Office of Chief Counsel
Internal Revenue Service

memorandum

CC:LM[redacted]:TL-N-2101-98
[redacted]

date:

to: Territory Manager, [redacted], LM:[redacted], Team Manager

from: LMSB Counsel,[redacted]

---

subject: [redacted]- I.R.C. Sec. 172(f) Specified Liability Losses

This memorandum is pursuant to your request for assistance regarding specified liability losses claimed by[redacted]for the taxable years [redacted] and [redacted].

ISSUE

Whether deductions for the following categories of expenses are specified liability losses pursuant to I.R.C. Sec. 172(f):

a. Product liability.

b. Product liability investigation, settlement and/or opposition expenses.

c. Interest on federal tax deficiencies.

d. Expenses related to the reclamation/remediation of hazardous waste sites.

e. Interest on state tax deficiencies.

f. Settlement payments related to a[redacted]audit.

g. Settlement payments related to Tarriffs and excise taxes.

h. Payments related to claims brought under the [redacted]Act

i. Payments for claims and expenses related to various federal and state consumer protection laws/acts.

CONCLUSION

The following categories are specified liability losses pursuant to I.R.C. Sec. 172(f):

a. Product liability.

b. Product liability investigation, settlement and/or opposition expenses to the extent that they are related to specific liability claims.

d. Expenses related to the reclamation/remediation of hazardous waste sites.

The remaining categories of deductions are not allowable as specified liability losses pursuant to I.R.C. Sec 172(f).

FACTS

In [redacted] reported a net operating loss of $[redacted] Of this loss, $[redacted] was carried back [redacted] years to [redacted], and $[redacted] was carried back [redacted] years to [redacted] under I.R.C. Sec. 172 (b)(1)(C) as specified liability losses. In [redacted] reported a net operating loss of $[redacted] Of this loss, $[redacted] was carried back [redacted] years to [redacted] and, $[redacted] was carried back [redacted] years to [redacted] under I.R.C. Sec. 172 (b)(1)(C) as specified liability losses.

On [redacted] filed an amended informal claim increasing the portion of the [redacted] NOL attributable to specified liability losses from $[redacted] to $[redacted] and increasing the portion of the [redacted] NOL attributable to specified liability losses from $[redacted] to $[redacted]

The breakdown of the portions of the NOLS for [redacted] and [redacted] attributable to specified liability losses consists of 14 separate categories. (See att. A-Spreadsheet of 172(f) losses). This advice memorandum addresses nine of those fourteen categories.

a. Product liability

The amounts attributable to [redacted]s claimed specified liability losses for product liability expenses are $[redacted] and $[redacted] for the years [redacted] and [redacted] respectively.

During [redacted], [redacted] instituted the [redacted] program with their insurance carrier, [redacted]. The expenses claimed as specified liability losses in this deduction category for [redacted] and [redacted] are attributable to expenses paid by [redacted] to [redacted] with respect to product liability claims subject to the [redacted] program.

The examination division has proposed adjustments to the amount of the deduction for product liability expenses for [redacted] and [redacted] which the taxpayer had claimed as specified liability losses. The proposed adjustments would decrease the amount claimed as specified liability losses in the amounts of $[redacted] and $[redacted] for the years [redacted] and [redacted] respectively. The adjustments were proposed to correct the amount of the deductions for a timing difference and for expenses not properly allowed as product liability costs due to the fact that damage was sustained by [redacted] owned by the taxpayer. The taxpayer has agreed to the adjustment proposed by the examination division for this deduction.

b. Product liability investigation, settlement and/or opposition expenses

The amounts attributable to the claimed specified liability losses for product liability investigation expenses are $[redacted] and $[redacted] for the years [redacted] and [redacted] respectively.

The above amounts consist of the following categories for [redacted] and [redacted]

In-house salaries	$ [redacted]	$ [redacted]
Outside Legal		
In-house engineering wages		

[redacted] claims that the outside legal and in-house salaries are related to product liability claims paid in [redacted] and [redacted] relative to the [redacted] program discussed above. The In-house engineering wages allegedly represent [redacted]% of the wages for a group of approximately [redacted] engineers whose function, as represented by the taxpayer, is to assist the [redacted] legal staff in defending [redacted] against product liability claims. The taxpayer has been unable to provide information which would indicate the specific duties the in-house engineers allegedly performed. The taxpayer has also been unable to provide information which would link the expenses noted above to specific liability claims.

c. Interest on federal tax deficiencies

The amounts attributable to the specified liability losses for interest on federal tax deficiencies are $[redacted] and $[redacted] for the years [redacted] and [redacted] respectively. The taxpayer has agreed to a proposed adjustment for the [redacted] deduction to account for a bookkeeping error in the amount of $[redacted]

The interest on federal taxes represents interest on federal tax deficiencies for the years [redacted]-[redacted] and [redacted]-[redacted]

With respect to the [redacted] deduction for interest on federal income tax deficiencies, the accrued interest amount as of [redacted] was $[redacted]. With respect to the [redacted] deduction for interest on federal income tax deficiencies, the accrued interest amount as of [redacted], was $[redacted]

d. Expenses related to the reclamation/remediation of hazardous waste sites

The amounts attributable to the specified liability losses for expenses related to the reclamation or remediation of hazardous waste sites are $[redacted] and $[redacted] for the years [redacted] and [redacted] respectively. The deduction amount includes legal fees in the amounts of $[redacted] and $[redacted] for the years [redacted] and [redacted], respectively.

