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Rules for Product Liability Losses for Consolidated Groups

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A group of affiliated corporations can elect to file a single consolidated Federal income tax return. The Treasury Regulations governing consolidated returns are among the most lengthy and confusing of any regulations promulgated by the Treasury Department. In order to calculate the consolidated taxable income of an affiliated group of corporations, some items of income are calculated separately for each member of the group, as if it filed its own separate return, and then aggregated together, while other items of income and deduction are calculated on a consolidated basis. These consolidated items include net operating losses, capital gain net income (or loss), charitable contribution deductions, and dividends-received deductions.

This complexity can be baffling even to tax specialists. It is certainly no wonder that, when non-specialist judges on the Courts of Appeals are faced with issues relating to the consolidated return regulations, mistakes, misinterpretations, and often, bad law, can be the unfortunate result. The United States Court of Appeals for the Fourth Circuit recently struggled with various aspects of the consolidated return regulations in its opinion in *United Dominion Industries, Inc. v. United States*.[1] The issue in that case was the proper amount of product liability expenses incurred by various corporations in a consolidated group that qualified for tax favored treatment as a "product liability loss."

The term "product liability loss" is defined in the Internal Revenue Code (the "Code") as the sum of the product liability expenses and other expenses incurred in the investigation or settlement of, or opposition to, claims against the taxpayer on account of product liability, that are otherwise allowable as deductions under the Code. Product liability losses may be carried back for <u>ten</u> years to offset income and generate refunds, rather than the normal rule of <u>three</u> years for other net operating loss carrybacks.[2] The amount of the product liability loss for any taxable year, however, cannot exceed the amount of the net operating loss for that year. Therefore, if a corporation has positive taxable income, it will not have any product liability loss regardless of the extent of its product liability expenses. For example, if the corporation had $300 of product liability expenses, but a net operating loss of $100, only $100 of its product liability expenses could be characterized as a product liability loss and carried back for 10 years to offset prior taxable income.

AMCA was the parent of an affiliated group of corporations that elected to file consolidated income tax returns. During the years at issue, AMCA claimed "product liability loss" deductions for $1,618,306 of product liability expenses incurred by various members of its group. While the consolidated group had a consolidated net operating loss that exceeded this amount, several of the individual corporations that incurred product liability expenses had positive taxable income, when computed on a "separate corporation" basis for the years at issue. The question before the court was how to compute the group's product liability loss: Was it necessary to compare the separate product liability expenses of each member with that member's separate taxable income (or loss), so that only the separately calculated product liability losses would be aggregated to determine the consolidated product liability loss? Neither the Code or the Treasury Regulations provides specific guidance as to the proper approach for calculating a consolidated product liability loss.

The taxpayers argued that the determination should be made on a consolidated basis, aggregating all of the product liability expenses incurred by the various members of the group and comparing that total to the consolidated net operating loss of the group, which resulted in the entire amount of the group's product liability expenses being characterized as a product liability loss. The Internal Revenue Service (the "Service") argued that the calculation should be done entity-by-entity; as several of the corporations which incurred product liability expenses had positive separate taxable income, the expenses incurred by those corporations would, thus, not be included in the total product liability loss of the group.

The court agreed with the Service on this point, noting that the Treasury Regulations explicitly define a consolidated net operating loss, but make no reference to a consolidated product liability loss. The Court placed great emphasis on this omission, stating that it "makes clear that blending those expenses is not permitted" and "confirms that product liability expenses are linked to the consolidated net operating loss only though their nexus to the group member, so that any related tax carryback benefits are therefore also tied to the group member." The court's reasoning is undercut, however, by the fact that the regulations quoted by the court were promulgated in 1966 -- long before 1979, the year in which the concept of a product liability loss was introduced into the Code -- and had not been subsequently amended. To rely on an omission in the regulations regarding a deduction that was not even available at the time that the regulations were written seems a weak, if not improper, justification for the court's opinion.[3]

