



DEPARTMENT OF THE TREASURY  
INTERNAL REVENUE SERVICE  
WASHINGTON, D.C. 20224

OFFICE OF  
CHIEF COUNSEL

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**ACTION ON DECISION**  
CC-2003-02

**SUBJECT:** Internet Corporation & Subs. v. Commissioner  
Docket No. 8246-97  
Opinion: 117 T.C. 133 (filed Oct. 2, 2001)  
Decision: February 4, 2002

**Issue:**

Whether deductions for state income tax deficiencies and interest thereon as well as interest on federal income tax deficiencies, all attributable to tax liabilities arising at least three years before the beginning of the taxable year, and taken into account in computing a net operating loss, qualify for a ten-year carryback as specified liability losses under former I.R.C. § 172(f)(1)(B).

**Discussion:**

The Tax Court ruled against the Commissioner in the subject case on the litigated issue set forth above. In addition, the Service lost Host Marriott Corp. v. United States, 113 F.Supp. 2d 790 (D. Md. 2000), aff'd, 267 F.3d 363 (4<sup>th</sup> Cir. 2001), a case similar to Internet. In light of these two losses and notwithstanding the prior Service-favorable opinions in Sealy Corp. v. Commissioner, 107 T.C. 177 (1996), aff'd, 171 F.3d 655 (9<sup>th</sup> Cir. 1999), the Service will no longer assert that liabilities for state income tax deficiencies and any interest accruing on those deficiencies or on federal tax deficiencies do not arise under federal or state law for purposes of determining whether those expenditures qualify as specified liability losses under former § 172(f)(1)(B).

The Tax Court in Internet also concluded that the deduction for interest accruing within three years of the beginning of the taxable loss year qualifies as a specified liability loss because the act giving rise to the entire interest liability is the failure to pay the correct amount of tax by the return due date. The Service disagrees with allowing this portion of the interest to qualify as a specified liability loss.

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Interest involves a failure to act (i.e., nonpayment). Interest accruing for the loss year and for the three-year period preceding the beginning of the loss year should be regarded as failing to satisfy the three-year rule under § 172(f)(1)(B)(i). Interest is imposed with respect to unpaid taxes from the last date prescribed for timely payment of the tax until the tax is paid. 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, the Service will continue to challenge a taxpayer's treatment of interest that accrues within three years of the beginning of the loss year as a specified liability loss, because such interest does not satisfy the statutory three-year rule.

In addition, the Service believes that interest on state or federal tax deficiencies is not a deduction with respect to the underlying liability for state or federal taxes. Instead, a deduction allowable with respect to a liability, for purposes of section 172(f)(1)(B), is the deduction for the expense item that, from a financial accounting standpoint, is debited simultaneously with the crediting of the liability. Thus, the Service will not treat interest on an underlying state or federal tax deficiency arising at least three years before the beginning of the loss year as an amount being incurred "with respect to" the deficiency.

**Recommendation:**

Nonacquiescence in part (prior acquiescence in result, hereby revoked).

**Reviewers:**

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