OFFICE OF
CHIEF COUNSEL

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

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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

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

SUBJECT:

Field Service Advice
Specified Liability Losses under I.R.C. ' 172(f)

This Field Service Advice responds to your request dated February 8, 1999, which we received on February 22, 1999. As discussed by telephone, although we can now advise you as to some of the expenses in issue, we will need you to develop more information and/or clarify the facts presented with regard to certain of the other expenses in issue. In addition, we note at least one area that is more appropriate for a Technical Advice Memorandum.

This Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document may not be cited as precedent.

LEGEND:

Taxpayer	=	
Year 1	=	19
Year 2	=	19
Year 3	=	19
Year 4	=	19
Year 5	=	19
Year 6	=	19

ISSUE:

Whether net operating losses sustained by Taxpayer as a result of payments made in connection with various lawsuits, workers compensation claims, state tax liabilities, and interest on federal income and state tax liabilities are specified liability losses qualified for the ten-year carryback period under the provisions of I.R.C. '' 172(b)(1)(C) and 172(f)(1).

CONCLUSION:

With certain exceptions for those expenses in issue upon which Service position is as yet unsettled, or for which further factual development is required, the costs incurred by Taxpayer are not specified liability losses and, thus, do not qualify for the ten-year carryback period under the provisions of I.R.C. '' 172(b)(1)(C) and 172(f)(1).

FACTS:

For ease of reference, any pertinent asserted facts surrounding each claimed specified liability in issue are set forth below under the heading for each category. We base these factual assumptions upon the taxpayer-prepared attachments you included with your request. Although only one of Taxpayer=s attachments specifically itemizes individual expense claims (for Year 6), from our brief review of the material you have submitted, we have set out below the various general categories of claims involved for the three taxable years in issue (i.e., Years 4, 5, and 6) for which the putative losses therein where carried back ten years (for the Years 1, 2, and 3).

LAW AND ANALYSIS:

Background

The net operating loss deduction of section 172 responds to a potential unfairness resulting from the fact that the income tax is generally computed on an annual accounting basis. Without the ability to deduct net operating losses, businesses with fluctuating incomes would lose the benefit of their deductions in taxable years in which expenses exceeded income. As the Supreme Court has stated, the net operating loss provisions were designed to permit a taxpayer to "set off its lean years against its lush years." Libson Shops, Inc. v. Koehler, 353 U.S. 382, 386 (1957).

Under the original net operating loss deduction, enacted after World War I as a temporary measure, losses could be carried only to the taxable years immediately preceding and succeeding the loss year. Revenue Act of 1918, ' 204(b), 40 Stat. 1057 (1918). Since then, the congressionally prescribed periods for carrybacks and/or carryforwards have been changed frequently. See, e.g., H.R. Rep. No. 1337, 83d Cong., 2d Sess. (1954); S. Rep. No. 1622, 83d Cong., 2d Sess. (1954). The current general ruleBa 1997 enactment--is that a net operating loss should be carried back to the preceding two years with any unabsorbed excess thereafter carried forward to the twenty succeeding years. Section 172(b)(1)(A). That was a change from three and fifteen years, respectively.

In certain circumstances, depending upon the type of taxpayer or the nature of the loss involved, a different carryback or carryforward period may apply. The issue presented here entails one of those special situations, i.e., the scope of the alternative 10-year carryback allowance for deferred liabilities provided for in section 172(b)(1)(C) (a component of total "specified liability loss" under section 172(f)).

The portion of section 172 providing a special ten-year carryback was initially added by the Deficit Reduction Act of 1984 (DRA). Section 91 of DRA was the same section that added the economic performance rules of code section 461(h). Thus, it is our position that the operation of section 172(f) should be interpreted in the context of its enactment as part of the overall changes to the code resulting from adopting the economic performance rules. In enacting the economic performance rules, Congress recognized that this resulted in pushing deductions substantially further into the future than had been the rule under the "all events" test. Section 172(f) represents an effort to ameliorate the possible harshness created by that rule. It was not intended to extend the net operating loss carryback period for current operating expenses; rather, it was intended to serve the limited purpose of extending the carryback period for those "certain liabilities" deferred under the economic performance rules. See S. Rep. No. 169, 98th Cong., 2d Sess., at 269 (1984).

Section 172(f) presents a more narrow exception to the general three-year carryback rule than has been asserted by Taxpayer as well as other taxpayers. The specified liability loss exception is more limited than that which would be extant under a supposed Aplain 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.

Against this legislative backdrop, the Service sought, and has now secured, congressional clarification of the scope of the section. See Tax and Trade Relief Extension Act of 1998, ' 3004, reprinted in CONG. REC. H11287 (daily ed. Oct. 19, 1998). Yet, the amendment is only effective for tax years ending after enactment; consequently, we are still confronted by the problem of application in earlier years under examinationBincluding those in issue here.

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, land used for mining purposes cannot be reclaimed environmentally during the time in which it is actually being mined; accordingly, there is an inherent delay of the deduction for reclamation expenses to later years when the reclamation can actually occur.

