OFFICE OF
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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:

FROM: ASSOCIATE CHIEF COUNSEL (INCOME TAX & ACCOUNTING) CC:ITA

SUBJECT: I.R.C. § 172 – LITIGATION EXPENSES; RECALL CAMPAIGNS

This Field Service Advice responds to your request dated November 21, 2000. It is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

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LEGEND:

Taxpayer =
Federal Statute A =
Federal Statute B =)
State =

Date 1 =
Products =
$X =
$$X =
$$$$$X =
$2X =
$$2x =
$$$$2X =
Tax Year 1 =
Tax Year (1-10) =
Tax Year (1-7) =
Tax Year 2 =
Tax Year (2-10) =
Tax Year (2-8) =
Tax Year (1-4) =
Tax Year (2-4) =

ISSUES:

1. Whether expenses incurred in connection with the investigation, opposition, or settlement of various federal and State civil rights lawsuits qualify as specified liability losses under I.R.C. § 172(f)(1)(B) and, therefore, are eligible for a ten-year net operating loss carryback period.

2. Whether expenses incurred in connection with the investigation, opposition, or settlement of "miscellaneous tort liability" lawsuits qualify as specified liability losses under section 172(f)(1)(B) and, therefore, are eligible for a ten-year net operating loss carryback period.

3. Whether voluntary recall campaign payments purportedly made under certain federal statutes qualify as specified liability losses under section 172(f) and, therefore, are eligible for a ten-year net operating loss carryback period.

CONCLUSION:

The expenditures described in Issues 1, 2, and 3, as discussed herein, have not been shown to qualify as specified liability losses under section 172(f).

FACTS:

In Tax Year 1, Taxpayer reported a net operating loss (NOL) of $$$$$X. Of that NOL, $X was carried back ten years to Tax Year (1-10) and $$X was carried

back seven years to Tax Year (1-7) as purported specified liability losses under section 172(b)(1)(C).

In Tax Year 2, Taxpayer reported a net operating loss (NOL) of $$$$2X. Of that NOL, $2X was carried back ten years to Tax Year (2-10) and $$2X was carried back eight years to Tax Year (2-8) as purported specified liability losses under section 172(b)(1)(C).

On Date 1, Taxpayer filed an amended informal claim increasing significantly the portion of the NOLs in both Tax Year 1 and Tax Year 2 that it claimed were attributable to purported specified liability losses under section 172(b)(1)(C). Those purported losses are spread over several categories of expenditures.

The categories of expenditures discussed herein involve: (1) expenses incurred in connection with the investigation, opposition, or settlement of various federal and State civil rights lawsuits and miscellaneous tort liabilities; and (2) recall campaign payments, made voluntarily, pursuant to Federal Statute A and Federal Statute B.

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 rule–a 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 an immediate 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 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 Applicable Statute and its Legislative History

Congress first enacted the statutory language pertinent to this case in the Tax Reform Act of 1984 (1984 Act) when it enacted section 172(k) of the Internal Revenue Code of 1954. The amounts described in section 172(f)(1)(B) as specified liability losses were originally described in section 172(k) as deferred statutory or tort liability losses. Prior to its amendment in section 3004(a) of the Tax and Trade Relief Extension Act of 1998,[1] section 172(f)(1)(B) treated as a specified liability loss the portion of a NOL generated by:

> (B) any amount [other than product liability expenses and certain expenses related thereto] allowable as a deduction under [chapter 1 of the Internal Revenue Code] with respect to a liability which arises under a [f]ederal or [s]tate law or out of any tort of the taxpayer if –
>
> > (i) in the case of a liability arising out of a [f]ederal or [s]tate 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 failures 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.

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. This specified liability loss exception, in other words, is much more severely limited than that which would be extant under a supposed “plain meaning” reading of the section 172 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.

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[1] Congress has clarified the scope of the section--at least prospectively. See Tax and Trade Relief Extension Act of 1998, § 3004. Yet, the new 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.

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.

Prior to the enactment of the economic performance requirement in section 461(h), Treas. Reg. § 1.461-1(a)(2) generally treated an accrual method taxpayer as incurring a liability for federal income tax purposes when the following two-pronged test was satisfied: (1) all the events occurred that established the fact of the liability; and (2) the amount of the liability could be determined with reasonable accuracy. This is the so-called all events test.

