability losses" to account for at the consolidated level. The entire amount of the consolidated net operating loss is thus subject only to the three-year carryback authorized by Section 172(b), rather than the ten-year carryback provided for "product liability losses" under Section 172(j).

d. Congress has directed the Secretary of the Treasury—rather than the courts—to devise rules to ensure that consolidated returns achieve a full and clear reflection of income. 26 U.S.C. 1502. See *United States* v. *Correll*, 389 U.S. 299, 307 (1967).[19] It is evident from inspection of the complexities of the anti-abuse rules established in 26 C.F.R. 1.1502-79A that the Secretary will be required to give careful attention to ensuring that any detailed rule in this area guards against the "opportunity for juggling" that consolidated returns can provide in this and related contexts. *Woolford Realty Co.* v. *Rose*, 286 U.S. at 330. It is therefore appropriate to defer to the future the question whether the "separate net operating loss" definition contained in the anti-abuse regulations should apply, by analogy, to a case in which the facts could possibly call for application of such a rule. See note 18, *supra*. Since that issue is not presented on the facts of this case, and since Congress has authorized the Secretary to resolve this

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[19] "Congress has delegated to the Commissioner, not to the courts, the task of prescribing 'all needful rules and regulations for the enforcement' of the Internal Revenue Code." *United States* v. *Correll*, 389 U.S. at 307. Deference to the agency's interpretations "helps guarantee that the rules will be written by 'masters of the subject,' *United States* v. *Moore*, 95 U.S. 760, 763 (1878), who will be responsible for putting the rules into effect." *National Muffler Dealers Ass'n* v. *United States*, 440 U.S. 472, 477 (1979).

matter prospectively in legislative rules adopted under Section 1502, it is not necessary for the Court to attempt at this time to anticipate the Secretary's eventual ruling on that issue.

B. *Petitioner Is Not Entitled To The Product Liability Loss Deductions That It Claims In This Case*

Petitioner is wrong in contending that the court of appeals committed a "fundamental error" by "think[ing] of the issue in this case as involving the taxpayer's right to a deduction" (Pet. Br. 29). Petitioner cannot recover on its refund claims in this case unless it is allowed to carry back to its consolidated returns for 1973-1976 the same product liability expenses that have already been deducted in determining the *positive* net incomes of its profitable affiliates in the years 1983-1986. In *Charles Ilfeld Co.* v. *Hernandez*, 292 U.S. 62, 66 (1934), this Court held that an affiliated group that files a consolidated return is not entitled to a claimed deduction in the absence of a statutory provision or a consolidated return regulation "that fairly may be read to authorize it." That principle is dispositive of this case, for both the statute and the regulations preclude the double application of the deduction that petitioner proposes.

1. The text of Section 172 directs that product liability expenses be calculated at the individual taxpayer level and be applied first against the current income of that entity. By directing that product liability expenses be based on the "liability of the taxpayer" (26 U.S.C. 172(j)(2)(A)) and be reduced from the current income of that same "taxpayer" in calculating the "net operating loss" of that taxpayer (26 U.S.C. 172(j)(1)), Section 172 confines the benefit of an extended carryback of losses to the entity that is itself

liable for these product liability expenses. The statute has no application to, and provides no extended carryback benefits for, any affiliates of that taxpayer that are not themselves subject to such product liability.

Petitioner is incorrect in asserting (Pet. Br. 25-26) 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." 26 U.S.C. 7701(a)(14).[20] 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 this Court has emphasized, while a consolidated group files a return that aggregates information developed from the various separate affiliates, "[t]he fact is not to be ignored that each of [the] corporations joining * * * in a consolidated

[20] Section 7701(a)(1) of the Code provides that, "where not otherwise distinctly expressed or manifestly incompatible with the intent thereof," "[t]he term 'person' shall be construed to mean and include an individual, a trust, estate, partnership, association, company or corporation." 26 U.S.C. 7701(a)(1). By contrast, an affiliated group is defined for purposes of the Code as "1 or more *chains* of includible corporations connected through stock ownership with a common parent corporation * * *." 26 U.S.C. 1504(a)(1)(A) (emphasis added). Cf. *First Chicago NBD Corp.* v. *Commissioner*, 135 F.3d 457, 458 (7th Cir. 1998) (holding that a statute that referred to "a" corporation did not include an affiliated group of corporations that filed a consolidated return).

return is none the less a taxpayer." *Woolford Realty Co.* v. *Rose*, 286 U.S. at 328.