The examination division has audited the expenses for deductions on a statistical basis and determined that the deductions relate to expenditures by the taxpayer for the reclamation/remediation of approximately [redacted] and [redacted] hazardous waste sites during the years [redacted] and [redacted], respectively.

e. Interest on state tax deficiencies

The amounts attributable to the specified liability losses for interest on state tax deficiencies are $[redacted] and $[redacted] for the years [redacted] and [redacted] respectively.

The interest on state taxes includes interest paid on state tax liabilities relating to pre[redacted] tax years for [redacted] and pre-[redacted] tax years for [redacted]. For [redacted], the tax years involved cover various tax years during the period [redacted]-[redacted] and tax liabilities for [redacted] different states. For [redacted], the tax years involved cover various tax years during the period [redacted]-[redacted] and tax liabilities for [redacted] different states.

The interest is attributable to various state tax liabilities of [redacted] and its various subsidiaries. The amounts of the specified liability loss attributable to deductions of the subsidiaries that had separate taxable income (determined on an individual subsidiary basis) are $[redacted] and $[redacted] for the year [redacted] and [redacted], respectively.

f. Settlement payments related to a [redacted] audit

The amount attributable to the specified liability loss for [redacted] audit expenses reflect payments made by [redacted] as a result of an audit/investigation conducted by the [redacted] and the [redacted]. The amount of the deduction for the [redacted] Audit claimed by [redacted] as a specified liability loss is $[redacted] for the [redacted] tax year. No deduction for this category was claimed for [redacted].

The amount of $[redacted] consists of two settlements paid in [redacted] in the amounts of $[redacted] and $[redacted]. [redacted] paid the first settlement amount of $[redacted] for disputes arising between [redacted] and [redacted]. The settlement amount includes interest of $[redacted] to the date of payment on [redacted]. Interest accruing prior to [redacted] (i.e. [redacted] years before the loss year) is $[redacted].

[redacted] paid the second settlement amount of $[redacted] for an [redacted]. The settlement amount includes interest of $[redacted] computed to a [redacted], of which $[redacted] was accrued prior to [redacted].

g. Settlement payments related to tarriffs and excise taxes

The amount attributable to the specified liability losses for expenses related to tarriffs and excise tax payments made by [redacted] for imported items are $[redacted] and $[redacted] for the [redacted] and [redacted] tax years, respectively. The amounts paid by [redacted] related to goods imported and exported in years prior to [redacted].

The fees were paid as a result of voluntary disclosures made by [redacted] (pursuant to 19 C.F.R. § 162.74) to U.S. Custom officials regarding violations of 19U.S.C. §§ 1592 and 1593a. The violations related to custom tariffs and excise taxes [redacted] should have paid for years prior to [redacted].

h. Payments related to claims brought under the [redacted] Act

The amounts attributable to the specified liability losses for expenses allegedly related to the investigation, settlement, and/or opposition of lawsuits against [redacted] based upon the [redacted] Act (codified at [redacted] et. seq.) are $[redacted] and $[redacted] for the [redacted] and [redacted] tax years, respectively.

[redacted]

[redacted]

The facts indicate that during [redacted], the expenses relate to [redacted] separate claims against [redacted] filed under the [redacted] Act totaling $[redacted] and [redacted] specific claims against [redacted] filed under various other federal and state law claims (including torts) which total $[redacted]. During [redacted], the expenses relate to [redacted] separate claims against [redacted] filed under the [redacted] Act totaling $[redacted] and [redacted] specific claims against [redacted] filed under various other federal and state law claims including torts. [redacted]

[redacted].

i. Payments for claims and expenses related to various federal and state consumer protection laws/acts.

The amount attributable to the specified liability losses for expenses allegedly related to the investigation, settlement, and/or opposition of lawsuits and claims against [redacted] based upon the [redacted] and various state [redacted] laws are $[redacted] and $[redacted] for the [redacted] and [redacted] tax years, respectively.

[redacted].

A sampling of the claims provided by [redacted] in support of this issue indicates serious documentation problems with respect to the amounts claimed. The audit team sampled seven of the claims presented and found that only [redacted]% of the amount claimed could be substantiated with records provided by [redacted] (See attachment B) .

Discussion and Analysis

In general, a taxpayer may carry a net operating loss back 3 years before the loss year and forward 15 years after the loss year under section 172(b)(1)(A) of the Code.[1] However, a "specified liability loss" may be carried back to each of the 10 taxable years preceding the loss year under section 172(b)(1)(C). Section 172(f)(1) defines a specified liability loss as follows:

> The term "specified liability loss" means the sum of the following amounts to the extent taken into account in computing the net operating loss for the taxable year:
>
> (A) Any amount allowable as a deduction under section 162 or 165 which is attributable to
>
> (i) product liability, or
>
> (ii) expenses incurred in the investigation of, or opposition to, claims against the taxpayer on account of product liability.
>
> (B) Any amount (not described in subparagraph (A)) allowable as a deduction under this chapter with respect to a liability which arises under a federal or state law or out of any tort of the taxpayer if
>
> (i) in the case of a liability arising out of a federal or state law, the act (or failure to act) giving rise to such liability occurs at least 3 years before the beginning of the taxable year, or
>
> (ii) in the case of a liability arising out of a tort, such liability arises out of a series of actions (or failure to act) over an extended period of time a substantial portion of which occurs at least 3 years before the beginning of the taxable year.

