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to: Associate Area Counsel (Thousand Oaks)
(Small Business/Self-Employed)

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subject: Priority of CERT and SLL Deductions

This Chief Counsel Advice responds to your request for assistance dated October 25, 2005. This advice may not be used or cited as precedent.

LEGEND

Taxpayer =

Target =

Year 1 =

Year 2 =

\$A =

\$B =

\$C =

\$D =

\$E =

ISSUES

(1) May a taxpayer net interest income against interest deductions in determining the amount of allocable interest deductions under section 172(h)(2)¹?

(2) In determining which deductions generate a net operating loss, do allocable interest deductions or specified liability loss deductions take priority?

CONCLUSIONS

(1) A taxpayer cannot net interest income against interest deductions in determining the amount of allocable interest deductions under section 172(h)(2).

(2) Allocable interest deductions take priority over specified liability loss deductions in determining which of the two types of deductions generate an NOL.

FACTS

In Year 1, Taxpayer, a corporate taxpayer, acquired Target in a stock acquisition that qualified as a corporate equity reduction transaction (CERT) within the meaning of section 172(h)(3). For Year 2, Taxpayer reported \$A of allocable interest deductions as defined in section 172(h)(2), the type of deductions that may generate a section 172(h)(1) corporate equity reduction interest loss (CERIL) resulting from a CERT. In determining its allocable interest deductions, Taxpayer netted interest income against interest expense. Without allowing an offset against interest income, Taxpayer's allocable interest deductions would have been \$B. For Year 2, Taxpayer also claimed \$C of deductions that could potentially generate a specified liability loss (SLL) as defined in section 172(f).

For Year 2, Taxpayer claimed a net operating loss (NOL) of \$D. Taxpayer treated \$C of the NOL as a SLL. Taxpayer treated the remainder of the NOL, that is \$E, as a CERIL. Taxpayer claims that in determining the portion of an NOL that is attributable to SLL deductions and the portion that is attributable to allocable interest deductions, the SLL deductions take priority.

LAW AND ANALYSIS

Issue 1

¹ Section and Code references refer to the Internal Revenue Code of 1986 as applicable to the taxable years at issue.

Section 172(b)(1)(E)(i) prohibits carrying back a CERIL to a taxable year preceding the taxable year in which the CERT occurs. Section 172(h)(1) defines a CERIL with respect to any loss limitation year, as the excess (if any) of --

- (A) the NOL for such taxable year, over
- (B) the NOL for such taxable year determined without regard to any allocable interest deductions otherwise taken into account in computing such loss.

Section 172(h)(2)(A) defines "allocable interest deductions" as deductions allowed under Chapter 1 of the Code for interest on the portion of any indebtedness allocable to a CERT. Section 163(a) generally allows as a deduction all interest paid or accrued within the taxable year on indebtedness.

As indicated, section 172(h)(2)(A) expressly limits allocable interest deductions to those deductions that are allowed under Chapter 1 of the Code. The provisions of section 172(h)(2) do not state, nor do they imply, that these deductions should be netted in any manner against any income items, such as interest income, and nothing else in the Code, the legislative history underlying the CERT provisions, or any other tax authority suggests that a taxpayer should be allowed to offset the interest that it incurs in a CERT against its unrelated interest income for purposes of determining its allocable interest deductions under section 172(h)(1)(B). Indeed, allowing such an offset could, under certain circumstances, allow a taxpayer to completely contravene the carryback restrictions in section 172(b)(1)(E)(i) despite having engaged in a highly leveraged CERT. Congress obviously did not intend for such a result.

Consequently, Taxpayer cannot net its interest income against its interest deductions for purposes of arriving at the allocable interest deductions from which its CERIL is computed.

Issue 2

Section 172(a) provides a deduction equal to the aggregate of the NOL carryovers and carrybacks to the taxable year. Section 172(b)(1)(A) generally provides an NOL carryback period consisting of each of the 2 taxable years preceding the taxable year of the loss and an NOL carryover period equal to the 20 taxable years following the taxable year of the loss. Section 172(b)(2) requires the entire NOL to be carried first to the earliest taxable year to which it may be carried, and then, to the extent the NOL has not been absorbed by modified taxable income in taxable years to which it has already been carried, to succeeding taxable years in the carryback and carryover periods.