The Treasury Department became concerned when courts began interpreting the two-pronged all-events test in a manner that allowed accrual method taxpayers to deduct liabilities far in advance of when the liabilities had to be satisfied by payment or other performance. Because of the time value of money, the benefit to taxpayers from such accruals could be substantial, especially in periods of exceptionally high interest rates.

For example, state and/or federal laws generally require miners to restore the surface of land they have strip mined to a condition comparable to its prior state. A miner's legal obligation to restore arises when the miner disturbs the land, although actual restoration may not occur until some time thereafter. If miners failed to estimate reasonable future costs to restore the land, the Service succeeded in preventing them from deducting estimated restoration costs for taxable years when the land was disturbed. Patsch v. Commissioner, 208 F.2d 532, 534-535 (3d Cir. 1953); Commissioner v. Gregory Run Coal Co., 212 F.2d 52, 57-58 (4th Cir.), cert. denied, 348 U.S. 828 (1954). On the other hand, if the deductions claimed were based on reasonably accurate estimates of future costs to restore, the courts generally allowed the strip miners to deduct the estimated costs for the taxable years when the land was disturbed. Harrold v. Commissioner, 192 F.2d 1002, 1006 (4th Cir. 1951); Denise Coal Co. v. Commissioner, 271 F.2d 930, 936 (3d Cir. 1959); Ohio River Collieries Co. v. Commissioner, 77 T.C. 1369, 1377 (1981).

Of similar concern, courts concluded that the occurrence of a work-related injury satisfied the first prong of the all-events test in the case of uncontested self-insured workmen's compensation liabilities. This allowed taxpayers which could reasonably estimate liabilities to be paid well in the future, such as workmen's compensation disability or survivor annuities, to deduct such amounts currently rather than when actually paid. Crescent Wharf & Warehouse Co. v. Commissioner, 518 F.2d 772 (9th Cir. 1975); Wien Consolidated Airlines, Inc. v. Commissioner, 60 T.C. 13 (1973), aff'd, 528 F.2d 735 (9th Cir. 1976).

Another situation that involved a much greater potential for a taxpayer to deduct an amount far in excess of the present value of the legal obligation giving rise to that deduction involved the obligation to decommission a nuclear power plant. In the case of a nuclear power plant the legal obligation to decommission could arise well in advance of the time when the decommissioning was completed.

The Administration decided to seek a legislative solution to the problem caused by such cases. Specifically, the Administration proposed the addition of an "economic performance" requirement to the all-events test. See Staff of the Joint Committee on Taxation, Summary of Administration's Revenue Proposals in the Fiscal Year 1985 Budget Proposal 31 (Comm. Print 1984). Under the proposed change, the all-events test would be "clarified" so that with certain exceptions, deductions would not be permitted until services were performed, the use of property actually occurred, or in the case of workmen's compensation or similar liabilities, the liability was actually satisfied. Id. "Under the proposal, the net operating loss carryback rules would be amended to allow losses to be carried back to the year in which the obligation generating the loss arose." Id.

The Subcommittee on Oversight of the House Ways and Means Committee held a hearing on the Administration's proposal to deal with "premature accruals" by the addition of a new economic performance requirement. See Timing and Measurement of Taxpayer Deductions for Obligations to be Paid in the Future, Hearing Before the Subcommittee on Oversight of the Committee on Ways and Means House of Representatives, 98th Cong., 2d Sess. (February 24, 1984). Many of the taxpayers and tax practitioners who testified at the hearing objected to the proposal because, in their view, it would result in a mismatching of revenue and expenses.

In the case of mining reclamation, for example, if reclamation costs can only be deducted in the taxable year when the work is actually done, such deductions will not be matched with the earlier income these costs helped generate. On the other hand, immediately deducting the total estimated cost of restoration overstates the true economic cost to the taxpayer. Thus, Treasury proposed liberalizing the NOL provisions for deductions deferred because of economic performance:

> Our proposals provide for extension of the carryback period in appropriate circumstances to insure that the deferred expenses will be able to be fully utilized.
>
> Generally expenses attributable to liabilities arising more than 3 years prior to economic performance will be permitted to be carried back for a period not to exceed 10 years, subject to certain transition rules. Special carryback rules might be appropriate for certain expenses to be paid in the future such as the nuclear powerplant decommissioning costs.