I.R.C. § 172(f)(2) limits the amount of the specified liability loss for any taxable year to the amount of the NOL for the taxable year. In addition, an amount described in section 172(f)(1)(B) shall not be taken into account as a specified liability loss unless the taxpayer used an accrual method of accounting throughout the period or periods during which the failure to act or failures to act giving rise to such liability occurred.

---

[1] Effective for net operating losses for tax years after August 5, 1997, the carry back period is two years and the carry forward period is 20 years. 1997 P.L. 105-34 Section 1082.

Statutory context and legislative history of I.R.C. § 172(f)

It is well settled that legislative history may be used to clarify an ambiguous statute or where the legislative scheme clearly indicates a result contrary to that dictated by the literal language of the statute. See City of New York v. Commissioner, 103 T.C. 481 (1994), aff'd, 70 F.3d 142 (D.C. Cir. 1995), See also Abdalla v. Commissioner, 647 F.2d 487 (5th Cir. 1981), aff'g, 69 T.C. 697 (1978).

An examination of the legislative history of the deferred statutory and tort liability provisions of Section 172(f) is appropriate here because the language of the statute is ambiguous. Additionally, the legislative history indicates a result contrary to that dictated by a literal reading of the statute. The statute provides a "specified liability loss" includes "[a]ny amount ... with respect to a liability which arises under a federal or state law," and which meets the three-year rule under section 172(f)(1)(B)(i). The quoted language is not defined in the statute. However, the legislative history contains unequivocal evidence that Congress intended the ten-year carry back provision to apply to a narrow class of liabilities, a conclusion not drawn from a literal reading of the statute. Further, the legislative history of the statute is instructive for purposes of applying the ejusdum generis rule of statutory construction to interpret the scope of the statute which provides for both specific and general classes of qualifying liabilities.

The legislative history of section 172(f)(1)(B) establishes that Congress intended the ten-year carry back rule to apply to some, but not all, of the types of liabilities for which deductions would be delayed by operation of the economic performance rules. The conference report states a ten-year carry back is provided for "Net operating losses attributable to certain liabilities deferred under these provisions." H.R. Conf. Rep. No. 98-861, 98th Cong., 2d Sess. 872 (1984)(emphasis added). See also H.R. Rep. No. 98-432 (Part 2) 1256 (1984)(the ten year carry back provision is for "certain deferred liability losses"); Timing and Measurement of Taxpayer Deductions for Obligations to Be Paid in the Future: Hearing Before Subcommittee on Oversight of the Committee on Ways and Means, House of Representatives, 98th Cong., 2d Sess. 7 (1984)(Statement of Ronald Pearlman, Deputy Assistant Secretary for Tax Policy, Department of the Treasury)(after mentioning specific examples of certain liabilities to which the economic performance rules would apply, including land reclamation costs, nuclear power plant decommissioning costs, and offshore drilling rig dismantlement costs, Mr. Pearlman indicates the administration's proposal provides for an extended carry back period in appropriate circumstances to ensure deferred expenses will be fully utilized). Congress intended ten-year carry back treatment to apply to "certain" liabilities for which a deduction is delayed by the economic performance rules. Congress described some of the eligible liabilities with specificity, namely, nuclear power plant decommissioning costs and torts involving a series of actions or failures to act over an extended period of time. By earlier legislation, Congress specifically designated product liability losses as qualifying for a ten-year carry back. In addition to

enumerating specific types of liabilities, Congress allowed a ten-year carry back for a nonspecific class of liabilities that "[arise] under a federal or state law." I.R.C. § 172(f)(1)(B). Based on the foregoing, it is clear Congress intended to enact a limited exception to the normal three-year carry back rule for a narrow class of liabilities.

This conclusion is further supported by the fact the legislative history contains only one, narrowly drawn example of a qualifying liability. That example is contained in the House Report and involves a situation where a taxpayer incurs a tort liability for failure to protect another person from a hazardous substance, such as chemical waste over an extended period of time. H.R. Rep. 98-432 (Part 20, supra, at 1256.) Congress' use of a single example of limited application to illustrate the scope of section 172(f)(1)(B) effectively demonstrates Congress viewed this provision as a limited exception to the normal carry back rule.

Congress made major changes to I.R.C. § 172(f) in section 3004(a) of the Tax and Trade Relief Extension Act of 1998 (the 1998 Act), effective for NOLs arising in taxable years ending after October 21, 1998. After the 1998 Act, I.R.C. § 172(f)(1) generally defines a specified liability loss as the portion of an NOL generated by certain deductions attributable to product liability and other deductions allowable under Chapter 1 of the Code (except for deductions allowable under section 468(a)(1) or section 468A(a)) allowable in satisfaction of a liability arising under a federal or state law requiring:

(1) the reclamation of land,

(2) the decommissioning of a nuclear power plant (or any unit thereof),

(3) the dismantlement of a drilling platform,

(4) the remediation of environmental contamination, or

(5) a payment under any workers compensation act (within the meaning of section 461(h)(2)(C)(i).

As under prior law, to be taken into account as a federal or state law liability, the liability must result from an act (or failure to act) occurring at least 3 years before the beginning of the taxable year of the allowable deduction and the taxpayer must use an accrual accounting method throughout the period or periods during which such act or failure to act occurred. Given the prospective nature of the new statute, however, we are still confronted by the problem of application in any earlier years under examination.