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. For example, Section 172(h)(4)(C) of the current Code provides a special rule for net operating loss carrybacks of any "corporate equity reduction interest loss" authorized under Section 172(b)(1)(E). It states that, "[e]xcept as provided by regulations, all members of an affiliated group filing a consolidated return under section 1501 shall be treated as 1 taxpayer *for purposes of this subsection and subsection (b)(1)(E)*." 26 U.S.C. 172(h)(4)(C) (1994 & Supp. IV 1998) (emphasis added). See also 26 U.S.C. 860E(a)(2) (1994 & Supp. IV 1998) ("All members of an affiliated group filing a consolidated return shall be treated as 1 taxpayer *for purposes of this subsection.*") (emphasis added); 26 U.S.C. 860J(d) (Supp. IV 1998) ("All members of an affiliated group filing a consolidated return shall be treated as one taxpayer *for purposes of this section.*") (emphasis added). Congress has not enacted similar language in Section 172 to provide for the carryback of product liability losses on a consolidated, rather than individual "taxpayer," basis. Although it is obvious that Congress knows how to provide for consolidated treatment of the special net operating loss provisions of Section 172 when it desires to do so, Congress made no such provision for the "product liability loss" carryback established under Section 172(j).

The "taxpayer" referred to in Section 172(j) is thus the corporation that itself has incurred product liability expenses and is unable fully to 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 product liability expenses. The statute is not designed to provide tax benefits for affiliated entities that (either by corporate design or by historical fact) themselves have no liability for these expenses. As the sponsor of this legislation explained (124 Cong. Rec. at 34,733 (Sen. Culver) (emphasis added)):

> The amendment would allow businesses to "carry back" product liability losses and apply them against taxable income for the 10 preceding years. This is an extension specifically for product liability losses 7 years beyond the 3-year period permitted for most business losses. By allowing businesses to use previous taxable income as at least a partial reserve against major product liability losses, the amendment would help assure that *a business which suffered a major product liability loss* would have the funds both to stay in business and provide reasonable compensation to injured consumers.

It is the "business which suffered [the] loss"—rather than the affiliates of that business which, due to their separate corporate existence, are not themselves liable for the loss—that the statute is designed to assist.

In enacting the "product liability loss" provision, Congress sought to assist only those corporations that experience financial difficulties from product liability. Congress did not provide any benefit to a profitable corporation even though that corporation might have had large product liability expenses. 26 U.S.C. 172(j)(1). The ten-year carryback authorized by Section 172(j) applies only when the product liability expenses cannot currently be utilized as deductions by the corporation because it incurred a net *loss* in the current period. *Ibid.* After a profitable corporation employs its product liability expense deductions to reduce its net income in the current period, there are no remaining unused deductions—or "product liability losses"—for it to pass on to its affiliates either as current deductions on the consolidated return or as a carryback to prior years under Section 172(j). See pages 16-18, *supra*.

2. For these same reasons, petitioner errs in contending that the fact that the consolidated return regulations ultimately yield a "consolidated" net operating income or loss means that the "product liability loss" provisions are to be applied *only* at the consolidated level. Pet. Br. 14-19. The consolidated net operating loss that is calculated under 26 C.F.R. 1.1502-21(a) is obtained only after first determining, and then aggregating, the "separate taxable income" of each separate affiliate. Although a few specific items (such as capital gains and charitable deductions) are treated as consolidated, rather than separate items, product liability expenses are treated initially at the separate entity level. Under the "separate taxable income" approach of the regulations, product liability expenses are first deducted against the current income of the individual affiliates that incurred them. See page 21, *supra*. As the court of appeals correctly concluded in this case, the requirement of the consolidated return regulations that a "separate taxable income" be computed for each affiliate "makes clear that blending those expenses is not permitted, *i.e.*, that a comparison of the group members' aggregated product liability expenses to the consolidated net operating losses in order to derive a consolidated 'product liability loss' is not intended." Pet. App. 16a. Instead, first "determining 'product liability loss' separately for each group member is correct and consistent with the regulations." *Id.* at 17a.

