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

OFFICE OF
CHIEF COUNSEL

April 10, 2001

Number: **200133005**
Release Date: 8/17/2001
CC:ITA:TL-N-1114-00
UILC: 172.07-00

INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR:

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

SUBJECT: I.R.C. § 172 – ELIGIBILITY FOR CARRYBACK: VARIOUS EXPENSES

This Chief Counsel Advice responds to your request dated January 9, 2001. In accordance with I.R.C. § 6110(k)(3), this Chief Counsel Advice should not to be cited as precedent.

LEGEND:

Taxpayer =
Date A =
Date B =
Products =
Public Entity =
$X =
Tax Year 1 =
Tax Year (1-10) =
Tax Year (1-9) =
Tax Year (1-8) =
Tax Year (1-5) =
Tax Year (1-2) =

ISSUES:

Whether any of the following categories of expenses incurred by Taxpayer in Tax Year 1 are specified liability losses under I.R.C. § 172(f)(1)(B) in effect for that year and, thus, qualify for a ten-year net operating loss carryback period:

1. State Sales and Use Taxes;

2. Federal Payroll Taxes;

3. Workers' Compensation Payments

4. Certain Environmental Remediation Costs

5. Litigation Settlement Payment to Former Employee

6. Federal Insurance Act Contributions (FICA) in Conjunction with Issue 5 Settlement Payment

7. Contract Settlement Payment to Public Entity

CONCLUSIONS:

The expenditures described in Issues 3, 4, and 5, as discussed herein, may qualify as specified liability losses under I.R.C. § 172(f), while those described in Issues 1, 2, 6, and 7 do not qualify.

FACTS:

Taxpayer, a corporation reporting income on the accrual method, distributes Products and provides certain services for those Products to a wide range of industries. For Tax Year 1, Taxpayer incurred a net operating loss (NOL), a significant portion of which ($X) Taxpayer alleges is attributable to specified liability losses under section 172(f). Taxpayer filed Form 1139 on Date A, seeking tentative refund for Tax Year (1-9) and Tax Year (1-8). The earliest year in the putative carryback period, Tax Year (1-10), absorbed none of the loss since Taxpayer had no net income in that year.

The Service issued a refund about six to eight weeks after the filing of the Form 1139. Subsequently, on Date B, the Service issued a Letter 569, disallowing the specified liability loss carryback. For ease of reference, additional facts relevant to each category of expenses are discussed, infra, with respect to the specific discussion of each particular category.

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–enacted in the Taxpayer Relief Act of 1997, § 1082(a), and effective for tax years beginning after August 5, 1997--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 Applicable Statute and 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)

---

[1] Congress has clarified the scope of the section--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 earlier years.

> 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.

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 offering 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

[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

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 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]

---

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.

[3] 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

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 liabilities in issue here–except for workers' compensation payments--constitute costs that do not involve an inherent substantial 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.

<u>Host Marriott Corp. v. United States</u>

In <u>Host Marriott Corp. v. United States</u>, 113 F. Supp. 2d 790 (D. Md. 2000), the taxpayer claimed the portion of its NOL generated by deductions for workers' compensation payments and federal tax deficiency interest as a specified liability loss within the meaning of section 172(f)(1)(B). The Service contended that those liabilities did not qualify as inherent delay liabilities and therefore did not fall within the narrow class of liabilities arising under federal or state law within the meaning of the statute.

The district court specifically rejected the government's arguments with respect to an inherent delay factor. In doing so, the court disavowed <u>Sealy</u> 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.

Because the court found the statutory language to be clear, it also considered as inappropriate any resort to legislative history to determine the

---

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).

meaning of the phrase “liability which arises under federal or state law”. The court concluded that the workers’ compensation and federal tax deficiency interest liabilities arose under federal or state law within the meaning of the statute. The court also concluded that the act or failure to act giving rise to all of the interest liabilities at issue occurred when the taxpayer filed its tax returns without paying all of the tax ultimately determined to be due. That result is clearly erroneous in our view; thus, we have appealed Host Marriott to the Fourth Circuit.

As is noted in this advice below, as well as in our previous TAM 200043018, we now recognize that some workers’ compensation liabilities have the inherent delay characteristic and therefore fall within the narrow class of liabilities that arise under federal or state law within the meaning of section 172(f)(1)(B); however, notwithstanding the Service-adverse decision in Host Marriott, we continue to believe that the Tax Court in Sealy correctly concluded that only a narrow class of liabilities arise under federal or state law within the meaning of section 172(f)(1)(B). Consequently, we have appealed only that portion of the Host Marriott judgment pertaining to the federal tax deficiency interest to the Fourth Circuit.