Sealy Corp. v. Commissioner

The Tax Court's decision in Sealy Corp. v. Commissioner, 107 T.C. 177 (1996), aff'd 171 F.3d 655 (9th Cir. 1999), supports a narrow reading of section 172(f). In Sealy, the Court held a taxpayer's cost to comply with various federal laws did not qualify for ten-year carry back treatment. The taxpayers had claimed the portion of the net operating losses generated by deductions for legal, accounting, and other professional fees qualified as specified liability losses under section 172(f)(1)(B). The legal, accounting, and other professional fees were incurred by the taxpayers for services rendered in connection with an IRS audit of several federal income tax returns, and to comply with financial reporting requirements under the Securities and Exchange Act of 1934 and the Employee Retirement Income Security Act of 1974.

The Tax Court denied the 10-year carry back based on:

1) the taxpayer's liability for the compliance costs was not established by state or federal law but rather by the taxpayer's actions in contracting for and receiving services;

2) the taxpayer's accrual of a deduction for the compliance costs was not deferred by the economic performance rules; and

3) I.R.C. § 172(f)(1)(B) was intended to apply to "a relatively narrow class of liabilities similar to the others identified by the statute." and the compliance costs at issue were routine costs and not of the same general type as others specifically identified in the statue.

The Tax Court found the taxpayer's liability for compliance costs did not arise until it chose the means by which to comply with the cited federal laws. The Court concluded those laws only required the act of compliance by the taxpayer, but not any particular means of compliance. Since the taxpayer's act of compliance giving rise to its liability, i.e., the contract and receipt of the professional services, did not occur at least three years prior to the years at issue, the compliance costs could not be taken into account in the year incurred in determining the taxpayer's specified liability loss under section 172(f)(1)(B)(i).

The Court also concluded section 172(f)(1)(B) was intended to apply to a "relatively narrow class of liabilities similar to the others identified by the statute." Sealy at 186. According to the Court in Sealy, the types of liabilities within the narrow class identified by the statute, include product liability expenses, tort losses, and nuclear power plant decommissioning costs. The Court held the taxpayer's compliance costs were "routine costs and [were] not of the same general type as those other categories." 107 T.C. at 186.

In reaching its decision, the Sealy Court applied the ejusdum generis rule of statutory construction to interpret the scope of section 172(f)(1)(B). Under that rule, general words that follow the enumeration of specific classes are construed as applying only to things of the same general class of those enumerated. Woods v. Simpson, 46 F.3d 21, 23-24 (6th Cir. 1995) (applying the rule of ejusdum generis to interpret "other income," as used in Code section exempting from levy any salary, wages, or other income of taxpayer); Canton Police Benevolent Association of Canton v. United States, 844 F.2d 1231, 1236 (6th Cir. 1988) (upholding a treasury regulation interpreting "other benefits" consistent with the ejusdum generis rule); Coleman v. Commissioner, 76 T.C. 580, 589 (1981) (applying the rule of ejusdum generis to interpret "other casualty").

Application of the rule of ejusdum generis requires a determination of the characteristics of the class suggested by the enumerated items. The liabilities identified in the statute as qualifying for a ten-year carry back share a distinguishing characteristic. Inherent in the nature of each type of identified liability is an element of substantial delay between the time the act giving rise to the liability occurs and the time a deduction may be claimed for the liability. For example, there is often a substantial time lag between the act of selling a defective product and a deduction for product liability loss. The delay in the deduction is inherent in the nature of the loss since it may be several years after the sale of the defective product before an injury caused by the product occurs or is discovered.[2] Similarly, a taxpayer's deduction for nuclear power plant decommissioning costs is inherently delayed by the substantial number of years expiring between the time a nuclear power plant is commissioned and when it is decommissioned.[3]

The tort liabilities for which a ten-year carry back is permitted also have the inherent delay feature. Pursuant to section 172(f)(1)(B)(ii), a ten-year carry back is allowed for a liability arising out of a tort, but only if "such liability arises out of a series of actions (or failure to act) over an extended period of time a substantial portion of which occurs at least 3 years before the beginning of the taxable year" (a "continuing tort"). A deduction for a continuing tort is inherently likely to be delayed for the same

---

[2] While product liability losses share the "inherent delay" trait with the other items enumerated in section 172(f), a ten-year carryback was permitted for product liability losses even before Congress extended the ten-year carryback provision to certain liabilities for which deductions are delayed by economic performance.

[3] Section 172(f)(3) contains a special rule for nuclear powerplants. Under that provision, the portion of a specified liability loss that is attributable to amounts incurred in the decommissioning of a nuclear powerplant may be carried back to each of the taxable years during the period (1) beginning with the taxable year in which the plant was placed in service and (2) ending with the taxable year preceding the loss year.

reasons as a product liability loss, that is, because of a delay between the time of the act giving rise to the liability, and the occurrence or discovery of an injury. Significantly, the only example of a ten-year carry back liability contained in the legislative history is a continuing tort, namely, exposing a person to chemical waste over an extended period of time.

Section 172(f)(1)(B)(i) provides that a deferred statutory liability is a "specified liability loss" if "the act (or failure to act) giving rise to such liability occurs at least 3 years before the beginning of the [loss] year . . . " The words "act" or "failure to act" are appropriately descriptive of the conditions under which "inherent delay" types of liabilities arise. For example, the act of placing a nuclear power plant in service gives rise to a future liability for nuclear decommissioning costs. Similarly, the act of excavating a surface mine gives rise to a future liability for reclamation costs. Congress' choice of language makes sense in this context.

In affirming the Tax Court's decision, the Court of Appeals noted it is "not simply an expense incurred with respect to an obligation under federal law but an act 'giving rise' to the liability that qualifies as a specified liability under the statute." Sealy at 171 F.3d 657 (9th Cir. 1999). More importantly the appeals court rejected the taxpayer's argument that the act giving rise to the liability is the first event in a chain of causes which gives rise to the liability.

