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DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR: ASSOCIATE DISTRICT COUNSEL, CLEVELAND DISTRICT
CC:NER:OHI:CLE
ATTN: CHRISTOPHER A. FISHER

FROM: DEBORAH A. BUTLER
ASSISTANT CHIEF COUNSEL (FIELD SERVICE)
CC:DOM:FS

SUBJECT:

This Field Service Advice responds to your request of September 2, 1998. It is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND:

Year 1 =

Year 2 =

Year 3 =

Year 4 =

ISSUE:

Whether certain expenses are specified liability losses within the meaning of section 172(f)(1) and, therefore, eligible for a ten-year net operating loss carryback period rather than the generally applicable three-year period.

CONCLUSION:

The two categories of taxpayer's expenses in issue do not qualify for the ten-year carryback for specified liability losses under section 172(f).

FACTS:

Taxpayer is the parent company of a consolidated group of corporations. The examination of its tax years Year 3 and Year 4 resulted in a large consolidated net operating loss (NOL) for Year 3. Since taxpayer had no taxable income for the three years immediately preceding the loss year, it could not use the NOL carryback under the general three-year rule. Instead, the taxpayer purported to carry back the NOL as a specified liability loss under section 172(f) to even earlier Years 1 and Year 2.

LAW AND ANALYSIS:

Section 172(f) presents a more narrow exception to the general three-year carryback rule than has been asserted by this taxpayer as well as others. The specified liability loss exception is much more severely limited than that which would be extant under a supposed "plain meaning" reading of the section's elements. The correct narrower reading is based upon our interpretation of the scant legislative history as well as the statutory and practical context within which this relief provision was adopted by Congress. Given that backdrop, the Service recently sought, and has now obtained, a congressional clarification of the scope of the section, prospectively at least. See Tax and Trade Relief Extension Act of 1998, § 3004, reprinted in CONG. REC. H11287 (daily ed. Oct. 19, 1998). Yet, the statute is only effective for tax years ending after enactment; thus, we are still confronted by the problem of application in any earlier years under examination.

As you note, the only Tax Court opinion to consider section 172(f) to date is Sealy Corp. v. Commissioner, 107 T.C. 177 (1996), appeal docketed, No. 98-70369, et seq. (9th Cir. March 31, 1998). Sealy set out a very narrow reading of the section; nevertheless, the opinion did not address all aspects of numerous current arguments in this area. The case does, however, provide a Service-favorable starting point for any analysis of litigation risk.

Another Tax Court case has also been briefed and we await an opinion. That case is of particular relevance here. See Intermet Corp. v. Commissioner, Dkt. No. 8246-97. As presented on your facts as well, Intermet involves whether state taxes and interest on state and federal taxes qualify as specified liability losses. We have taken the position therein that those expenditures are not eligible for the ten-year carryback under section 172(f). In adhering to the principles argued and

upheld in Sealy and consistent with our framework for analysis in Internet and other cases we have reviewed, our position as to the expenses you have questioned follows.

Settlement of "Strike Fund" Payment

It is unclear to us whether this category represents ultimate payment for a tort liability at all (i.e., whether the unfair trade practices complained of and settled are actually torts in a strict legal sense). If so, it is also uncertain whether such acts were merely so-called "single act" tort liabilities or, instead, were multiple act torts requiring a series of actions or failures to act over an extended period of time a substantial portion of which occurred before the three-year period prior to the taxable year in issue. See section 172(f)(1)(B)(ii).

Notwithstanding this uncertainty, while specific further factual development might be welcome, on the basis of what we do know, we would hold this category to be excluded from section 172(f) in either event. Single act torts are not covered by the statute, and are thus excluded from ten-year treatment. To similar result, even if the liabilities in question were multiple act torts arising from a series of actions or failures to act, it is certainly not clear that these acts or failures occurred over an extended period of time. Therefore, under either view—single or multiple--the payments are not qualified as specified liability losses under section 172(f).

State Tax Deficiencies

In Year 3, as a result of state income tax examinations of Year 1 through Year 2 of some members of the consolidated group, taxpayer made certain tax payments to two states. It now claims specified liability loss treatment for these state tax payments. It is unclear whether those liabilities were contested; regardless, you would advise allowing section 172(f) treatment. While we agree that the contested v. uncontested aspect is of no moment in our determination, we disagree that delayed payment is adequate to support section 172(f) applicability.


That portion of section 172 that provides for a ten-year carryback for deferred statutory or tort liability losses was added to the Code in 1984, when the economic performance rules under section 461(h) were enacted. Deficit Reduction Act of 1984, Pub. L. 98-369, § 91(d). The statutory context, as well as the limited legislative history, indicate that Congress intended the ten-year carryback to apply to only a narrow class of liabilities.

The distinguishing feature of those liabilities within the eligible narrow class is an element of delay in the timing of the deduction that is inherent in the nature of the deduction itself. For example, arguably, land used for mining purposes cannot be reclaimed environmentally during the time which it is actually being mined.

Accordingly, there is an inherent delay of the deduction for reclamation expenses to later years. Similarly, there is often a substantial time lag between selling a defective product and an injury caused by the product. The state tax liabilities at issue here do not have that inherent delay nature.

In Internet, supra, we argued our position that taxes are not within that narrow class of expenses that are eligible for the ten-year carryback. There is no inherent delay in the nature of the liability. As stated in our brief, Congress clearly did not intend the special carryback rule to apply to all liabilities for which a deduction is delayed by the economic performance rules. If merely routine costs—which surely includes state income taxes—were within the eligible class, then nonpayment of current liabilities for more than three years would qualify a taxpayer for a ten-year carryback upon the payment of those costs. Thus, the tax payments of the subject taxpayer are likewise ineligible for the ten-year carryback.

CASE DEVELOPMENT, HAZARDS, AND OTHER CONSIDERATIONS:

There are obviously known litigation hazards in our current position, given the paucity of cases and legislative history addressing section 172(f). In the case of United States v. Balsam Corp., 1998 LEXIS 24409 (8th Cir. Sept. 30, 1998), for example, the bankruptcy, district and appellate courts—simply put—just would not venture past the taxpayer’s broad assertion that all its losses resulted from a fraud liability. There was no analysis of the origin and nature of each of the myriad deductions, or whether inherent delay was involved as to any, that made up the NOL involved. 

In sum, on the basis of the foregoing, as to the two described expenses in issue, we conclude that the expenses are not qualified specified liability losses. We encourage you to seek our help in any way you need during any factual development process on the other expenses. Should you have any questions, please call (202) 622-7900.

DEBORAH A. BUTLER

By: /s/
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