Id. at 7 (statement of Ronald A. Pearlman, Deputy Assistant Secretary for Tax Policy, U.S. Treasury).

Congress adopted the economic performance requirements by enacting section 461(h) of the Code in section 91(a) of the 1984 Act. In section 91(d), it also enacted the ten-year carryback for deferred statutory or tort liability losses. The discussion of the new carryback provision appears in the same section of the committee reports as the section 461(h) discussion. Although the House and Senate Reports describe the operation of the proposed new ten-year carryback, neither of those reports discuss the reason for its enactment. The Conference Report, however, alludes to the carryback for losses attributable to certain liabilities deferred under "these provisions of the bill." H.R. (Conf.) Rep. No. 861, 98th Cong., 2d Sess. 872-73 (1984). Context indicates the reference is to the economic performance requirements.

Sealy Corp. v. Commissioner

The first Tax Court opinion to consider the application of section 172(f) was Sealy Corp. v. Commissioner, 107 T.C. 177 (1996), aff'd, 171 F.3d 655 (9th Cir. 1999).[2] In Sealy, the taxpayer asserted that a portion of a net operating loss generated by deductions for the following items constituted a specified liability loss within the meaning of section 172(f)(1)(B): (1) professional fees incurred to comply with reporting, filing, and disclosure requirements imposed by the Securities and Exchange Act of 1934; (2) professional fees incurred to comply with ERISA reporting requirements; and (3) professional fees incurred in connection with an IRS income tax audit. The Tax Court held that deduction of the above expenses did not result in a specified liability loss because the liability for the expenses did not arise under a federal or state law within the meaning of section 172(f)(1)(B).

The Tax Court gave three reasons for its conclusion. First, the court noted that the federal law cited by the taxpayer did not establish its liability to pay the amounts at issue. The taxpayer's liability did not arise until the services were

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[2] Another Tax Court case, Intermet Corp. v. Commissioner, 111 T.C. 294 (1998), rev'd and remanded, 209 F.3d 901 (6th Cir. 2000), presented the issue of whether state taxes and interest on state and federal taxes qualify as specified liability losses. We argued therein that those expenditures are ineligible for the ten-year carryback under section 172(f). The Tax Court's opinion, however, did not reach that issue; rather, the case was resolved at the trial level in favor of the Commissioner upon what the court saw as the dispositive threshold matter of whether there was a net operating loss under section 172 and the consolidated return regulations (i.e., the "netting" issue). See Treas. Regs. §§ 1.1502-12; 1.1502-21A(f). Upon taxpayer's appeal, however, the Sixth Circuit reversed on that netting issue and remanded the case for a determination of whether the tax and interest expenses in issue were qualified as specified liability losses under section 172(f). A subsequent Tax Court ruling is still pending.

contracted for and received and the taxpayer's choice of the means of compliance, rather than the cited regulatory provisions, determined the nature and amount of their costs. If the taxpayer had failed to comply with the auditing and reporting requirements or had not obtained the particular services at issue, liability would not have been measured by the value of the services they actually contracted for and received. 107 T.C. at 184.

Second, the Tax Court read the legislative history to suggest that Congress intended the provision to apply only to liabilities the deduction of which the economic performance requirement caused to be deferred. Because the economic performance requirement did not delay taxpayer's accrual of the deductions at issue, the court concluded that Congress did not intend for losses generated by those deductions to qualify as specified liability losses. Id. at 185-86.

