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from: William A. Jackson
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(Income Tax & Accounting)

subject: Specified Liability Losses and Insurance Recoveries

This Chief Counsel Advice responds to your request for assistance dated June 20, 2006, as modified on February 2, 2007. This advice may not be used or cited as precedent. We have condensed your inquiries into four issues.

LEGEND

Taxpayer =

ISSUES

(1) May a taxpayer claim a deduction under section 165 or section 162 for an amount with respect to which the taxpayer has a right or expectation of recovery through insurance or otherwise? When does the prospect of an insurance recovery prevent a taxpayer from deducting as a section 162 expense or a section 165 loss amounts arising out of various claims against the taxpayer?

(2) If a SLL expense is disallowed as a deduction in a taxable year either because of the actual recovery of such expense during the taxable year or because of insurance recoveries anticipated to be received in a subsequent taxable year, how does that affect the utilization of the expense in determining the amount of a taxpayer's SLL?

(3) If a taxpayer satisfies the requirements to deduct a SLL expense in one taxable year and deducts such expense for that year, but receives a reimbursement of the deducted expense through insurance recoveries in a subsequent taxable year, how is that reimbursement treated for federal income tax purposes? May the Service require the taxpayer to reduce its SLL expense deductions for the taxable year of recovery by the amount of the recovery (netting)?

(4) Do deductions for legal fees incurred in asserting claims for insurance reimbursements for product liability expenses qualify as product liability deductions?

CONCLUSIONS

(1) A taxpayer may not claim a section 165 loss deduction to the extent the taxpayer has a claim for reimbursement for which there is a reasonable prospect of recovery. A taxpayer may not claim a section 162 business expense deduction to the extent the taxpayer has a right to reimbursement, even if the right is not certain or is subject to a contingency. The standards "reasonable prospect of recovery" under section 165 and "right to reimbursement" under section 162 are highly factual. Whether a taxpayer claims a deduction for an expense under section 165 or section 162, the deduction should be denied if, based on the facts and circumstances, the taxpayer has insurance coverage that appears to provide a right to reimbursement and there is no indication that an exception to coverage applies.

(2) A SLL expense must be allowed as a deduction for the taxable year in order to generate a SLL for that year.

(3) The taxpayer generally must include the amount of reimbursement for prior year SLL expenses in gross income in the taxable year of reimbursement pursuant to the tax benefit rule. To be eligible to generate a SLL, section 172(f)(1) simply requires an item to qualify as a SLL expense and to be deductible (under section 162 or section 165 for product liability expenses) for the taxable year. Neither section 172(f) nor the regulations thereunder provide any authority to net recoveries of SLL expenses deducted in prior taxable years against unrelated SLL expenses for the current taxable year in determining SLL deductions for the current taxable year.

(4) Deductions for legal and other fees incurred in connection with resolving issues that do not bear on Taxpayer's product liability to third party claimants but relate only to Taxpayer's claims against its insurers do not qualify as product liability deductions.

FACTS

Taxpayer manufactures products that are sold to a broad range of customers. Various parties have asserted claims and filed lawsuits against Taxpayer seeking damages claimed to be attributable to alleged defects in Taxpayer products. A certain amount of these claims will result in actual liability to Taxpayer (allowable product liability claims) either through concession, settlement, or judgments. Taxpayer has also incurred liabilities for environmental remediation. Taxpayer has liability insurance coverage for some of these liabilities.

For federal income tax purposes, Taxpayer deducts allowable product liability claims for the taxable year paid. Taxpayer reduces the amount claimed as a deduction for the taxable year to the extent Taxpayer receives insurance reimbursement for the paid claim in the same taxable year. If Taxpayer receives insurance reimbursement for a product liability claim paid in a prior taxable year, Taxpayer includes the reimbursement in gross income rather than reducing its current deduction for unrelated product liability claims paid.

For federal income tax purposes, Taxpayer deducts allowable environmental remediation liabilities for the taxable year paid. Taxpayer takes anticipated insurance recoveries for environmental remediation liabilities previously paid into account when Taxpayer believes the right to the reimbursement is fixed and determinable, which may or may not be for the taxable year in which the environmental remediation liabilities are claimed as deductions.