By contrast, petitioner is seeking to amend the consolidated return regulations to provide, as an additional "consolidated item" under 26 C.F.R. 1.1502-12, a consolidated, rather than separate, product liability expense deduction. On petitioner's theory of this case, the product liability expenses of each member of the group would be treated in the same manner as charitable deductions, capital gains and the other consolidated items specified in the regulations. See pages 22-23, *supra*. Under that theory, each member would compute its separate taxable income *without* taking into account its product liability expenses, and those expenses would instead be utilized as deductions only at the consolidated level.

The rule that petitioner proposes plainly conflicts with the express requirements of the regulations that the Secretary has promulgated under the broad authority of Section 1502. Under those regulations, each member of an affiliated group must take its product liability expenses into account in computing its "separate taxable income." See page 21, *supra*. Moreover, petitioner's attempt to aggregate those same expenses and take them into account only at the consolidated level also conflicts with the fundamental objectives of the statute, which seeks to provide benefits only for a business that itself incurs product liability expenses. 26 U.S.C. 172(j)(2). The statute is not designed to provide benefits for other corporations or affiliates which, either by intentional corporate design or historical accident, shoulder none of that exposure.[21]

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[21] Petitioner errs in asserting (Pet. Br. 22) that the Commissioner's position "ascribes overwhelming tax significance to the organizational structure of the taxpayer's business" and produces "a result that is completely at odds with the underpinnings of the

Petitioner's efforts to use its consolidated return to accomplish a tax benefit that Congress did not intend thus suffers from the defect identified by this Court in *Woolford Realty Co.* v. *Rose*, 286 U.S. at 330. In rejecting the taxpayer's effort in that case to employ a consolidated return to take advantage of deductions that Congress had not intended to allow, the Court stated (*ibid.*):

> Submission to such mischiefs would be necessary if the statute were so plain in permitting the deduction as to leave no room for choice between that construction and another. Expediency may tip the scales when arguments are nicely balanced. True, of course, it is that in a system of taxation so intricate and vast as ours there are many other loopholes unsuspected by the framers of the statute, many other devices whereby burdens can be lowered. This is no reason, however, for augmenting them needlessly by the addition of another.

Petitioner's claim in this case should be denied because petitioner has failed to sustain its "burden of clearly showing the right to the claimed deduction" under either the statute or the regulations. *INDOPCO, Inc.* v. *Commissioner*, 503 U.S. 79, 84 (1992) (quoting *Interstate Transit Lines* v. *Commissioner*, 319 U.S. 590, 593 (1943)). See also *Woolford Realty Co.* v. *Rose*, 286 U.S. at 330 (the statute is not "plain in permitting the deduction").

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consolidated tax return regime." The "product liability loss" provisions of Section 172 are not intended to provide benefits for corporations that, due to "the organizational structure" adopted by the affiliated enterprises, have kept themselves apart from any exposure to product liability claims. See page 32, *supra*.

3. Petitioner errs in asserting (Pet. Br. 19-20) that its approach in this case is "perfectly in harmony" with positions taken by the Internal Revenue Service in prior agency rulings. Petitioner 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 petitioner.[22] Moreover, the authorities that petitioner cites are simply unrelated to the issues presented in this case. The Notice of Proposed Rulemaking cited by petitioner (Pet. Br. 20-21) merely makes the unremarkable observation that, under the governing regulations (26 C.F.R. 1.1502-11 & 12), 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.[23] 56 Fed. Reg. 4229 (1991). As we have described in detail, however, these same regulations require each individual corporation with product liability expenses first to claim and utilize those deductions in computing its "separate taxable income." See pages 21-23, *supra*. The "separate taxable income" calculated independently for each of the several affiliates is *thereafter* combined to derive a consolidated income figure. *Ibid*. When, as in this case, the product liability expenses are

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[22] The technical advice memoranda and similar agency documents cited by petitioner have no precedential weight, and Congress has specified that such informal written determinations "may not be used or cited as precedent." 26 U.S.C. 6110(k)(3) (Supp. IV 1998). We cite them here only to address petitioner's misuse of these documents.