Third, in determining the scope of liabilities arising under either federal or state law within the meaning of section 172(f)(1)(B), the court considered the specific types of liabilities referred to in section 172(f), i.e., product liability, nuclear decommissioning liabilities, and torts. Invoking the statutory construction rule of ejusdem generis, the court concluded that Congress intended the 10-year carryback to apply to a relatively narrow class of liabilities similar to those identified in the statute. The court thought the costs at issue in Sealy were routine costs not like those identified in the statute. Id. at 186.[3]

Application of the statutory construction doctrine of ejusdem generis requires a determination of the characteristics of the class suggested by the enumerated items. The specific liabilities arising under federal or state law, identified in the statute and discussed in the legislative history to the 1984 Act, share a distinguishing characteristic. Inherent in the nature of each type of identified liability is an element of substantial delay between the act or failure to act giving rise to the liability and the time a deduction may be claimed for the liability because of the economic performance requirement. For example, because of the economic performance requirement, a taxpayer's deduction for nuclear decommissioning costs is inherently delayed by the substantial number of years that expire between the time a nuclear power plant begins operation, resulting in a legal obligation to decommission, and the actual decommissioning of the plant.

In contrast to the types of liabilities arising under federal or state law identified in the statute and the legislative history to the 1984 Act, the purported liabilities in issue here constitute costs that do not involve an inherent substantial

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[3] On appeal the Ninth Circuit focused on the fact that the acts giving rise to the liabilities at issue in Sealy did not occur at least three years before the beginning of the taxable year of the related deductions as required by section 172(f)(1)(B)(i). The Ninth Circuit did not expressly address the Tax Court's conclusion that the liabilities at issue did not arise under federal or state law within the meaning of section 172(f)(1)(B).

delay between the time the events giving rise to the liability occur and when the deduction for such liability becomes allowable. While there may be substantial delays between the events giving rise to liability and the time when such liability becomes an allowable deduction (for example, an accrual method taxpayer may contest a liability and then may ultimately prove unsuccessful in court) such delays are not inherent in the nature of the liability.

Specific Expenditures of Taxpayer

1. Civil Rights Actions

The putative acts or omissions underlying the State and/or Federal civil rights causes of action have not been elucidated. Whether such “civil rights” liabilities, if any, of Taxpayer are indeed in the narrow class cognizable under section 172(f) must remain an open matter. In addition, there appear to be serious questions with regard to whether such civil rights liabilities would have an inherent delay factor at all. By way of example only, an unlawful discriminatory practice (which may be subject to punitive action or damages) in the hiring process is not inherent in the act of assembling a workforce. Consequently, that particular liability would not be within the narrow class reached by the specified liability provisions. Nevertheless, it may be possible that a cause of action couched primarily in civil rights terms may actually have an environmental or tort aspect that would support a separate section 172(f) applicability argument. To the extent that legal or other professional fees represent a part of this total outlay, on the basis of Sealy, of course, it is our position that these fees are not specified liability losses.

This aspect of its claim needs to be further developed and fully demonstrated by Taxpayer, before it can avail itself of the relief provided for specified liability losses. As currently presented, that special treatment must be denied.

2. “Miscellaneous” Tort Liabilities

Apparently, the acts giving rise to these purported liabilities represent sundry allegations against Taxpayer including breach of contract, fraud, interference with business relations, as well as violations of various federal antitrust statutes and state commercial codes. Notwithstanding the assumption that the three-year rule of section 172(f) has been met, we find little basis upon which to assume that specified liability loss treatment is otherwise appropriate.

Each alleged tort must meet the statutory requirements of section 172(f) on its own footing. Currently, it is unclear whether the costs in issue represent payment for purported tort liabilities at all (i.e., whether the 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 whether such acts were merely so-called “single act” tort liabilities (e.g., 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 before the three-year period prior to the taxable year in issue. See section 172(f)(1)(B)(ii). It is the office's position that single act torts are not covered by the statute.

The Service positions on at least two aspects of this whole "lawsuit" area in the context of section 172(f) have been established. These are: (1) irrespective of whether the underlying liability is a qualified specified liability loss, as stated above, any attendant legal or professional fees with respect to that liability are not similarly qualified, i.e., those fees arise instead from a contract; and (2) if a liability does arise out of a tort, it is not also cognizable under the "Federal or State law" provision of section 172(f)(1)(B)(i), i.e., there would be no reason for Congress to have adopted redundant relief side-by-side in the Code. While the first principle flows fairly clearly from an application of Sealy, the application of the second is a bit more complex. This can be illustrated by taking an example from one of the specific allegations against Taxpayer here, say a Sherman Act violation.