Taxpayer accounts for environmental remediation liabilities based on each cleanup site. If Taxpayer believes that it has a fixed and determinable right to reimbursement for cleanup costs at a particular site for a taxable year, Taxpayer will reduce its deduction for environmental remediation expenses for that site for the taxable year by the amount of the anticipated recovery. Taxpayer includes anticipated recoveries in excess of actual expenses for a particular site for the taxable year in gross income. Taxpayer does not reduce its deductions for environmental remediation expenses for one site by anticipated insurance recoveries of expenses incurred at a different site.

LAW

Section 172(a)¹ 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 each of the 20 taxable years following the taxable year of the loss. However, section 172(b)(1)(C) provides a 10-year NOL carryback period for a specified liability loss (SLL).

¹ References to the Code refer to the Internal Code of 1986 as applicable to the taxable years at issue. Likewise, section references refer to sections of that Code.

With certain modifications, 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 section 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 in computing the NOL for the taxable year. Deductions for product liability fall into the set of deductions that may generate a SLL.

Product liability deductions include any amount allowable as a deduction under section 162 or 165 which is attributable to (1) product liability, or (2) expenses incurred in the investigation or settlement of, or opposition to, claims against the taxpayer on account of product liability. Section 172(f)(4) defines the term "product liability" as:

(1) liability of the taxpayer for damages on account of physical injury or emotional harm to individuals [hereafter referred to as personal injury], or damage to or loss of the use of property, on account of any defect in any product which is manufactured, leased, or sold by the taxpayer, but only if

(2) such injury, harm, or damage arises after the taxpayer has completed or terminated operations with respect to, and has relinquished possession of, such product.

Treas. Reg. § 1.172-13(b)(2)(ii) expands upon the statutory definition by providing that the term "product liability" does not include liabilities arising under warranty theories relating to repair or replacement of the property that are essentially contract liabilities.

Pursuant to section 172(f)(1)(A)(ii), expenses that Taxpayer incurs in the investigation, settlement, or opposition to product liability claims against Taxpayer, such as legal fees, may qualify as product liability deductions. However, Treas. Reg. § 1.172-13(b)(1) provides that indirect corporate expenses, or expenses for overhead, do not qualify as product liability deductions.

Section 172(f)(1)(B) also includes within the class of deductions that may generate a SLL certain deductions allowable for satisfying five types of federal or state law liabilities provided: (1) the deductions are not allowable under either section 468(a)(1) or 468A(a), (2) the act (or failure to act) giving rise to such liability occurs at least 3 years before the beginning of the taxable year, and (3) the taxpayer used an accrual method of accounting throughout the period or periods during which such act (or failure to act) occurred. Federal or state law liabilities requiring the remediation of environmental contamination constitute one of the five types of qualifying liabilities.

ANALYSIS

Issue 1. May a taxpayer claim a deduction under section 165 or section 162 for an amount with respect to which the taxpayer has a right or expectation of recovery through insurance or otherwise? When does the prospect of an insurance recovery

prevent a taxpayer from deducting as a section 162 expense or a section 165 loss amounts arising out of various claims against the taxpayer?

Standards under Section 165

Section 165 and the related treasury regulations, cited in the request for Chief Counsel Advice, directly address when insurance recoveries or the prospect of insurance recoveries prevent a taxpayer from deducting losses. Section 165(a) allows a deduction for any loss sustained during the taxable year and not compensated for by insurance or otherwise. Losses must be bona fide, evidenced by closed and completed transactions, fixed by identifiable events, and sustained during the taxable year. Treas. Reg. § 1.165-1(b), (d). No portion of the loss with respect to which reimbursement may be received is sustained for purposes of section 165 until it can be ascertained with reasonable certainty whether or not the reimbursement will be received. Whether a reasonable prospect of recovery exists with respect to a claim for reimbursement of a loss is a question of fact to be determined upon examination of all facts and circumstances. Treas. Reg. § 1.165-1(d)(2)(i).