Specific Expenditures of Taxpayer Asserted as Specified Liability Losses

1. State Sales and Use Taxes

Taxpayer claims specified liability loss treatment for state sales and use tax payments. There is some factual question as to whether those amounts constitute contested liabilities for previous years;[4] nevertheless, we must presume for present purposes that is the case, since the three-year rule would obviously not be met if the tax obligations went to loss year liabilities (i.e., in Tax Year 1). Any contested versus uncontested aspect of these payments, however, is of no moment in our determination. Merely delaying payment--whether through contesting the liability or other “extraneous” means--is inadequate to support section 172(f) applicability.

Taxpayer apparently asserts that any liability literally imposed by federal or state law constitutes a liability arising under either federal or state law within the meaning of section 172(f)(1)(B). In contrast to the fact pattern in Sealy, presumably state or federal statutes directly impose the tax liabilities at issue here. We agree with the Tax Court, however, that Congress intended section 172(f)(1)(B) to apply to deductions allowable with respect to a relatively narrow class of liabilities rather than to deductions allowable with respect to any liability literally imposed under federal or state law.

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 stated in our Intermet

[4] Taxpayer has apparently not provided specifics with regard to these expenses.

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 costs–which surely includes state income taxes and interest–were 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 be the case here.

When we consider the legislative history of the 1984 Act as well as the characteristics of the specifically enumerated liabilities in section 172(f) to determine the characteristics of the liabilities for which Congress intended section 172(f)(1)(B) to apply, we must conclude that Congress did not intend state taxes (or interest thereon) to be included within that class. Application of the rule 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 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.

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, a state tax liability constitutes a routine cost that does not involve an inherent substantial delay between the time the events giving rise to the liability occur and when the deduction for such liability becomes allowable. There may be substantial delays between the events giving rise to a state tax liability and the time when such liability becomes an allowable deduction. For example, an accrual method taxpayer may report too little state tax liability on its tax return and then may unsuccessfully contest the assertion of a greater tax liability. In this case, assuming that the taxpayer does not pay the tax liability pending resolution of the contest, the tax deduction will be delayed until resolution of the contest and payment of the liability. Such a delay, however, is not part of the inherent nature of the liability. A taxpayer need not report and pay less than the proper amount of its state tax liability. Thus, a state tax liability does not have the inherent delay feature required to qualify for the narrow class of liabilities that arise under federal or state law within the meaning of section 172(f)(1)(B).[5]

2. <u>Federal Payroll Taxes</u>

---

[5] It also follows that an interest liability on a due but unpaid tax liability does not possess the inherent delay characteristics necessary to qualify as arising under federal or state law within the meaning of section 172(f)(1)(B).

As discussed above with regard to state tax liabilities, the same rationale applies to disqualify federal payroll taxes–notwithstanding the liability meets the three-year test.[6] Congress did not intend the special carryback rule to apply to all liabilities for which a deduction is delayed. If routine costs–including payroll taxes–were within the eligible class, then the mere nonpayment of current liabilities for more than three years would qualify a taxpayer for a ten-year carryback upon payment of those costs. Congress clearly could not have intended that result; thus, federal payroll taxes also cannot be specified liability losses under section 172(f).

3. Workers' Compensation Payments

In contrast to our previous litigating positions, the Service now believes, as a technical matter, that deductions for a taxpayer's self-insured workers' compensation liabilities that meet certain criteria satisfy the inherent delay test and therefore may generate a specified liability loss within the meaning of section 172(f)(1)(B).[7] Consequently, while Taxpayer may have certain costs which–as a factual matter–might not qualify under this revised position, as a general matter we do recommend allowing the specified liability loss carryback for workers' compensation expenses. Notwithstanding this technical position, it remains Taxpayer's obligation to demonstrate that it meets the aforementioned criteria for qualified workers' compensation expenses. We defer to your application of these standards to the factual scenario Taxpayer proffers.

As discussed above, the question of when workers' compensation liabilities satisfy the pre-economic performance two-pronged all-events test has received judicial consideration. In Crescent Wharf & Warehouse Co. v. Commissioner, 59 T.C. 751 (1973), rev'd & remanded, 518 F.2d 772 (9th Cir. 1975), a case involving both California and federal workers' compensation law, the taxpayer retained an outside administrator to estimate the maximum amount of its exposure for self-insured workers' compensation liabilities.

The Tax Court concluded that worker injury did not constitute all of the events necessary to fix all of the worker's compensation liabilities claimed as deductions by the taxpayer. On appeal the Ninth Circuit agreed with the taxpayer's assertion that in an uncontested case a work-related employee injury constituted the only event necessary to establish workers' compensation liability attributable to that injury. In that Circuit's view, if an injury occurs so that economic consequences ensue to the employer under the statutes, the only relevant remaining consideration

---

[6] The payroll taxes in issue here apparently resulted from a reclassification of putative independent contractors as employees for earlier years.