Section 2 of the Sherman Act, simply put, bars monopolization and attempts or conspiracies to monopolize "any part of" interstate or foreign trade. 15 U.S.C. § 2. It is our position that there is no "inherent delay" entailed in monopolizing or attempting to monopolize the relevant market leading to a violation of the Sherman Act; thus, such a liability would not be within the narrow class of liabilities for which Congress meant to provide relief under section 172(f)(1)(B)(i). So, while a literal reading may certainly cover it, the Sherman Act is not a "Federal or State law" congressionally intended to be reached by section 172(f). Whether subparagraph (ii) of section 172(f)(1)(B) applies, however, is indeed a much closer question. A brief review of the legislative and historical context within which the Sherman Act was adopted supports this view.

Contemporary proponents of the Sherman Act viewed the measure merely as a federal enactment of common law prohibitions against certain restraints of trade. See Sklar, The Corporate Reconstruction of American Capitalism, 1890-1916, 105-117 (1988); Van Cise, Understanding the Antitrust Laws, at 20-23 (1976). In fact, Senator John Sherman, the Act's namesake, said that it only set out "the rule of the common law which prevails in England and this country.[4]" 20 Cong. Rec. 167 (1889). Senator Sherman also cited several common law cases during its debate. 21 Cong. Rec. 2457-59 (1890). In this light, notwithstanding their subsequent "federal enactment," antitrust violations–like patent infringement--may essentially be considered to be torts. See Carbice Corp. v. American Patents Development

[4] See, e.g., Darcy v. Allen, 11 Coke 84, 77 Eng. Rep. 1260 (K.B. 1602), discussed in Sullivan, Antitrust, at 157-58 (1977 ed.) and Van Cise, Understanding the Antitrust Laws, at 12-14 (1976) (grant of a monopoly to a court favorite by Elizabeth I over the manufacture and importation of playing cards was invalidated by the Court of King's Bench because it prejudiced the public by raising prices and lowering quality).

Corp., 283 U.S. 27, 33 (1931) ("[patent] [i]nfringement, whether direct or contributory, is essentially a tort[.]").

The Supreme Court, in reviewing the provisions of the Sherman Act, noted that "[i]t is certain that those terms, at least in their rudimentary meaning, took their origin in the common law, and were also familiar in the law of this country prior to and at the time of the act in question." Standard Oil Co. v. United States, 221 U.S. 1, at 51 (1911). Consequently, we might view an antitrust claim of monopolization or attempt or conspiracy thereto, as a tort within the meaning of section 172(f)(1)(B)(ii) (to what extent this conclusion would extend to other proscribed restraints of trade, e.g., price fixing under the Clayton Act or price discrimination under other statutes, we do not address for present purposes).

As a factual matter, moreover, common sense likely tells us that monopolization of a particular relevant market for Sherman Act purposes would necessarily result from "a series of actions . . . over an extended period of time" within the meaning of section 172(f)(1)(B)(ii). In other words, it would not be a single act tort (which we have taken the technical position are outside section 172(f)). While further factual development is clearly necessary in that regard, assuming that such a monopolization scenario is factually demonstrated, a multiple act "tort" within the meaning of section 172(f)(1)(B)(ii) probably does exist and the 10-year carryback should be allowed.

We do not wish to make too much of the aforementioned example; yet, in short, it demonstrates that simple rubrics may not apply. Consequently, the various legal and factual allegations making up the "miscellaneous tort liabilities" of Taxpayer must be explored in depth to determine whether these constitute specified liability losses under section 172(f). While some liabilities perhaps may be rejected categorically as not constituting such losses (any actions which sound solely in breach of contract, for example), we are unable to make ultimate determinations for the majority of the suits on the basis of the facts presented. To the extent any settlement agreements reached on these suits add to that underlying uncertainty, Taxpayer's ability to invoke section 172(f) is only further impaired.

3. Voluntary Recall Campaign Payments

With regard to these expenditures, Taxpayer has refused to provide specific information as to the exact costs involved. It asserts that the specifics are irrelevant to whether the costs are eligible. Apparently, the particular amounts claimed in this category as specified liability losses go to expenditures incurred in Tax Year 1 to recall Products manufactured in Tax Year (1-4) and in Tax Year 2 to recall Products manufactured in Tax Year (2-4). According to Taxpayer, these purported liabilities arise under the likely assertion by the government of Taxpayer's obligations with respect to Federal Statute A and Federal Statute B, notwithstanding the actual voluntary compliance of Taxpayer.