If in the year of the casualty or other event a portion of the loss is not covered by a claim for reimbursement with respect to which there is a reasonable prospect of recovery, then that portion of the loss is sustained during the taxable year in which the casualty or other event occurs. Treas. Reg. § 1.165-1(d)(2)(ii). A taxpayer will not sustain a loss for purposes of section 165 for amounts covered by claims for reimbursement, from insurance companies or otherwise, until the taxable year in which the taxpayer no longer has a reasonable prospect of recovery with respect to its claims, because they have been resolved, for example, through settlement, adjudication, or abandonment. Treas. Reg. § 1.165-1(d)(2)(i).

A “reasonable prospect of recovery” exists when a taxpayer has a bona fide claim for recoupment from third parties or otherwise and there is a substantial possibility that the claims will be decided in the taxpayer’s favor. *Ramsay Scarlett & Co. v. Commissioner*, 61 T.C. 795, 811 (1974), *aff’d*, 521 F.2d 786 (4th Cir. 1975). A taxpayer is not required to be an “incorrigible optimist,” however, so that claims with remote or nebulous potential for success do not defer a loss deduction. *Id.* The reasonableness of a prospect of recovery is primarily tested on the basis of objective facts known or reasonably foreseeable at the end of the taxable year of the loss, although subjective facts also may be considered. *Id.* at 811-812; *Julicher v. Commissioner*, T.C. Memo. 2002-55. The fact that a settlement or favorable judgment may occur in the future does not postpone the deduction, as long as at the close of the loss year, there exists no reasonable prospect of recovery. *Id.*

One factor to consider in determining whether there is a reasonable prospect of recovery is whether the taxpayer has filed a claim or lawsuit against third parties to recover the loss. *Julicher v. Commissioner* (filing of lawsuit to recover loss gives rise to an inference of a reasonable prospect of recovery); *Concord Instruments Corporation v.*

Commissioner, T.C. Memo. 1994-248 (taxpayer's pursuit of claim for reimbursement from insurer precluded deduction in years at issue). The Sixth Circuit concluded that a trustee who filed a lawsuit relating to the embezzlement of the trust's funds had reasonable grounds for his belief that there were good prospects of recovery so that the loss deduction was appropriately claimed in the year the legal proceedings were concluded. *Estate of Levi T. Scofield v. Commissioner*, 266 F.2d 154, 159-160 (6th Cir. 1959).

Another factor is whether insurers or other responsible parties have denied liability for the taxpayer's claim. In *Gale v. Commissioner*, the Tax Court noted that the denial of liability by the taxpayers' insurer was not a decisive factor in determining whether they had a reasonable prospect of recovery in light of the taxpayers' decision to commence a lawsuit against the insurer. *Gale v. Commissioner*, 41 T.C. 269, 276 (1963). See also *Julicher v. Commissioner* (denial of liability by insurance company is not the sole factor in determining whether a reasonable prospect of recovery exists); *Clem v. Commissioner*, T.C. Memo. 1991-414 (denial of liability by insurer is a significant factor in determining the reasonableness of the prospects of recovery but must be viewed in light of the surrounding facts and circumstances).

Standards under Section 162

Section 162 does not expressly address the issue of when insurance recoveries or the prospect of insurance recoveries prevent a taxpayer from deducting expenses that are otherwise deductible under that section. Section 162(a) provides that a taxpayer may deduct all ordinary and necessary expenses paid or incurred during the taxable year in carrying on a trade or business. See also Treas. Reg. § 1.162-1(a). Treas. Reg. § 162-10(a), however, specifically limits the deduction for amounts paid or accrued as compensation for injuries to the amount not compensated for by insurance or otherwise.

A deduction for an expense for which there is a *right* or *expectation* of reimbursement may be disallowed because these payments are not expenses of the taxpayer and are instead in the nature of an advance or a loan. The extent to which the right must be established has varied. Some cases have denied the deduction because the right of reimbursement was fixed, others have allowed the deduction because the right of reimbursement was uncertain, and other cases have denied the deduction even if the taxpayer's right to reimbursement was subject to a contingency.