TAM 24674696

In Technical Advice Memorandum No. 24674696, the Service ruled deductions for interest on a federal income tax liability cannot generate a specified liability loss under section 172(f)(1)(B). The Service further ruled deductions for legal fees incurred to contest a proposed federal income tax deficiency and related state tax deficiency cannot generate a specified liability loss. The taxpayer had contended deductions allowable "with respect to" a liability that arises out of any federal or state law includes not only deductions for that liability but also other deductions that have a close relationship to that liability, i.e., the compound interest imposed on the federal tax liability and the legal fees incurred with respect to contesting the federal and state tax liabilities.

In its ruling however, the Service rejected this argument and agreed with the Tax Court in Sealy Corp. v. Commissioner, 107 T.C. 177 (1996), that Congress intended section 172(f)(1)(B) to apply to deductions allowable with respect to a relatively narrow class of liabilities rather than to deductions allowable with respect to any liability literally imposed under a federal or state law. The distinguishing characteristic of the "narrow class" is an element of substantial delay between the time the act giving rise to the liability occurs and the time a deduction may be claimed for the liability. The memorandum recognized that while federal statutes directly imposed

interest liability incurred by the taxpayer, such liability did not fall within the "narrow class" since interest on a federal tax liability is a routine cost not involving an inherent delay between the time the events giving rise to the liability occur and the time a deduction is claimed for the liability.

The Service found, in contrast to the types of liabilities specified in the statute, there is no inherent delay between the time the events occur which give rise to the interest due on a federal income tax liability and the time in which the interest is deductible. In the case of interest, economic performance occurs as the interest economically accrues. Since interest is deductible immediately upon its economic accrual, the Service found there is no inherent delay in the deduction caused by the economic performance rules.

The Service recognized there may be delays between the time an interest liability on past due federal income taxes economically accrues and when such interest becomes an allowable deduction (as in the case of accrual method taxpayers contesting deficiencies). However, such delay is not part of the inherent nature of the liability since a taxpayer need not under report its federal income tax liability in the first instance.

By inference, the Service reached the same conclusion with respect to the taxpayer's federal income tax liability and related state tax liability. Under the economic performance rules, if the liability of a taxpayer is to pay a tax, economic performance occurs as the tax is paid. Thus, the economic performance rules do not delay the deduction of a tax liability. (Of course, federal income tax liability is not deductible). Accordingly, neither arise under a federal or state law within the meaning of section 172(f)(1)(B).

Finally, the Service ruled the deductions for legal fees associated with federal income tax liability or related state tax liability cannot generate a specified liability loss, no matter how broadly or narrowly the phrase "with respect to" in section 172(f)(1)(B) is construed since such liabilities do not arise under either a federal or state law within the meaning of section 172(f)(1)(B).

Private Letter Rulings 199927012 and 199922046

In PLR 199927012 and 199922046 the Service revoked several previous rulings dealing with specific deductions that were to be treated as part of a consolidated group's specified liability loss.

In the original rulings, the Service had concluded the deductions for interest related to federal and state tax assessments and expenses related to product liability could be treated as part of the consolidated group's specified liability loss. However, as discussed above, since the Tax Court ruled in Sealy Corp. v. Commissioner, 107 T.C. 177 (1996), aff'd, 171 F.3d 655 (9th Cir. 1999) that Congress intended section 172(f)(1)(B) to apply to deductions allowable for a relatively narrow class of liabilities rather than to deductions allowable for any liability literally imposed under federal or state law, the Service has concluded Congress did not intend the interest on federal and state tax liabilities at issue in the earlier rulings to be included within that class.

United States v. Balsam

In United States v. Balsam, 82 AFTR2d ¶ 98-5398 (E.D. Mo. 1997), the court reviewed an order of a bankruptcy court which allowed a specified liability loss pursuant to I.R.C. § 172(f)(1)(B)(ii). The Balsam court, determined the bankruptcy court's factual determination of the existence of a specified loss was not clearly erroneous. Since the Balsam court found the bankruptcy court's determination was not clearly erroneous, it provided little substantive analysis or discussion regarding specified liability losses. The Eighth Circuit Court of Appeals, which affirmed the Balsam decision, did so by way of an unpublished one-paragraph opinion. United States v. Balsam, 163 F.3d 601 (8th Cir. 1998). The summary treatment of the specified liability loss issue provided by the Balsam line of cases adds little insight or assistance in determining the proper scope of liabilities intended by congress to be characterized as specified liability losses.

To the extent the Balsam cases are misinterpreted by [redacted] as conflicting with the correct application of the analysis of specified liability losses applied in Sealy or subsequent IRS National Office Guidance, such conflict would be limited to the Eighth Circuit Court of Appeals. The appeal of any judicial decision in the present case would lie with the Sixth Circuit Court of Appeals.

TAM 200043018

In Technical Advice Memorandum 200043018, the Service determined that workers' compensation liabilities may generate a specified liability loss within the meaning of section 172(f)(1)(B) if certain requirements were met. Furthermore, the Service determined that (1) deductions for sales and use tax deficiencies; (2) deductions for federal tax deficiency interest; (3) deductions for certain priority tax claims and interest; (4) deductions for increases in state unemployment insurance attributable to layoffs; (5) various costs incurred in complying with a bankruptcy reorganization plan; and (6) legal fees incurred to pursue litigation against the chairman of the taxpayer's board of directors and an investment advisory firm do not meet the requirements of specified liability losses under section 172(f)(1)(B).