Taxpayer is correct. We agree that the specific costs are irrelevant. In our view, however, any costs in this category would fail to qualify as specified liability losses because these "liabilities" do not meet the three-year test. Irrespective of when the Products were manufactured, there is no "liability" within the meaning of section 172(f) until there is some manifest reason to make a recall–whether voluntary or mandatory. Any inchoate or potential liability of Taxpayer that resides in the Products at the time of manufacture and initial sale is more a function of contract warranty.[5] The liability under federal or state law (even assuming that it is does not always remain purely one of contractual obligation) does not actually arise until the product fails the use for which it was designed and/or someone is injured as a result of that failure. All else being equal, to the extent these Product failures resulted in any liability of Taxpayer, those costs where incurred within the three year period preceding the "loss" year (i.e., in the actual loss year itself).

4. Carrybacks to Taxable Years Beginning before January 1, 1984

Taxpayer seeks to carryback NOLs from its Tax Year 1 and Tax Year 2 based on the purported specified liability losses to years beginning prior to January 1, 1984. Even if Taxpayer did incur specified liability losses within the meaning of section 172(f)(1)(B)--which we argue it did not, of course--the carryback period of such losses would not include Taxpayer's Tax Year (1-10) and Tax Year (2-10).

As originally enacted in the 1984 Act, section 172(k)(4) 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 section 172, provides:

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[5] As we have noted above, the Service position is that contract liabilities are outside the scope of section 172(f). See Sealy, supra.

> [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. Section 11811(b)(2)(A) of the 1990 Act, the subparagraph referred to in the above-quoted text, is the section in which Congress actually amended section 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. Therefore, Taxpayer cannot carry the portion of any of its NOLs for Tax Year 1 and Tax Year 2, even if any of the losses incurred in those years qualifies as specified liability losses within the meaning of section 172(f)(1)(B), to its Tax Year (1-10) and Tax Year (2-10).

CONCLUSION:

The expenditures described in Issues 1, 2, and 3, as discussed herein, have not been shown to qualify as specified liability losses under section 172(f); thus, these expenditures are not eligible for a ten-year carryback.

CASE DEVELOPMENT, HAZARDS, AND OTHER CONSIDERATIONS:

There are obviously litigation hazards in our current position, given the paucity of cases and legislative history addressing section 172(f). We must concede that a simplistic "plain reading" of the statute, without more, could lead a court to a very broad application of the "specified liability loss" phrase so as to cover the Taxpayer expenditures in issue here. This is probably especially true outside the context of a Tax Court action, where the Sealy case might likely be viewed as less compelling. In the case of United States v. Balsam Corp., 82

AFTR2d ¶ 98-5398 (E.D. Mo. 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 that made up the NOL.

In Host Marriott Corporation v. United States, 113 F. Supp. 790 (D. Md. 2000), the district court specifically rejected the government's arguments with respect to an inherent delay factor. In doing so, the court disavowed Sealy to the extent that an inherent delay requirement was announced there. In addition, as a corollary to that "inherent delay" holding, the court also found the application of the ejusdem generis rule to be inapposite to that taxpayer, and, by implication, to any section 172(f) determination. That result is clearly erroneous in our view; thus, we have appealed Host Marriott to the Fourth Circuit. Nonetheless, it is a hazard.

Ambiguity also exists regarding what deductions are allowable "with respect to" a liability under the statute. A court might interpret "with respect to" as meaning merely "related to in some manner." Under that broad interpretation, in addition to deductions for the liability itself, other related deductions having some connection with the liability would qualify as deductions allowable "with respect to" the liability–and thus qualify as specified liability losses. In our opinion, however, Congress meant to provide relief for existing liabilities the deduction of which is deferred for a prescribed period. To effectuate this intent, "with respect to," as used in section 172(f)(1)(B), should be treated as tantamount to the simple preposition "for." A court's willingness to accept that is, of course, not doubt-free.

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