A fixed or established right of reimbursement precludes a taxpayer from deducting expenses that would otherwise be deductible under section 162. Rev. Rul. 79-263, 1979-2 C.B. 82 (no deduction for portion of expenses for which the taxpayer knows he will be reimbursed since the taxpayer suffers no economic detriment with respect to these expenses). A right to reimbursement is sufficiently fixed to preclude a deduction when the right has matured without further substantial contingency. *Charles Baloian Company, Inc. v. Commissioner*, 68 T.C. 620, 626, 628 (1977), *nonacq. on other gds*, 1978-2 C.B. 3. A fixed right of reimbursement has been shown through written

agreements specifically providing that the taxpayers' expenses were to be reimbursed or written statements from a third party authorizing the taxpayer to incur the expenses. See *Manocchio v. Commissioner*, 710 F.2d 1400, 1402 (9th Cir. 1983); *Glendinning, McLeish & Co. v. Commissioner*, 61 F.2d 950, 952 (2d Cir. 1932); *Webbe v. Commissioner*, T.C. Memo. 1987-426, *aff'd*, 902 F.2d 688 (8th Cir. 1990); Rev. Rul. 78-388, 1978-2 C.B. 110 (a taxpayer's moving expenses for which the taxpayer has a fixed right of reimbursement are not deductible under section 162 or section 165).

In *Levy v. Commissioner*, 212 F.2d 552 (5th Cir. 1954), the taxpayer paid for roof repairs to a building the taxpayer rented for business purposes. After questioning the high cost of the repairs the owner nonetheless agreed to pay and requested that the bills be forwarded. The taxpayer instead paid for additional repairs and notified the owner, but received no reimbursement. The court held that the taxpayer was not entitled to deduct the cost of the repairs as an ordinary and necessary business expense because the taxpayer had a right to reimbursement, despite the owner's ultimate failure to reimburse.

If the right to reimbursement is not fixed, the deduction may be allowed. See *George K. Herman Chevrolet, Inc. v. Commissioner*, 39 T.C. 846, 853 (1963) (taxpayer had no right to reimbursement at the time the expenses were incurred); *Allegheny Corporation v. Commissioner*, 28 T.C. 298, 305 (1957), *acq.*, 1957-2 C.B. 3 (deduction not precluded by contingent possibility of future reimbursement from assets of debtor of legal fees and costs for representation in bankruptcy proceeding). In *Electric Tachometer Corporation v. Commissioner*, 37 T.C. 158, 161-162 (1961), *acq.*, 1962-2 C.B. 4, the taxpayer was allowed a deduction in the year expenses were paid for moving machinery as the result of a condemnation action because there was no fixed right of reimbursement but only an indefinite and general right to recover its expenses. The court concluded that, although the taxpayer had a general right to reimbursement of moving expenses, conflicting evidence at hearings to determine the amount of compensation indicated the lack of definiteness of the taxpayer's right. In *Varied Investments, Inc. v. United States*, 31 F.3d 651, 653 (8th Cir. 1994), a taxpayer was allowed a deduction under section 162 in the taxable year it transferred money to a trust to provide for the satisfaction of a judgment after three insurers denied liability, even though the taxpayer recovered some insurance proceeds in subsequent years.

An *expectation* of reimbursement, rather than a fixed and absolute right of reimbursement, may be sufficient to preclude a deduction under section 162. Rev. Rul. 80-348, 1980-2 C.B. 31, holds that travel expenses that otherwise would be allowable as a deduction under section 162(a) may not be deducted if there is an expectation of reimbursement, even if the reimbursement is not received until a later year.