Section 172(b)(1)(B) through (H) provide exceptions to the normal NOL carryback and carryover periods prescribed by section 172(b)(1)(A). Section 172(b)(1)(C) provides a 10-year NOL carryback period for a SLL. Section 172(b)(1)(E)(i) provides that a CERIL incurred in any loss limitation year may not be carried back to a taxable year preceding the taxable year in which the CERT occurs. For this purpose, a loss limitation year

includes the taxable year in which the CERT occurs and the 2 succeeding taxable years.

With certain modifications², a corporate taxpayer's NOL for a taxable year equals the excess, if any, of the deductions allowed to the taxpayer by Chapter 1 of the Code over the taxpayer's gross income for the taxable year. See §172(c); Treas. Reg. § 1.172-2.

Section 172(f)(1) defines a SLL as the sum of certain deductions *to the extent taken into account* [emphasis supplied] in computing the NOL for the taxable year. These deductions include certain section 162 or 165 deductions associated with product liability and certain deductions attributable to the satisfaction of 5 types of liabilities arising under federal or state law. A taxpayer's SLL for a taxable year cannot exceed the taxpayer's NOL for that taxable year. Section 172(f)(2).

For any loss limitation year, section 172(h)(1) defines a CERIL as the excess, if any, of (1) the NOL for the taxable year, over (2) the NOL for such taxable year determined without regard to any allocable interest deductions otherwise taken into account in computing the NOL. For purposes of section 172(h)(1), section 172(h)(4)(A) provides that allocable interest deductions are taken into account last in computing the NOL.

If a taxpayer has gross income and deductions, the deductions may either offset gross income or, to the extent they exceed gross income, generate an NOL. If the sum of a taxpayer's SLL deductions and allocable interest deductions exceeds the amount of the taxpayer's NOL, it is necessary to determine what portion of each type of deduction is taken into account in computing the NOL.

As previously stated, the Code generally defines an NOL as the excess of allowable deductions over gross income. Thus, if a taxpayer incurs an NOL and one ignores the possible effect of the allowance of one deduction on another deduction or item of gross income, the marginal effect of removing a single dollar of any type of deduction results in a one dollar reduction in the NOL. This holds true for every additional dollar of deduction removed until the entire NOL is eliminated. In the absence of any explicit ordering rule, one might argue that each type of deduction should be allocated pro-rata between offsetting gross income and generating the NOL based on the relative amounts of the deductions.

² Section 172(d)(5) provides that percentage of taxable income limitations on certain dividends received deductions, as well as certain limitations on dividends paid deductions on certain preferred stock, are to be disregarded in computing the NOL of a corporate taxpayer. The limitations on dividends received deductions are also disregarded in computing a corporate taxpayer's taxable income if to do so would result in an NOL. If an additional dollar of deduction causes these limitations on dividends received or paid deductions to no longer apply, the marginal impact of that additional dollar of deduction on the taxpayer's taxable income and NOL may be quite substantial. To avoid unnecessary complexity, and because it is not germane to the points being made, the discussion in the text disregards the possible impact of any dividends received or paid deductions on taxable income or the taxpayer's NOL.

However, to determine the amount of a CERIL, section 172(h)(4)(A) explicitly requires that allocable interest deductions be taken into account last in computing the NOL. Because allocable interest deductions must be taken into account last in computing the amount of any NOL, section 172(h) treats the NOL as first generated by allocable interest deductions.

On the other hand, section 172(f)(1) defines a SLL as the sum of certain deductions *to the extent taken into account* [emphasis supplied] in computing the NOL for the taxable year. In most situations, the Service has treated SLL loss deductions as taken into account last in determining what portion of an NOL qualifies as a SLL. However, in contrast to the explicit ordering rule found in section 172(h)(4)(A), the vague directive in section 172(f)(1) does not require that SLL deductions always be taken into account last in determining what portion of an NOL qualifies as a SLL. Consequently, where a taxpayer incurs an NOL and has both allocable interest deductions and SLL deductions, giving the allocable interest deductions first priority in characterizing the nature of the NOL gives full effect to and harmonizes both statutory provisions.

