**INTERNAL REVENUE SERVICE**
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

April 06, 2004

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Taxpayer's Name:
Taxpayer's Address:

Taxpayer's Identification No
Years Involved:
Date of Conference:

**LEGEND:**

| | |
|---|---|
| Parent | = |
| Target | = |
| Date 1 | = |
| Date 2 | = |
| Date 3 | = |
| X | = |
| Y | = |
| Z | = |

**ISSUE(S):**

For purposes of applying the corporate equity reduction transaction (CERT) rules of sections 172(b)(1)(E) and (h):

(1) Should the interest expense incurred by Target on post-CERT third-party debt be included in the determination of the allocable interest deduction for the loss limitation years?

(2) Should the interest expense incurred by Target on pre-CERT third-party debt be included in the P group's 3-year interest expense average for purposes of calculating the allocable interest deduction limitation under section 172(h)(2)(C)?

**CONCLUSION(S):**

(1) Under section 172(h)(4)(C), Target's post-CERT interest expense on third-party debt must be taken into account in determining the P group's allocable interest deductions under section 172(h)(2).

(2) Target's pre-CERT interest expense on third-party debt must be taken into account in computing the P group's 3-year interest expense average for purposes of calculating the section 172(h)(2)(C) limitation.

**FACTS:**

The information submitted indicates that Parent is the common parent of a consolidated group (the P group) that files its returns on the basis of a calendar taxable year.

On Date 1, Parent purchased all of the outstanding stock of Target, an unrelated corporation (the "Acquisition"). Prior to the Acquisition, Target was the common parent of a consolidated group. As a result of the Acquisition, Target and its subsidiaries became members of the P group.[1]

Parent financed the Acquisition, in part, by borrowing either $X (according to the taxpayer) or $Y (according to Examination) from a third-party lender.[2] Both prior and

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[1] For purposes of this memorandum, all further references to Target include Target's subsidiaries.

[2] The factual disagreement between the parties on the amount borrowed is immaterial to the conclusions reached in this memorandum.

subsequent to the Acquisition, Parent and Target each incurred interest expenses on the repayment of third-party debt.

**LAW:**

Section 172(b)(1)(E)(i) provides, in pertinent part, that if there is a corporate equity reduction transaction and an applicable corporation has a corporate equity reduction interest loss for any loss limitation year ending after August 12, 1989, then the corporate equity reduction interest loss shall be a net operating loss carryback and carryover, except that such loss shall not be carried back to a taxable year preceding the taxable year in which the corporate equity reduction transaction occurs.

Section 172(b)(1)(E)(ii) defines the term “loss limitation year” as the taxable year in which a corporate equity reduction transaction occurs and each of the 2 succeeding taxable years.

Section 172(b)(1)(E)(iii)(I) defines an "applicable corporation" to include a C corporation that acquires stock, or the stock of which is acquired in a major stock acquisition.

Section 172(h)(1) provides that the term "corporate equity reduction interest loss" means, with respect to any loss limitation year, the excess (if any) of--

(A) the net operating loss for such taxable year, over

(B) the net operating loss 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 corporate equity reduction transaction. Under section 172(h)(2)(B), indebtedness is allocated to a corporate equity reduction transaction in the manner prescribed in section 263A(f)(2)(A)(ii) (not tracing interest directly related to any transaction actually related to the CERT; rather, the interest cost of engaging in the CERT is determined using the taxpayer’s weighted average cost of borrowing).

Section 172(h)(2)(C) provides that allocable interest deductions for any loss limitation year shall not exceed the excess (if any) of--

(i) the amount allowable as a deduction for interest paid or accrued by the taxpayer during the loss limitation year, over

(ii) the average of such amounts for the 3 taxable years preceding the taxable the year in which the corporate equity reduction transaction occurred.

Section 172(h)(3)(A)(i) provides that a corporate equity reduction transaction includes a "major stock acquisition," which section 172(h)(3)(B)(i) generally defines as the acquisition by a corporation of 50 percent or more (by vote or value) of the stock in another corporation.

Section 172(h)(4)(C) provides that all members of an affiliated group filing a consolidated return under section 1501 shall be treated as 1 taxpayer for purposes of sections 172(b)(1)(E) and (h).

Treas. Reg. §1.1502-76(b)(1)(i) provides, in pertinent part, that a consolidated return must include the common parent's items of income, gain, deduction, loss, and credit for the entire consolidated return year, and each subsidiary's items for the portion of the year for which it is a member. If the consolidated return includes the items of a corporation for only a portion of its tax year determined without taking this section into account, items for the portion of the year not included in the consolidated return must be included in a separate return (including the consolidated return of another group).