A line of cases has held that an attorney representing clients on a contingent fee basis may not deduct advances to or expenses paid on behalf of the clients as ordinary and necessary business expenses. The amounts were to be repaid from any recovery and although, generally, the taxpayers screened cases they accepted to maximize recoveries, the taxpayers never recovered 100% of the expenditures. *Burnett v.*

Commissioner, 356 F.2d 755, 760 (5th Cir.), *cert. denied*, 385 U.S. 832 (1966); *Herrick v. Commissioner*, 63 T.C. 562, 567, 568 (1975); *Canelo v. Commissioner*, 53 T.C. 217, 225 (1969), *aff'd*, 447 F.2d 484 (9th Cir. 1971), *acq.* 1971-2 C.B. 2, *nonacq. in part*, 1982-2 C.B. 2; *Silverton v. Commissioner*, T.C. Memo. 1977-198, *aff'd*, 647 F.2d 172 (9th Cir.), *cert. denied*, 454 U.S. 1033 (1981); *Watts v. Commissioner*, T.C. Memo. 1968-183. In *Flower v. Commissioner*, 61 T.C. 140, 152 (1973), *aff'd*, 505 F.2d 1302 (5th Cir. 1974), which involved a fixed right to reimbursement, the court characterized *Burnett* as holding that even a contingent right to reimbursement is sufficient to disallow a deduction.² Based on these authorities, we conclude that a right of reimbursement precludes a deduction for a business expense under section 162 even if there is not a certainty of reimbursement. A mere possibility of reimbursement does not preclude a deduction. In most cases, if the taxpayer has an insurance policy that, on its face, covers the item in question, and there is no indication that an exception to coverage applies, then a deduction under section 162 should be disallowed, as the taxpayer would have a fixed contractual right to reimbursement.

Conclusion—Issue 1.

A taxpayer may not claim a section 165 loss deduction to the extent the taxpayer has a claim for reimbursement for which there is a reasonable prospect of recovery. A taxpayer may not claim a section 162 business expense deduction to the extent the taxpayer has a right to reimbursement, even if the right is not certain or is subject to a contingency. The standards “reasonable prospect of recovery” under section 165 and “right to reimbursement” under section 162 are highly factual. Whether a taxpayer claims a deduction for an expense under section 165 or section 162, the deduction should be denied if, based on the facts and circumstances, the taxpayer has insurance coverage that appears to provide a right to reimbursement and there is no indication that an exception to coverage applies.

Under section 165, if, in the year of the loss, there is a claim for reimbursement with respect to which there is a reasonable prospect of recovery, then the loss deduction is deferred until the taxable year in which there is no longer a reasonable prospect of recovery. Under section 162, if, in the year of the expenditure, the taxpayer has a right to reimbursement, even if subject to a contingency or not certain, the taxpayer may not deduct the expenses in that year. If the taxpayer receives less reimbursement than expected in subsequent taxable years, then the taxpayer may take a deduction for the

² We note two cases that addressed whether expenses relating to flood-damaged property were deductible under § 162. *R.R. Hensler v. Commissioner*, 73 T.C. 168, 178 (1979), *acq. in result*, 1980-2 C.B. 1, *action on dec.*, 1980-164 (Aug. 5, 1980), allowed the deduction under § 162, rather than § 165, because the expense was in the nature of a repair. In *Louisville and Nashville Railroad Company v. Commissioner*, T.C. Memo. 1987-616, the taxpayer was required to deduct the cost of restoring railroad track and grading damaged in a hurricane under § 165 rather than § 162 because the taxpayer substantially replaced rather than repaired the damaged property. However, neither case addresses the effect of a claim for reimbursement or compensation on deductibility.

portion of the expenses that are not reimbursed and for which the taxpayer no longer has a right to reimbursement.

Application of the Standards

Evidence that the Service should consider in determining whether a taxpayer has a reasonable prospect or expectation of reimbursement includes:

- (1) the terms of the insurance policy (for example, does the policy cover the types of claims at issue, under what circumstances may coverage be denied),
- (2) a copy of any insurance claims,
- (3) correspondence from the insurance company indicating the likelihood of coverage,
- (4) past history of insurance coverage of similar claims,
- (4) standard industry practice with claims of a similar nature,
- (5) opinions of insurance adjusters or other insurance company representatives,
- (6) notes or correspondence from any legal counsel as to whether the insurance claims are collectible, and
- (7) whether the taxpayer has pursued legal action against the insurance company.

Issue 2. If a SLL expense is disallowed as a deduction in a taxable year either because of the actual recovery of such expense during the taxable year or because of insurance recoveries anticipated to be received in a subsequent taxable year, how does that affect the utilization of the expense in determining the amount of a taxpayer's SLL?