To reach the conclusions in TAM 200043018, the Service stated "we agree with the Tax Court [in Sealy Corp. v. Commissioner, 107 T.C. 177 (1996)] that Congress intended section 172(f)(1)(B) to apply to deductions allowable with respect to a relatively narrow class of liabilities rather than deductions allowable with respect to any liability imposed under federal or state law." To determine whether certain liabilities fall within the narrow class of liabilities to which Congress intended section 172(f)(1)(B) to apply, the Service adopted an "inherent delay test."

Under the inherent delay test, a liability will qualify for section 172(f)(1)(B) treatment if the liability involves an inherent substantial delay between the time the events giving rise to the liability occur and when the deduction for such liability becomes allowable. The TAM applied this inherent delay test to determine that federal tax deficiency interest does not generate a specified liability loss within the meaning of section 172(f)(1)(B). The Service recognized that a taxpayer need not report and pay less than the proper amount of tax. Thus, a tax liability, and the associated interest liability, does not have the inherent delay feature required to qualify for the narrow class of liabilities that arise under federal or state law within the meaning of section 172(f)(1)(B).

After the analysis of whether the expenses at issue could create specified liability losses, the Service examined the issue of whether specified liability losses from post-1990 tax years were eligible for carry-back to pre-1984 tax years if they meet the pre-1990 definition of a deferred statutory or tort liability loss. The Service noted I.R.C. § 172(k)(4), as originally enacted in the 1984 Act, prevented a deferred statutory or tort liability loss from being carried back to a taxable year beginning before January 1, 1984, unless such loss could be carried back to such year without regard to the special 10-year carryback period provided for deferred statutory or tort liability losses.

In the Revenue Reconciliation Act of 1990 (the 1990 Act) Congress, in the course of eliminating expired and obsolete provisions from section 172, placed under

section 172(f) both the statutory language defining product liability losses and the statutory language defining what had previously been called deferred statutory or tort liability losses, most likely because both types of losses generally qualify for a 10-year carryback. In that act Congress attached the new name "specified liability loss" to both product liability losses and what had formerly been called deferred statutory or tort liability losses. The legislative history to the 1990 Act indicates that these amendments were not intended to produce any substantive changes. See H.R. Rep. No. 894, 101st Cong., 2d Sess. 36 (1990).

Section 11811(b)(2)(B) of the 1990 Act, an uncodified provision enacted as a note to I.R.C. § 172, provides:

> [t]he portion of any loss which is attributable to a deferred statutory or tort liability loss (as defined in section 172(k) of the Internal Revenue Code of 1986 as in effect on the day before the date of the enactment of this Act) may not be carried back to any taxable year beginning before January 1, 1984, by reason of the amendment made by subparagraph (A).

In section 11811(b)(1) of the 1990 Act Congress struck certain subsections of section 172 and redesignated others. Section11811(b)(2)(A) of the 1990 Act, the subparagraph referred to in the above-quoted text, is the section in which Congress actually amended I.R.C. § 172(f). In section 11811(c) of the 1990 Act Congress made the amendments enacted in section 11811 of the 1990 Act applicable-to NOLs for taxable years beginning after December 31, 1990.

As amended in the 1990 Act, section 172(b)(1)(C) provides a 10-year carryback period for specified liability losses. Section 11811(b)(2)(B) of the 1990 Act only applies to NOL carrybacks; attributable to NOLs arising in taxable years beginning after December 31, 1990.

Thus, in light of the statutory language itself, the legislative history thereto, and the historical limitation on the carrying back of deferred statutory or tort liability losses, one may only logically conclude that Congress enacted section 11811(b)(2)(B) of the 1990 Act to ensure that the portion of any specified liability loss that would have met the definition of a deferred statutory or tort liability loss under pre-1990 Act law not be eligible to be carried back to any taxable year beginning before January 1, 1984.

In the present case, [redacted] is attempting to carry back a portion of its [redacted] NOL to [redacted] and a portion of its [redacted] NOL to [redacted]. Thus, even if the [redacted] were successful in claiming the categories of expanses at issue could generate specified liability losses, it

could not cannot carry the portion of any of its NOLs for the loss years at issue that qualify as specified liability losses within the meaning of section 172(f)(1)(B) to its taxable years ended [redacted] or [redacted]

Host Marriott Corp. v. United States

In Host Marriott Corp. v. United States, 113 F. Supp. 2d 790 (D. Md. 2000); 2000 U.S. Dist. LEXIS 12290, the taxpayer filed a claim for refund seeking specified liability loss treatment under section 172(f)(1)(B) for funds paid pursuant to worker's compensation claims and federal income tax deficiencies. The United States District Court for the District of Maryland applied a broad interpretation of section 172(f)(1)(B) and granted the taxpayer's motion for summary judgement, holding that both payments were specified liability losses under section 172(f)(1)(B).

The district court held the principle of ejusdum generis to be inapplicable. Unlike the Tax Court in Sealy Corp. v. Commissioner, 107 T.C. 177, 186 (1996), the district court was "unconvinced that the statute is ambiguous." Host Marriott, 2000 U.S. Dist. LEXIS at *12 (internal quotations omitted). Thus, the district court refused to consider the legislative history of section 172(f) stating "[b]ecause the statutory language is clear, there is no need to refer to the legislative history." Id. Consequently, the court applied a broad application of section 172(f)(1)(B).