The court also made another, perhaps more persuasive argument for its result, noting, "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"). . . . Because the tax regulations plainly provide the ten-year carryback only for "product liability loss" (and not for product liability expenses), we conclude that an interpretation removing the close nexus between such expenses and whether the affected company operated at a loss is inconsistent with the regulations."[4]

The court then proceeded to address the proper methodology for calculating whether each member had a product liability loss, as computed on a separate company basis. The Service argued that the product liability expenses of each member should be compared to that member's "separate taxable income." The "separate taxable income" of each member, as that term is defined in the consolidated return regulations, excludes income and deductions that would normally be included in the calculation of a corporation's taxable income or net operating loss if that entity was filing a separate return. Thus, a corporation might have a net operating loss computed under ordinary tax principles, although it simultaneously had positive "separate taxable income" computed under consolidated return principles. The court, therefore, agreed with the taxpayers that "separate taxable income" could not be the appropriate reference point in determining whether any given member of the group had a product liability loss.

The court rejected the taxpayer's argument, however, that the only net operating loss available for comparison is the consolidated net operating loss. Instead, the court allocated a portion of the consolidated net operating loss to each member of the group (the "separate net operating loss"). In order to do such an allocation, the court relied on a section of the Treasury Regulations designed to apportion the consolidated net operating loss to specific group members when one or more members leaves the group. While, as a computational matter, this approach to allocation could work for the issue before the court as well, there were no apparent legal grounds for the court to extend this single-purpose provision to the product liability loss area. The court therefore based this portion of its opinion solely on an analogy to an irrelevant provision. Without this analogy, the taxpayer might have been correct in its argument that the only net operating loss against which the separate product liability expenses could be compared was the consolidated net operating loss. The court thus ultimately held that the consolidated product liability loss had to be determined by looking at the product liability expenses of each member corporation, and comparing them to the portion of the consolidated net operating loss apportioned to that corporation. This result may well be correct, but the Fourth Circuit's opinion, unfortunately, does not justify it in a technically sound manner.

The court failed to take advantage of a large body of law and commentary addressing the broader question of whether or not the consolidated return regulations, as a general matter, view the group as a "single entity."[5] In fact, some commentators have concluded, "The basic concept underlying these [consolidated return] provisions is that the consolidated group is in substance a single taxable enterprise whose tax liability ought to be based on its dealings with outsiders."[6] Regardless of whether or not one agrees with that evaluation, however, a broader view of the issue would have resulted in a more nuanced opinion and in greater support, beyond a strained reading of a few individual provisions, for the court's conclusion.

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1 No. 98-2380 (4th Cir. March 24, 2000).

2 A 3-year carryback was in effect during the years at issue in this case, namely 1983-1986. Under current law, a non-product liability loss can be carried back for only two years.

3 There was a minor revision to the regulations in 1980 relating to the phrasing of the rules for "capital gain net income," but this did not reflect any intent by the Treasury to address (by indirection) other interim developments in the tax law.

4 While the court's *conclusion* may make sense, its articulation of the law is confused. For example, in numerous places throughout the opinion, the court refers to the "*parent*'s product liability loss" as the total of all of the member's product liability losses. This is incorrect. The parent corporation is treated like any other member of the group, and calculates its product liability loss on a separate basis. The court

means to refer to the *consolidated* product liability loss. The court also speaks of the "*parent*'s consolidated tax return," and the "*parent*'s consolidated net operating loss," when in fact, it means to refer to the group's consolidated tax return and consolidated net operating loss. Similarly, in explaining the calculation of a "net operating loss" *for* a year, the court provides as examples of allowable deductions, net operating loss carrybacks *to* that year and charitable contributions. However, the Code specifically *excludes* net operating loss carrybacks to a year from the calculation of a net operating loss for that year, and severely restricts the deductibility of charitable contributions in loss situations.

[5] This matter is addressed, with copious citations of authority, in section 6.04 ("Themes of Single Entity and Multiple Entities") of F. Peel, Consolidated Tax Returns (3d ed.).

[6] B. Bittker & L. Lokken, Federal Income Taxation of Income, Estates And Gifts, at 90-48 (2d ed. 1991).