The ordering rule of section 172(h)(4)(A) technically only applies for purposes of section 172(h)(1), that is, for purposes of defining a CERIL, rather than for purposes of all of section 172. Because of this, one might argue that section 172(h)(4)(A) does not prevent treating both allocable interest deductions and specified liability loss deductions as taken into account last in generating an NOL. However, doing so would create a conflict between the SLL provisions and the provisions dealing with CERILs.

Determining the taxable years to which a loss may be carried constitutes the most importance consequence of classifying a loss as either a SLL or a CERIL. Whereas a SLL may be carried back up to 10 taxable years preceding the taxable year of the loss, a CERIL may not be carried back to any taxable year preceding the taxable year in which the CERT occurs. Application of the CERIL carryback limitations prohibits NOL carrybacks to taxable years to which a SLL may be carried. It is a longstanding rule of statutory construction that “every part of a statute must be construed in connection with the whole, so as to make all the parts harmonize, if possible, and give meaning to each.” *Market Co. v. Hoffman*, 101 U.S. 112, 116 (1879). “[W]here possible, provisions of a statute should be read so as not to create a conflict.” *Louisiana Public Service Commission v. FCC*, 476 U.S. 355, 370 (1986) Because it is impossible to apply the SLL and CERIL carryback rules to the same loss, interpreting the provisions at issue to allow such a characterization would be incorrect.

Moreover, even if we were to find a conflict between the two statutes, in resolving that conflict the more specific language of sections 172(h)(4)(A) and 172(h)(1) controls over the general language of section 172(f)(1) unless Congress has manifested a contrary aim. *Greene v. United States*, 79 F.3d 1348, 1355 (2d Cir.), *cert. denied*, 519 U.S. 1028 (1996). Neither the legislative history to section 172(h) nor the legislative history to any of the acts dealing with SLLs discuss the interaction of the SLL and CERIL provisions. Here, the only evidence of intent must be drawn from the statutory language itself.

Based on well-established statutory construction principles, we conclude that allocable interest deductions take priority over SLL deductions in characterizing the nature of an NOL.

In MARTIN D. GINSBURG & JACK S. LEVIN, *MERGERS, ACQUISITIONS, AND BUYOUTS, A TRANSACTIONAL ANALYSIS OF THE GOVERNING TAX, LEGAL, AND ACCOUNTING CONSIDERATIONS*, Vol. 3 ¶1208.1.1 (July 2005), the authors discuss an argument similar to that set forth above for treating allocable interest deductions as taking priority over SLL deductions in characterizing NOLs. However, the authors also present the following two part alternative argument for treating SLL loss deductions as having priority over allocable interest deductions:

It can be argued that the SLL rules should control, because (1) the basic CERT limitation rule in Code §172(b)(1)(E)(i) (which was enacted after the SLL rules) refers only to the regular 2-year carryback period, not to the 10-year carryback rule for SLLs and (2) the 2-year carryback rule of Code §172(b)(1)(A) expressly incorporates the CERT carryback limitation by its opening words (“Except as otherwise provided in this paragraph”), whereas the 10-year SLL carryback rule of Code §172(b)(1)(C) does not expressly incorporate the CERT carryback limitation. Both points imply that Congress did not intend the CERT rules to limit 10-year SLL carrybacks.

Id.

We find these alternative arguments unpersuasive. Section 172(b)(1)(A) provides the general rule for the taxable years to which an NOL may be carried. The remainder of the subparagraphs under paragraph (1) of subsection (b) of section 172 (“Except as otherwise provided in this paragraph”) provide exceptions to the general rule. Some of these exceptions are based on the nature of the loss, some on the nature of the taxpayer, and some on a combination of taxpayer status and the nature of the loss. Included within these exceptions are the special rules for CERILs as well as the exceptions for every other special type of loss, including SLLs. The statutory structure is simple, a general rule followed by a list of exceptions.