The limited judicial precedent also supports that notion. As you are aware, the only Tax Court opinion to consider the specific scope of section 172(f) to date is Sealy Corp. v. Commissioner, 107 T.C. 177 (1996), aff=d, Nos. 98-70369, et seq. (9th Cir., March 26, 1999). Sealy sets out a very narrow reading of the section. The Tax Court agreed with the Commissioner that taxpayer's costs of compliance with reporting requirements of the SEC and ERISA federal statutes, as well as their IRS examination expenses, were not liabilities "arising under a Federal law or State law" within the meaning of section 172(f)(1)(B); nevertheless, neither the trial or appellate opinions address all aspects of numerous arguments in this area. The Sealy case does, however, provide a clearly Service-favorable starting point for any analysis of litigating risks.[1] Given these background considerations, we turn to an analysis of each of those categories claimed by Taxpayer.

State Taxes and Interest on Federal and State Taxes

Taxpayer claims specified liability loss treatment for contested state tax payments. These payments apparently involve state income taxes and state sales and use taxes as well as the interest on federal income taxes. The contested aspect of the payments is of no moment in our determination because merely delaying any payment--whether through contesting the liability or other Aextraneous@ means--is inadequate to support section 172(f) applicability. In Intermet, supra, we argued that the state tax liabilities at issue do not have that inherent delay nature; consequently, taxes are not within that narrow class of expenses that are eligible for the ten-year carryback. As was stated in our Intermet briefs, 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 merely routine costsBwhich surely includes state taxes and interest paymentsBwere within the eligible class, then simply nonpayment of current liabilities for more than three years would qualify a taxpayer for a ten-year carryback upon the payment of those costs. On the facts presented, that is what appears to have happened here.

As stated above, the distinguishing feature of those liabilities within the eligible narrow class is an element of inherent delay in the timing of the deduction itself. Land used for mining purposes cannot be reclaimed environmentally during the time which it is actually being mined. The state tax liabilities at issue here do not have that inherent delay nature. Thus, the tax payments of the subject taxpayer are also ineligible for the ten-year carryback.[2]

Worker=s Compensation

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[1] A more recent Tax Court case, Intermet Corp. v. Commissioner, 111 T.C. 294 (1998), presented the issue of whether state taxes and interest on state and federal taxes qualify as specified liability losses. Respondent argued there that those expenditures are ineligible for the ten-year carryback under section 172(f); however, unfortunately for present purposes, the opinion did not reach this question; rather, the case was resolved for the Commissioner upon what the court saw as the dispositive threshold matter of whether there was an NOL under section 172 and the consolidated return regulations (i.e., the Anetting@ issue). See Treas. Regs. '' 1.1502-12, -21A(f).

[2] Our position in Intermet, and herein, with respect to the eligibility of state taxes and interest on taxes would not be affected by the recent clarifying amendment to section 172(f), see Tax and Trade Relief Extension Act of 1998, supra, even if that amendment were applicable to the years in issue. Under either the former or new provision, these deductions are still outside the scope of specified liability losses.

Our comprehensive legal position with respect to worker=s compensation is still under development in the National Office; consequently, we can only recommend seeking a technical advice memorandum on this matter at this juncture. For the present, as a general matter, we are still counseling disallowance of these costs. In the context of this case, however, we understand that you will attempt to ascertain a more exact factual picture of the specific types of worker=s compensation costs involving Taxpayer. In this respect, specifically, in our reading of the materials, it is unclear whether the Apayments@ were for actual injury claims or for workers compensation premiums. This factual inquiry would also entail, as we have discussed, for example, what portion of these costs are for one-time payments for severed limbs or are part of other settlements with periodic payments for long-term medical care.

<u>Settlement of Purported AProduct Liability@ Claims</u>

Product liability is specifically defined in the statute. Section 172(f)(4) provides that it is a liability for damages on account of physical injury or emotional harm to individuals, 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 where such injury, harm, or damage arises after the taxpayer has completed or terminated operations with respect to, and has relinquished possession of, such product. Taxpayer argues that this definition is broad enough to include the purported Aproduct liabilities@ it encountered as well. We must, however, disagree.

It appears that the product settlements reached were merely a function of contractual warranty [3] or rather typical business efforts at customer satisfaction. As such, in this context, Taxpayer=s reading appears overly broad; moreover, that reading flatly ignores Treas. Reg. ' 1.172-13(b)(2)(ii), which specifically excludes warranty theories from the applicable definition of Aproduct liability.@ If Taxpayer=s reading were accepted, then virtually all contract claims would be covered under the statute. That expansion would not comport with the congressional intent.

<u>Various Lawsuit Liabilities</u>

In the case of the lawsuits encompassed within the claimed specified liability losses, particulars of each claimed injury must be elucidated. Currently, it is unclear whether the costs in issue represent payment for purported tort liabilities at all in some case (<u>i.e.</u>, whether Taxpayer=s actions complained of and/or settled legally sound in tort). Even if it were established that any of the various liabilities in issue were torts, it is uncertain in many instances whether such acts were merely so-called Asingle act@ tort liabilities (<u>e.g.</u>, a car accident) 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 at least three years prior to the taxable year in issue. See section 172(f)(1)(B)(ii). It is the office=s position that so-called Asingle act@ torts are not covered by the statute.