Section 172(f)(1) defines a SLL as the sum of certain deductions to the extent taken into account in computing the NOL for the taxable year. Thus, a deduction must be allowed for the taxable year in order to be included in the NOL for that year. Further, to be included in a SLL for the taxable year, a product liability expense must be deductible under section 162 or 165 for that year. Therefore, SLL expenses not deductible for a taxable year cannot generate either an NOL or SLL for that taxable year. The expense may only generate a SLL for the taxable year in which it is an allowable deduction.

Issue 3. If a taxpayer satisfies the requirements to deduct a SLL expense in one taxable year and deducts such expense for that year, but receives a reimbursement of the deducted expense through insurance recoveries in a subsequent taxable year, how is that reimbursement treated for federal income tax purposes? May the Service require the taxpayer to reduce its SLL expense deductions for the taxable year of recovery by the amount of the recovery (netting)?

Section 111(a) is a codification of part of the judicially created tax benefit rule. There are two components to the rule: an inclusionary component and an exclusionary component. Under the inclusionary component, an amount deducted for a taxable year may be included in gross income under section 61 in a subsequent taxable year as a result of an event occurring in the subsequent year that is fundamentally inconsistent with the premise on which the deduction was initially based. *Hillsboro National Bank v*

Commissioner, 460 U.S. 370, 383 (1983). The inclusionary component applies if had the later event occurred within the taxable year in which the original expense was paid or incurred, the event would have foreclosed the deduction for that expense. *Id.* at 383, 384.

However, the amount of an item otherwise includable in gross income pursuant to the inclusionary component of the tax benefit rule may be limited by the exclusionary component of the tax benefit rule. Section 111(a) provides that "[g]ross income does not include income attributable to the recovery during the taxable year of any amount deducted in any prior taxable year to the extent such amount did not reduce the amount of tax imposed by ... [chapter 1 of the Code]". For this purpose, section 111(c) provides that an increase in a carryover which has not expired before the beginning of the taxable year in which the recovery takes place shall be treated as reducing tax imposed by [chapter 1 of the Code].

A taxpayer may satisfy the requirements to deduct SLL expenses in a taxable year but still receive reimbursement for those expenses in a subsequent taxable year through insurance recoveries. If so, the later reimbursement constitutes an event fundamentally inconsistent with the prior deduction within the meaning of *Hillsboro*. Thus, if a taxpayer derives a tax benefit from deducting such expenses, the taxpayer must include the amount of reimbursed SLL expenses in gross income pursuant to the inclusionary component of the tax benefit rule. If the taxpayer takes reimbursements into account at the time the right to reimbursement becomes fixed and determinable, and the taxpayer derived a tax benefit from deducting such expenses in a prior taxable year, the taxpayer must include the anticipated reimbursements of SLL expenses in gross income pursuant to the inclusionary component of the tax benefit rule at that time.

The request for Chief Counsel Advice raises the issue of whether the amount of product liability expenses deducted in prior taxable years, but reimbursed in the current taxable year, can be netted against unrelated current product liability expenses thereby reducing the taxpayer's product liability deduction for the current taxable year rather than increasing the taxpayer's gross income. We find no support for this position in the applicable statutes, regulations, or legislative history pertaining to product liability losses.

To be eligible to generate a SLL, section 172(f)(1) simply requires an item to qualify as a product liability expense and to be deductible under section 162 or section 165 for the taxable year. Neither section 172(f) nor the regulations thereunder provide any authority to net recoveries of product liability expenses deducted in prior taxable years against unrelated product liability expenses for the current taxable year in determining product liability deductions for the current taxable year. Nor can we find any indication in the legislative history to the product liability loss provisions that Congress intended such netting. Likewise, in determining Taxpayer's SLL deductions for a taxable year, we find no support for offsetting the excess of amounts taken into account pertaining to

reimbursements of environmental remediation expenses over actual expenses for one remediation site against environmental remediation expenses for unrelated sites.

Issue 4. Do deductions for legal fees incurred in asserting claims for insurance reimbursements for product liability expenses qualify as product liability deductions?