The court in Host Marriott applied a two part test to determine whether a liability is a specified liability under section 172(f)(1)(B). The court first determined whether the liabilities at issue arose out of Federal or state law. After concluding that the liabilities at issue did arise out of Federal or state law, the court determined whether the liabilities arose out of acts or failures to act more than three years earlier. Because the injuries giving rise to the workers' compensation liability occurred more than three years prior to the claim, the court concluded that the workers' compensation liability was a specified liability loss. Furthermore, the court found the filing of the taxpayer's federal income tax returns to be acts giving rise to the liability for federal income tax deficiency interest. Thus, the court granted the taxpayer's request for summary judgement stating "the deductions in this case qualify as specified liability losses because Plaintiff's liability for workers' compensation claims and tax deficiency interest, and the amounts at issue, are set by federal or state law, not by Plaintiff's choice." Host Marriott, 2000 U.S. Dist. LEXIS at *8.

Although the court in Host Marriott applied a broad interpretation of section 172(f)(1)(B) to hold that liabilities from workers' compensation claims and federal income tax deficiency interest are specified liability losses, the Service need not follow its conclusions in the present case. Host Marriott was decided by the United States District Court for the District of Maryland. Should [redacted] elect to commence an action for

refund under section 7122, it will be required to file a complaint with either the United States District Court for the [redacted] or the United States Court of Federal Claims. Although the opinion in Host Marriott may have some persuasive authority in these forums, it, like the opinion of the Tax Court in Sealy Corp. v. Commissioner, 107 T.C. 177 (1996), is not controlling on either the Court of Federal Claims or the United States District Court for the [redacted]

Summary

In light of the foregoing discussion the following analysis may be applied in determining whether or not a claimed deduction qualifies as a specified liability loss:

1. Determine whether the deduction is allowable with respect to a liability which arises under federal or state law or out of any tort of the taxpayer.

2. Identify the act(s) or failures to act giving rise to such liability and determine whether such act(s) or failures to act occurred at least three years before the beginning of the taxable year in which the deduction was taken.

3. Determine whether the taxpayer's deduction for the expenses at issue were deferred solely by the economic performance rules.

4. Determine whether the expenses at issue fall within the narrow class intended by Congress. The narrow class is defined by the characteristic of inherent delay between the time the act giving rise to the liability occurs and the time a deduction may be claimed for the liability.

Analysis of Specific Deductions

c. and e. Interest on federal and state tax deficiencies.

In contrast to the types of liabilities specified in the statute interest on state and federal taxes, are not liabilities that involve an inherent delay between the time the liability is incurred and the time a deduction is claimed for the liability. Under the economic performance rules, a tax is a payment liability, for which a deduction may be accrued when the tax is paid to the governmental authority that imposed that tax. Section 461(h); Treas. Reg. § 1.461-(4)(g)(6)(i). In the case of interest, economic performance occurs as the interest cost economically accrues. Treas. Reg. § 1.461-4(e). Thus, as a general matter, state taxes, and interest on state and federal taxes, are currently deductible in the ordinary course of a taxpayer's business when paid or accrued. For this reason, deductible taxes and related interest are in the same general class of "routine" costs for which a ten-year carryback was denied in the Sealy case.

The Tax Court's exclusion of routine costs from the class of eligible liabilities is consistent with the legislative history of the ten-year carryback provision. Clearly, Congress did not intend the special carryback rule to apply to all liabilities for which a deduction is delayed by the economic performance rules. If routine costs were included in the eligible class, then mere nonpayment of current liabilities for more than three years would qualify a taxpayer for a ten-year carryback upon payment of those costs.

The fact that additional taxes may be determined against a taxpayer several years after a return is filed does not mean that deductible taxes and interest should qualify for a ten-year carryback. Almost any conceivable type of liability could result in an additional liability, either by agreement of the parties or upon final adjudication of a dispute between the parties. To interpret section 172(f) as conferring ten-year carryback treatment upon all such liabilities would be contrary to Congress' intent to create a narrow exception to the normal carryback rules. A state tax liability is not an "inherent delay" type of liability in the same sense as, for example, mine reclamation costs. With respect to the latter, the act of excavating the mine inherently gives rise to a liability to reclaim the land for which costs will be incurred and deducted several years after the initial act of excavation. In contrast, the filing of a tax return does not inherently mean that an additional tax liability will be determined due from the taxpayer for that period.

The economic performance rules did not delay petitioner's deduction of the taxes and interest at issue beyond the earliest year for which petitioner was permitted to deduct those amounts under its regular accounting method. The earliest year for which petitioner was entitled to a deduction for the additional state taxes under its regular accounting method, and under the economic performance rules, was [redacted]. Section 461(a) and (h); Treas. Reg. § 1.461-(4)(g)(6)(i). With respect to the interest at issue, the economic performance rules were satisfied as the interest economically accrued. Treas. Reg. § 1.461-4(e). Thus, the interest that accrued on petitioner's tax liabilities, prior to [redacted], satisfied the economic performance rules before petitioner's regular accounting method permitted a deduction for those amounts. The interest that accrued on petitioner's tax liabilities in [redacted] met the economic performance rules in [redacted] and was deductible under petitioner's regular accounting method in that year. Inasmuch as petitioner's deductions for taxes and interest were not delayed by the economic performance rules beyond the earliest year those deductions were allowed under its regular accounting method, petitioner should not be accorded the benefits of a provision that was intended to provide relief from the economic performance rules.