Treas. Reg. §1.1502-76(b)(1)(ii)(A)(1) generally provides that if a corporation becomes or ceases to be a member during a consolidated return year, it becomes or ceases to be a member at the end of the day on which its status as a member changes, and its tax year ends for all Federal income tax purposes at the end of that day.

**ANALYSIS:**

Background

Sections 172(b)(1)(E) and (h) (the "CERT Rules") generally limit the ability of a C corporation to carry back a net operating loss (NOL) incurred as a result of a corporate equity reduction transaction (CERT). In enacting these provisions, Congress expressed concern that the interest expense associated with certain debt-financed transactions did not have a sufficient nexus with prior period operations to justify the carryback of NOLs attributable to such expense. See H.R. Rep. No. 247, 101st Cong., 1st Sess. 1250 (1989), reprinted in 1989 U.S.C.C.A.N. 1906, 2720. Accordingly, the CERT Rules identify a portion of the NOL (called the corporate equity reduction interest loss, or CERIL) as effectively tainted, and prohibit the carryback of the CERIL to tax years preceding the CERT.

A special rule in section 172(h)(4)(C) treats all members of an affiliated group filing a consolidated return as 1 taxpayer for purposes of the CERT Rules. Thus, if a group member engages in a CERT, the losses of all members are potentially subject to limitation under the CERT Rules.

In the case of a consolidated group, the CERIL is equal to (A) the consolidated net operating loss (CNOL)[3] for the taxable year, over (B) the CNOL for the taxable year determined without regard to any allocable interest deductions otherwise taken into account in computing such loss. Section 172(h)(1). Allocable interest deductions are interest deductions allowable on the portion of any indebtedness allocated to a CERT. Section 172(h)(2)(A). The Avoided Cost Method of section 263A(f)(2)(A)(ii) is used to allocate indebtedness to a CERT. Section 172(h)(2)(B). The Legislative History describes this method of allocation as follows:

> [A] corporation's indebtedness is allocable to a CERT to the extent that the corporation's indebtedness could have been reduced if the CERT had not occurred, in the manner prescribed under section 263A(f)(2)(A)(ii) (without regard to clause (i) thereof). The interest expense associated with such indebtedness is equal to a pro rata portion of the corporation's total interest expense.

H.R. Rep. No. 247, 101st Cong., 1st Sess. 1251 (1989), reprinted in 1989 U.S.C.C.A.N. 1906, 2721. Therefore, the allocable interest deductions are computed by determining the amount of borrowing necessitated by participation in the CERT (regardless of whether the borrowing was incurred specifically in connection with the CERT). That borrowing is then deemed to produce interest expense at the taxpayer's weighted-average cost of borrowing.[4]

In this case, the parties agree that Parent's purchase of all of Target's stock constituted a "major stock acquisition" within the meaning of section 172(h)(3)(B)(i), and that each of Parent and Target qualifies as an "applicable corporation" as defined in section 172(b)(1)(E)(iii)(I). The parties further agree that Parent's acquisition of Target is a CERT under section 172(h)(3)(A)(i).

Issue One: Should the interest expense incurred by Target on post-CERT third-party debt be included in the determination of the allocable interest deduction for the loss limitation years?

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[3] The CNOL, which is the equivalent of negative taxable income, is computed by combining all of the members' separate and consolidated items for the taxable year, but excluding any CNOL deduction (carried over or carried back from another year). See §1.1502-21(e) and 1.1502-21A(f).

[4] Because the consolidated group is treated as a single taxpayer, the section 263A weighted-average computation must be done on a group-wide basis.

The taxpayer notes that section 172(h)(4)(C) treats all members of a consolidated group as 1 taxpayer for purposes of the CERT Rules. The taxpayer argues that because Target became a member of the P group as a result of the CERT, Parent and Target are treated as a single taxpayer under section 172(h)(4)(C). Therefore, the taxpayer concludes that Target's post-CERT interest expense on third-party debt must be taken into account in determining the interest expense that is subject to limitation under the CERT Rules.

Relying on the legislative history, Examination asserts that, in enacting the CERT Rules, Congress did not intend to affect a corporation's pre-acquisition debt, but rather to limit the carryback of losses attributable to interest expense on additional debt that was incurred by the acquiring corporation to fund an acquisition. Examination, therefore, contends that only the original borrower's interest deductions should be taken into account for purposes of determining the allocable interest deduction. Examination notes that, in this case, Parent incurred interest expense through borrowing for purposes of financing the acquisition of Target. Examination concludes that Target's post-CERT interest expense on third-party debt should not be included in the determination of the allocable interest deduction for the P group.