[23] Private Letter Ruling 88-16-002 (Dec. 31, 1987), which is cited by petitioner (Pet. Br. 19), similarly notes that an affiliated group computes a consolidated net operating loss *after* the separate taxable income of each affiliate is first determined.

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.

4. The Sixth Circuit erred in *Intermet Corp.* v. *Commissioner*, 209 F.3d 901 (2000), in reaching the contrary conclusion. Although the court stated in *Intermet* that the consolidated return "regulations do not specifically address" the application of the special ten-year carryback for a "specified liability loss" in the consolidated return context (209 F.3d at 905; see note 1, *supra*), the court ultimately concluded that this issue should be resolved by a provision in the regulations that neither party had cited. That regulation is 26 C.F.R. 1.1502-80(a), which specifies that "[t]he Internal Revenue Code, or other law, shall be applicable to the [consolidated] group to the extent the regulations do not exclude its application." The court in *Intermet* reasoned that, because the consolidated return regulations provide no specific rule for the treatment of product liability expenses, the entire affiliated group must be treated as a single "taxpayer" for purposes of Section 172(f). 209 F.3d at 906, 908.[24] The court stated that it found nothing in the regulations that modified the "default rule" in 26 C.F.R. 1.1502-80(a) that

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[24] The unexplained assertion of petitioner that "the Sixth Circuit did not rely on Treas. Reg. § 1.1502-80 to resolve the issue before it" (Pet. Br. 24) is refuted by the direct citation of that provision, and the direct reliance upon that provision, in the court's opinion. See 209 F.3d at 905-908. For example, the court of appeals stated that, "[t]o assess Intermet's position, the consolidated return regulations direct us first to determine whether the group, as opposed to its individual members, satisfies the Code's requirements for the SLL carryback. *See* Treas. Reg. § 1.1502-80(a)." 209 F.3d at 905-906.

requires the consolidated group to be treated as if it were a single taxpayer. 209 F.3d at 908.

The Sixth Circuit erred in its construction of this regulation. The regulation simply specifies that the usual rules found in the Internal Revenue Code, or other sources of law, apply to an affiliated group of corporations unless the consolidated return regulations exclude their application. 26 C.F.R. 1.1502-80(a). The usual rules of the Internal Revenue Code require each corporation to be treated as a separate taxpayer. See 26 U.S.C. 11(a). The usual rule incorporated into the consolidated return regulations is thus that the separate status of every corporation continues to be recognized except as the consolidated return regulations otherwise provide.[25] See also 26 C.F.R. 1.1502-12 ("[t]he 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"). As this Court stated in *Helvering* v. *Morgan's*, *Inc.*, 293 U.S. 121, 127 (1934), "[a]fter affiliation, as before, the affiliated corporations, although filing consolidated returns, continued to be separate taxable units." See also *Moline Properties, Inc.* v. *Commissioner*, 319 U.S. 436, 440 (1943) (an affiliated corporation is "as much a separate entity as if its stock had been transferred * * * to third persons"); *In re Chrome Plate, Inc.*, 614 F.2d 990, 996

[25] The example provided in the very next sentence of the regulation relied on by the court of appeals in *Intermet* makes clear that specific provisions of the Code continue to apply directly to individual members of the group when the consolidated return regulations have not specified otherwise. 26 C.F.R. 1.1502-80(a) ("[f]or example, in a transaction to which [26 U.S.C.] 381(a) applies, the acquiring corporation will succeed to the tax attributes described in section 381(c).").

(5th Cir. 1980) ("[t]he filing of [a consolidated return] * * * is insufficient to destroy the separate existence of the corporations").