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[3] This consideration would also obtain for some of Taxpayer=s expenses under the Alawsuit@ category. It appears that at least some of those costs arose primarily from contractBnot tort.

Irrespective of the uncertainty described above, while specific further factual development would 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 carryback 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 not clear that these acts or failures occurred over an extended period of time. In that case, under either view of these actionsBwhether single or multiple act torts--the payments are not qualified as specified liability losses under section 172(f). On the basis of what is set forth at present, we would hold this category to be excluded from section 172(f)(1)(B)(ii) to the extent the liabilities result from single act torts. If the liabilities in question here are torts and arise from a series of actions or failures to act, a substantial portion of which meets the three-year test, then the provisions of section 172(f)(1)(B)(ii) would likely apply.

National Office positions on at least two relevant aspects of this whole Alawsuit@ area have been established. These are: (1) irrespective of whether the underlying liability is a qualified specified liability loss, any attendant legal or professional fees with respect to that liability are not similarly qualified, and (2) if a liability arises out of tort, it is not also cognizable under the AFederal or State law@ provision of section 172(f)(1)(B)(i) as well.

<u>Attorneys= Fees</u>

As stated above, our position on this aspect of the Alawsuit@ area has been established. Irrespective of whether the underlying liability is a qualified specified liability loss, any attendant legal or professional fees with respect to that liability are not similarly qualified. Those fees arise from a contract between private parties. On this point, <u>Sealy</u>, <u>supra</u>, is direct support. From the materials submitted, it appears that numerous claimed losses by Taxpayer involve only this specific kind of expense.

<u>CASE DEVELOPMENT, HAZARDS, AND OTHER CONSIDERATIONS</u>:

There are obviously litigation hazards in our current position, given the paucity of cases and legislative history addressing section 172(f). In the case of <u>United States v. Balsam Corp.</u>, 1998 LEXIS 24409 (8th Cir. Sept. 30, 1998), for example, the bankruptcy, district and appellate courts simply refusedBin short--to 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 addition, we must concede that a reasonable Aplain reading@ of the statute, without more, could indeed lead a court to very broad application of the terms and phrases used therein, including, as well, Aproduct liability.@ See discussion at 6, <u>supra</u>. Taxpayer would probably prevail if such a position were adopted by the deciding court. This would be especially true outside the context of a Tax Court and/or Ninth Circuit venue, given the <u>Sealy</u> opinions. In that regard, therefore, since an appeal in this case from a Tax Court decisionBabsent any agreement by the parties--would lie to the Ninth Circuit, <u>Sealy</u> becomes the controlling authority. That factor clearly weighs heavily in favor of the Commissioner in this case.

With respect to a procedural consideration, as we understand the facts, Taxpayer filed a Form 1139 Application for the taxable year [redacted]; but the field did not respond--affirmatively or negatively--to that filing. Under section 6411, a taxpayer may request a tentative refund of amounts arising from NOL carrybacks. The Commissioner must act upon these claims within 90 days. Section 6411(b). The only bases set forth in the Code for not acting within 90 days are Aerrors or computation which cannot be corrected within 90 days or material omissions.@ Id. A decision to disallow a Form 1139 application is not subject to review. Rock v. United States, 279 F.Supp. 96, 99 (S.D.N.Y. 1968); Treas. Reg. ' 1.6411-3(c).

If a Form 1139 is filed in a processible form and the claim is not paid within 45 days of filing interest begins to accrue on the claimed amount. I.R.C. ' 6611(e)(1), (h). A Form 1139 is in processible form if it is (1) filed on the proper form; (2) filed in proper form with the taxpayer=s name, address, identifying number and signature; and (3) filed with sufficient information to verify the mathematical accuracy of liability shown on the form. I.R.C. ' 6611(h)(2); Columbia Gas System, Inc. v. United States, 70 F.3d 1244, 1246 (Fed. Cir. 1995). If a Form 1139 is processible when filed, even if it is disallowed, interest on the refund, if eventually paid, will accrue. Columbia Gas Systems v. United States, 32 Fed. Cl. 318, 329 (1994), aff=d, 70 F.3d 1244 (Fed. Cir. 1995).

Hence, two conclusions are compelled: (1) the only legitimate basis for disallowing a Form 1139 is if it is not in processible form; and (2) if a Form 1139 is in processible form, even if it is disallowed, interest will still accrue on the refund as of 45 days after the date of filing. Unless the form is not processible, as defined in section 6611(h)(2), the amount on the form should be refunded. The refund should be made even if the Service believes that the underlying basis for the refund is invalid. Thus, in this case, where the refund sought in the Form 1139 in question as based on a questionable interpretation of I.R.C. ' 172(f), it should have been paid anyway. See Rev. Rul. 78-639, 1978-2 C.B. 324. There is very limited authority, not applicable here, for disallowing a Form 1139 based on the validity of the basis for refund claimed on the form. See Rev. Rul. 84-175, 1984-2 C.B. 296.

By:

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