The first step to determining the taxable years to which an NOL may be carried is to characterize the nature of the NOL, that is, as either a garden variety NOL, a special type of NOL such as a SLL or CERIL, or some combination thereof. Once this has been done, with one primary exception³, section 172(f)(1)(A)-(H) simply provides rules concerning the taxable years to which the NOL may be carried. To determine if any portion of an NOL should be characterized as anything other than a garden variety NOL, the Code provisions which define the special types of NOLs control, not the provisions that indicate the taxable years to which non-garden variety NOLs may be

³ Section 172(b)(1)(F) provides rules defining a special type of NOL and the taxable years to which it may be carried back.

carried. As previously demonstrated, the most logical interpretation of the statutory rules defining CERILs and those defining SLLs indicate that allocable interest deductions take precedence over SLL deductions in characterizing an NOL.

The presence or absence of cross references between the provisions of section 172(b)(1)(A)-(H) has no relevance to the issue of whether allocable interest deductions or SLL deductions take precedence in determining the character of an NOL. The CERIL carryback and carryover rules expressly incorporate part of the general carryback rule and carryover rule of section 172(b)(1)(A). Specifically, section 172(b)(1)(E)(i) provides that a CERIL shall be an NOL carryback and carryover to the taxable years described in subparagraph (A) except that such loss shall not be carried back to a taxable year preceding the taxable year in which the CERT occurs. The taxable years described in subparagraph (A) are the 2 taxable years preceding the year of the loss and the 20 taxable years following the taxable year of the loss. Section 172(b)(1)(E)(i) simply provides an exception to the normal carryback period if the carryback would otherwise be to a taxable year preceding the year of the CERT.

There will be instances in which it will be permissible to carry a CERIL back to taxable years provided for by the general rule. For example, a CERIL may be carried back to the 2d taxable year preceding the loss if the loss limitation year in which the CERIL is incurred is the 2d succeeding taxable year following the taxable year of the CERT. Because a CERIL may only be incurred for the taxable year of the CERT and the two succeeding taxable years, and a CERIL can never be carried back to a taxable year preceding the taxable year of the CERT, it goes without saying that a CERIL may not be carried back to the 8-10 additional preceding taxable years to which a SLL may be carried. Contrary to alternative argument (1), the fact that the CERIL carryback rule refers to the general carryback rule in section 172(b)(1)(A) and not to the 10-year carryback period for SLLs has no bearing on the question of whether Congress intended for the SLL rules or the CERIL rules to take priority in characterizing an NOL.

The cross reference in section 172(b)(1)(E)(i) to the general rule of section 172(b)(1)(A) might be relevant to the priority of deductions issue if the cross-reference incorporated exceptions to the general rule other than the CERIL exception. This is not the case. Section 172(b)(1)(E)(i) does not incorporate any of the exceptions to section 172(b)(1)(A). Section 172(b)(1)(E)(i) does not refer to the opening clause of section 172(b)(1)(A) ("Except as otherwise provided in this paragraph"). It simply provides a general rule, subject to an exception for taxable years preceding the taxable year of a CERT, that CERILS shall be carried back and carried over to the taxable years described in section 172(b)(1)(A). Those taxable years are the 2 taxable years preceding the taxable year of the NOL and the 20 taxable years following the taxable year of the NOL.

Moreover, even if the language of section 172(b)(1)(E)(i) could be interpreted as including a reference to the opening clause of section 172(b)(1)(A), this would not provide a basis for giving SLL deductions priority over allocable interest deductions.

“Except as otherwise provided in this paragraph” includes all of the exceptions to section 172(b)(1)(A), including the carryback restrictions on CERILs.

Regarding alternative argument (2), that the section 172(b)(1)(C) special carryback rule for SLLs makes no reference to the section 172(b)(1)(E) CERIL carryback rules has no significance in determining which deductions have priority in characterizing an NOL. Likewise, whereas the opening clause of section 172(b)(1)(A) may be fairly interpreted to refer to the rules for CERILS in section 172(b)(1)(E), this opening clause (“Except as otherwise provided in this paragraph”), refers to all the exceptions to the general rule of section 172(b)(1)(A). We fail to see how alternative argument (2) has any bearing on the deduction priority issue.

For the reasons set forth above we conclude that allocable interest deductions have priority over SLL deductions in determining the character of an NOL. Because Taxpayer cannot net its interest income against its interest deductions to compute allocable interest deductions, for Year 2 Taxpayer has \$B of allocable interest deductions. Because Taxpayer’s NOL for Year 2 is only \$D, the entire NOL constitutes a CERIL.

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