In this case, as a result of the Date 1 Acquisition, Target became a member of the P group on Date 2; i.e., the beginning of the day following the Acquisition. §1.1502-76(b)(1)(ii)(A)(1). The Acquisition, which constituted a CERT, occurred during the Z taxable year. Thus, Z is a loss limitation year. Section 172(b)(1)(E)(ii). Because Target was a member of the P group in a loss limitation year, section 172(h)(4)(C) treats all group members as a single taxpayer, and therefore requires Target's post-CERT interest expense on third-party debt to be taken into account in determining the P group's allocable interest deductions for purposes of the CERT Rules.

Issue Two: Should the interest expense incurred by Target on pre-CERT third-party debt be included in the P group's 3-year interest expense average for purposes of calculating the allocable interest deduction limitation under section 172(h)(2)(C)?

As noted supra, the Avoided Cost Method generally has the effect of allocating a taxpayer's new and outstanding indebtedness to a CERT. The impact of this allocation method may be mitigated in certain cases by the application of section 172(h)(2)(C). This mitigating rule has the effect of limiting the CERIL (and thus, the extent to which losses are subject to the carryback limitations of the CERT Rules) to the lesser of (1) the allocable interest deductions for the loss limitation year, or (2) the excess (if any) of the taxpayer's allowable interest expense for the loss limitation year over the average of such amounts for the 3 taxable years prior to the taxable year in which the CERT occurred.

We concluded supra that under section 172(h)(4)(C), Target's post-CERT interest expense must be taken into account in determining the P group's allocable interest deductions. The related issue arises whether, in calculating the section 172(h)(2)(C) limitation, Target's pre-CERT interest is to be taken into account.

The taxpayer argues that if, under section 172(h)(4)(C), Target's post-CERT interest deductions are to be included in determining the P group's allocable interest deductions, as a matter of symmetry it follows that Target's pre-CERT interest expense must enter the calculation of the section 172(h)(2)(C) limitation. The taxpayer contends that the failure to adopt a symmetrical approach would distort taxable income by artificially inflating the amount of interest expense that is allocated to the CERT.

Examination concurs that a symmetrical approach to the treatment of pre- and post-CERT interest expense is necessary. Consistent with its position under Issue One, supra, Examination contends that only the original borrower's interest expense should be included in the section 172(h)(2)(C) 3-year baseline. Examination observes that, in this case, Parent incurred additional interest expense by borrowing to fund the acquisition of Target. Therefore, Examination maintains that in applying section 172(h)(2)(C), Target's pre-CERT interest expense is to be excluded from the P group's 3-year average interest expense.

The section 172(h)(2)(C) limitation measures the extent to which the taxpayer's post-CERT interest expense has increased over a historical 3-year baseline. In the absence of a net increase, no losses will be tainted under the CERT Rules. In the case of a CERT involving a consolidated group, any change in the composition of the group between the 3-year baseline and the loss limitation year potentially affects the computation of the section 172(h)(2)(C) limitation, thereby increasing or decreasing the amount of interest allocated to the CERT. Where, as in this case, new members join the group as a result of the CERT, it is important that the group members whose interest expense is factored into the allocable interest deduction in the loss limitation year also be included among the members for whom the 3-year average is computed. Otherwise, if an asymmetrical approach were adopted (e.g., excluding Target's pre-CERT interest expense from the 3-year baseline while including Target's post-CERT interest expense in the P group's allocable interest deductions), the imbalance would have the effect of artificially inflating the interest expense associated with the CERT.

Accordingly, because section 172(h)(4)(C) requires Target's interest expense to be taken into account in computing the P group's allocable interest deductions, it follows that Target's interest expense must also be taken into account in computing the average interest expense in the 3-year baseline under section 172(h)(2)(C).

As a final matter, we note that Target joined the P group on Date 2, and thus, had a short taxable year for the period from Date 3 through Date 1. See §1.1502-

76(b)(1)(i). Solely for purposes of determining the P group's allocable interest deductions and the section 172(h)(2)(C) limitation, Target's short year should be disregarded and Target's taxable years should be aligned with those of the P group in order to clearly reflect income. Cf. section 1502 (authorizing issuance of regulations to ensure the clear reflection of the consolidated group's income tax liability).

CAVEAT(S):

A copy of this technical advice memorandum is to be given to the taxpayer(s). Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.