It has thus long been held that the "general rule" established by this regulation is that, "to the extent the consolidated return regulations do not mandate different treatment, corporations filing consolidated returns are to be treated as separate entities when applying other provisions of the Code." *Gottesman & Co.* v. *Commissioner*, 77 T.C. 1149, 1156 (1981). Under 26 C.F.R. 1.1502- 80(a), "[w]here the consolidated return regulations do not require that corporations filing such returns be treated differently from the way separate entities would be treated, these corporations shall be treated as separate entities when applying provisions of the Code." *H Enterprises International, Inc.* v. *Commissioner*, 105 T.C. 71, 85 (1995).[26] The court of appeals erred in *Intermet* by giving this

[26] Petitioner acknowledges that, under the general rule of 26 C.F.R. 1.1502-80(a), "corporations filing consolidated returns are to be treated as separate entities to the extent that the consolidated return regulations do not require otherwise" (Pet. Br. 25). Petitioner merely contends that treating the members of an affiliated group as separate entities "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" (*ibid.*). In making that assertion, however, petitioner fails to account for the fact that the consolidated return regulations specify that product liability expenses must *first* be applied at the separate entity level and that only the unconsumed portion of such expenses may thereafter be applied at the consolidated level. See 26 C.F.R. 1.1502-12 & 21; pages 21-23, *supra*. Because all of the product liability expenses involved in this case were utilized at the separate entity level, there are no "product liability losses" to reach the consolidated return.

regulation an interpretation that simply turns its established meaning upside down.

As we have noted, no member of petitioner's affiliated group would have incurred a "product liability loss" under Section 172(j) if it had filed a separate return during the years in issue. See pages 7, 18 & note 14, *supra*. Application of the general rule of 26 C.F.R. 1.1502- 80(a) to this case would thus support rejection, rather than acceptance, of petitioner's claim. But there is, in any event, no need to rely on any "general" or "default" rule in this case, for the plain text of the regulations requires all product liability expenses first to be deducted in determining the separate income of the individual affiliate that incurred those expenses. 26 C.F.R. 1.1502-12(a); see pages 21-23, *supra*. On the facts of this case, there are no unutilized deductions at that level because each of these affiliates earned a profit during the relevant years. There are thus no "product liability losses" from these profitable affiliates to carry to the consolidated level or to carry back to prior years.

5. The rule that petitioner advocates would permit significant tax avoidance abuses. Under petitioner's approach, a corporation that is currently unprofitable but that 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.[27] Neither the terms nor the purpose of the

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[27] For example, a manufacturing company (with prior profits and current losses) that has no product liability exposure could

consolidated return regulations authorize that sort of "juggling" and trading of corporate tax attributes.[28] It is precisely because "[t]he mind rebels against the notion" that "an opportunity for juggling so facile and so obvious" should be permitted (*Woolford Realty Co.* v. *Rose*, 286 U.S. at 330) that Congress directed the Secretary to ensure that the consolidated return regulations be designed "to prevent avoidance of such tax liability." 26 U.S.C. 1502.

The result advocated by petitioner thus would not only contravene the text and intent of the product liability loss provisions in Section 172(j). It would also contravene the clear admonition of Congress, and of

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purchase a tobacco company (with both prior and current profits) that has significant product liability expenses. The combined entity could, on petitioner's theory, assert a ten-year carryback of "product liability losses" even though the tobacco company has always made a profit and never incurred a "loss" of any type. See also note 28, *infra*.

[28] In this respect, the anti-abuse regulation on which the court of appeals relied (26 C.F.R. 1.1502-79) reveals a fundamental flaw in petitioner's position. Four of the members of petitioner's affiliated group that computed positive separate taxable income and claimed product liability deductions between 1983 and 1986 (Jesco, Amtel, Litwin and Panamerican) were *not* members of petitioner's affiliated group during the years to which petitioner seeks to carry back its alleged product liability losses. It is clear under the anti-abuse regulation that, if those corporations had incurred "separate net operating losses" during the period from 1983 to 1986, those losses could have been carried back only to their *separate* return years under 26 C.F.R. 1.1502-79(a)(3) and could *not* have been carried back and used by petitioner. See notes 4, 6, *supra*. There is no logical reason why petitioner should be able to use these deductions to create product liability "losses" for itself simply because the affiliated corporations that actually incurred the product liability expenses realized profits instead of "losses."

this Court, that consolidated returns not be employed as an artifice to evade taxes.

CONCLUSION

The judgment of the court of appeals should be affirmed.

Respectfully submitted.

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