The 10-year carryback for NOLs generated by product liability deductions traces its origins to the Revenue Act of 1978 (the 1978 Act). Under section 172(f)(1)(A)(ii), deductions allowable under either section 162 or section 165 for expenses incurred in the investigation or settlement of, or opposition to, *claims against the taxpayer* [emphasis supplied] on account of product liability qualify as product liability deductions. The Conference Report to the 1978 Act discusses this provision as follows:

Product liability losses include not only the liability for damages under product liability claims, but also the expenses incurred in the investigation or settlement of, or opposition to, product liability claims. Indirect corporate expense, or overhead, is not to be allocated to product liability claims so as to become a product liability loss. Only expenses directly incurred in connection with the product liability claims are to be included in determining the amount of the product liability losses for the year.

H.R. (Conf.) Rep. No. 1800, 95th Cong., 2d Sess. 286 (1978).

Treas. Reg. § 1.172-13(b)(1)(B) defines product liability in part as section 162 or 165 deductions for “[e]xpenses (including settlement payments) incurred in connection with the investigation or settlement of or in opposition to *claims against the taxpayer* [emphasis supplied] on account of alleged product liability.” Finally, subject to an exception not relevant here, Treas. Reg. § 1.172-13(b)(2)(iv) provides that “[a]mounts paid for insurance against product liability risks are not paid on account of product liability.”

When a defect in one of Taxpayer’s products results in personal injury, property damage, or loss of use of property, this gives the injured parties a cause of action against Taxpayer, thereby resulting in a “claim against Taxpayer”. Consequently, expenses incurred in connection with the investigation or settlement of or opposition to the injured parties’ product liability claims against Taxpayer fall within the scope of section 172(f)(1)(A)(ii). By entering into a contractual arrangement for indemnification, Taxpayer may transfer some or all of the risk of loss from such claims to one or more insurance companies. However, expenses that relate solely to Taxpayer’s assertions of its claims for indemnification from its insurers pertain to claims against its insurers rather than claims against Taxpayer. Consequently, deductions for such expenses do not fall within the scope of section 172(f)(1)(A)(ii) and cannot qualify as product liability deductions.

Certain expenses may be incurred both in connection with the determination of product liability claims against Taxpayer and in connection with Taxpayer's claims against its insurers. For example, legal and investigatory expenses incurred to determine if an accident gives rise to a product liability claim against Taxpayer may also be pertinent to determining if that claim falls within the scope of Taxpayer's insurance coverage. If Taxpayer incurs the expense in connection with a product liability claim that is asserted or may be asserted against Taxpayer, a deduction for such an expense qualifies as a product liability deduction notwithstanding that the expense may be germane to determining if Taxpayer has a valid claim for insurance reimbursement for any loss attributable to that claim.³

On the other hand, issues involving an insured's right to indemnification from its liability insurer may have no relevance to the insured's primary liability to the third party claimant. See e.g. *America Fire and Casualty Co. v. Tankersly*, 270 Ala. 126 (1959) (failure to give notice of accident as soon as practicable as required by insurance policy released insurer from its obligation to defend and indemnify the insured); *Gerrard Realty Corp. v. American States Insurance Co.*, 89 Wis.2d 130 (1979) (failure to timely notify insurer of civil action against insured extinguished insurer's indemnification obligation). Deductions for legal and other fees incurred in connection with resolving issues that do not bear on Taxpayer's product liability to third party claimants but relate only to Taxpayer's claims against its insurers do not qualify as product liability deductions. To make a proper determination, each deduction for legal and other fees must be analyzed to determine whether the fees relate to the Taxpayer's product liability to third parties, to the Taxpayer's claims against its insurers, or to both types of claims.

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We hope this information has been useful. Please call us at _____ if you have any questions regarding this advice.

³ However, once Taxpayer's liability to third parties has been established, subsequently incurred expenses that in the absence of such establishment might have been relevant to both Taxpayer's liability to third parties and Taxpayer's claim for insurance reimbursement claim no longer have any relevance to Taxpayer's liability to third parties.