Even assuming for the sake of argument that interest on state and federal taxes is within the narrow class of liabilities that qualifies for a ten-year carryback, interest accrued on those liabilities, within the three-year period preceding the beginning of the loss year, should be disallowed, in any event, as failing to satisfy the three-year rule

under section 172(f)(1)(B)(i). Interest is imposed with respect to unpaid taxes from the last date prescribed for payment of the tax until the tax is paid. Sections 6601 and 6622; [redacted]. Each day that a taxpayer fails to pay a tax legally due is a failure to act that gives rise to liability for an additional day's interest. Accordingly, interest imposed on [redacted] for the time period after [redacted] and [redacted] (within three years before [redacted], and [redacted] respectively) should be disallowed because the act giving rise to liability (i.e., nonpayment) did not occur "at least 3 years before the beginning of the taxable year," within the meaning of section 172(f)(1)(B)(i).

f. Settlement payments related to a [redacted] audit.

The liability for the settlement payments [redacted] was required to make as a result of the audit/investigation by the [redacted] arose [redacted] rather than any federal or state law as required by section 172(f)(1)(B)(i) [redacted].

[redacted]. In this case, [redacted]'s failure to properly calculate billing amounts gave rise to the liability. The deductions related to the audit which were taken in [redacted] merely corrected the act of overbilling by [redacted] in earlier years.

g. Settlement payments related to Tarriffs and excise taxes.

The liability for the tariff and excise payments [redacted] was required to make as a result of its voluntary disclosure made to the U.S. Customs agency is not an inherent delay type of liability. The importation/exportation of various goods does not inherently give rise to a liability for failure to properly pay the associated tariffs and/or excise taxes. In this case [redacted]s failure to properly calculate the appropriate customs duties gave rise to the liability. The deductions related to the voluntary disclosures made in [redacted] merely corrected [redacted]s under reporting of those duties and fees earlier years.

h. Payments related to claims brought under the [redacted] Act

[redacted]'s liability for claims brought under the [redacted] Act arise out of numerous claims brought by various past, current and/or prospective [redacted]

[redacted] alleging actions under the [redacted] and/or other violations of federal and state law.

The acts giving rise to the liabilities in this category are set forth in the underlying complaints by the plaintiff [redacted] They include allegations of [redacted]. A sampling of the underlying complaints supports [redacted]'s contention that the alleged act occurred more than three years before the respective years at issue.

However, the deductions for payments made to the plaintiffs in these lawsuits are not within the narrow class of liabilities Congress intended to qualify for a ten-year carry back. Deductions for such payments are not inherent delay liabilities merely because there may be a delay between the time the act occurs which gives rise to the liability and the time [redacted] pays for the injury. Even though there may in fact be a delay between the acts and the time payment for the injury is deductible such delay is not inherent in the nature of the injury. i.e. the company need not extend the time between the occurrence of the acts and payment because of litigation and investigation or through structured settlement arrangements.

As discussed earlier, the liabilities specifically identified by the statute as qualifying for a 10-year carry back, product liability expenses, certain tort losses, and nuclear power plant decommissioning costs, share a distinguishing characteristic; inherent in the nature of each liability is an element of substantial delay between the time the act giving rise to the liability occurs and the time a deduction may be claimed for the liability.

Additionally, to the extent tort liability is claimed, in whole or in part, it is impossible to determine if the settlement agreement, which admits no wrongdoing, is based on the tort cause of action, the federal or state law claims, or something else. Even if you assume the settlement was based on the tort claim, there is nothing to show the claim was related to a single act tort rather than a continuing tort. Further assuming the claim related to a continuing tort, there is still no evidence provided to suggest the series of acts (which may have contributed to the continuing tort) occurred over an extended period of time

Some of the reviewed lawsuits suggest there might be an underlying breach of contract suit which would also be ineligible for the carryback. The underlying problem with respect to this entire category is the fact a majority of the lawsuits were resolved by "settlement agreements" which do not disclose the reason for the payment other than the payments resolve the cases without admitting liability or wrongdoing of [redacted]

In essence the payments are made to "make the lawsuit go away. Where there has been no determination of liability then there is no basis to support [redacted]s claim the payments are related to a qualifying liability. The lawsuits may allege a qualifying liability as well as liabilities that do not qualify i.e. single act torts and contract claims, but from the final settlement documents it is impossible to determine exactly why the payments are being made other than they "make the lawsuit go away" which, in and of itself, is not a qualifying liability. Thus, the ambiguity of the settlement documents, upon which the liabilities are based, prevent these deductions from being classified as specified liability losses.

i. Payments for claims and expenses related to various federal and state consumer protection laws/acts.

The expenses incurred by [redacted] with respect to various settlements involving federal and state consumer protection laws/act are not allowed as specified liability losses. This category lacks the element of inherent delay. Here, any delay between the act giving rise to the liability and the deduction of the payment is attributable to the contested liability of the ultimate payments.

This category is similar to the [redacted] settlements discussed above, in that the payments for violations of various consumer protection laws/acts are not inherent delay liabilities merely because there may be a delay between the time the act occurs which gives rise to the liability and the time [redacted] pays for the injury. Even though there may in fact be a delay between the acts and the time payment for the injury is deductible, such delay is not inherent in the nature of the injury, i.e. the company need not extend the time between the occurrence of the acts and payment because of litigation and investigation or through structured settlement arrangements.

If you have any further questions concerning this matter, please feel free to telephone the undersigned at [redacted]

[redacted]
Associate Area Counsel (LMSB)

By: [redacted]

Attorney