[7] On the other hand, periodic payments for workers' compensation insurance would still not generate a specified liability loss. There is apparently some question as to whether that is in fact what Taxpayer seeks to claim here.

to the accrual question is whether the amount of the liability may be reasonably estimated. 518 F.2d at 774.

In Wien Consolidated Airlines, Inc. v. Commissioner, 60 T.C. 13 (1973), aff'd, 528 F.2d 735 (9th Cir. 1976), a case involving workers' compensation survivor benefits, an Alaskan airline elected to be self-insured under the Alaska Workmen's Compensation Act. For the taxable year at issue and other taxable years affecting the tax liability for that year because of carryback and carryover provisions, a total of three of the taxpayer's pilots were killed in airplane crashes. The taxpayer did not contest its workers' compensation liabilities attributable to those deaths. Alaskan law required the taxpayer to make periodic payments to each pilot's widow until her death or remarriage. It also required the taxpayer to make periodic payments to each of the minor children of the deceased pilots until the child's death or the attainment of age nineteen. The Tax Court and Ninth Circuit determined that all the events fixing the taxpayer's liability occurred when the pilots were killed.

In Rev. Rul. 80-191, 1980-2 C.B. 168, the Service announced it would not follow the holding in certain workers' compensation deduction cases it had lost and would continue to disallow accruals of workers' compensation liabilities subject to the types of contingencies in those cases. Following the issuance of that revenue ruling, however, the Service lost each litigated case addressing the accrual of workers' compensation liabilities. See Kaiser Steel Corp. v. United States, 717 F.2d 1304 , 1306 (9th Cir. 1983) (under California law once a worker injury has occurred in the course of employment and liability is not contested by the employer, all events have occurred determining the fact of liability and the first prong of the all-events test has been met); Imperial Colliery Co. v. United States, 599 F.Supp. 653, 654 (S.D. W. Va. 1984) (adopted the Ninth Circuit's reasoning, concluding that all the events necessary to fix the liabilities at issue occurred upon worker injuries suffered during the course of employment). See also United States v. Hughes Properties, Inc., 476 U.S. 593 (1986) (casino could deduct amounts not yet won but guaranteed for payment on progressive slot machines even though such amounts might never have to be paid if the casino went out of business); United States v. General Dynamics, 6 Cl. Ct. 250 (1984), aff'd, 773 F.2d 1224 (Fed. Cir. 1985), rev'd, 481 U.S. 239 (1987) (the receipt of medical care by covered individuals was not the last event necessary to fix the taxpayer's liability).

When the 1984 Act amended section 461 to require that accrual method taxpayers not be able to deduct workers' compensation liabilities until paid, this prospectively changed the result that otherwise would have been required by a number of prior cases–from the standpoint of when workers' compensation liabilities may be accrued. See I.R.C. § 461(h)(2)(C)(i). Some courts had believed that the fact of liability was determined at the time of injury and that the amount of the liability could be reasonably estimated in many cases at the time of injury. After the enactment of section 461(h)(2)(C)(i), which required payment to deduct a workers' compensation liability, it was clear that in some cases there would be an inherent substantial delay between the act giving rise to such liability under prior case law and the allowance of the deduction because of the economic performance requirement.

We believe that the legislative record supports the conclusion that Congress intended for many workers' compensation deductions to generate section 172(f)(1)(B) specified liability losses to the extent such deductions generate NOLs. In the 1984 Act, Congress amended section 461 to specifically prohibit accrual method taxpayers from deducting workers' compensation liabilities until paid. Section 461(h)(2)(C)(i). From the standpoint of when workers' compensation liabilities may be accrued, this legislative fix prospectively changed the result that otherwise would have been required by a number of prior Service-adverse cases.

In keeping with our prior position regarding taxes, we disagree with the contention that in the case of a contested liability, the act, within the meaning of section 172(f)(1)(B)(i), giving rise to that liability does not occur until resolution of the contest. As we have said previously, the contest does not constitute the final act or failure to act giving rise to the taxpayer's liability. See 46 Am. Jur. 2d Judgments § 8 (1969) (the principal function of a judgment is to adjudicate the existence or nonexistence of the right or liability in question); Adams v. Davies, 156 P.2d 207, 209 (Sup. Ct. Utah 1945) (a judgment or decree duly entered, establishes in the most authentic form, that which had theretofore been in dispute, or unsettled or uncertain). A judgment for monetary damages for past acts does not create any liability that did not already exist, however, it merely confirms its existence. Thus, entry of a judgment or other settlement of a contested claim should not be considered the act or failure to act which gives rise to a liability for purposes of section 172(f)(1)(B). Our view is also consistent with the meaning of the phrase "act or failure to act" as used in section 6501(l)(1).

To satisfy the requirements of the 1984 Act version of section 172(f)(1)(B) any liability at issue must be directly imposed under federal or state law and must involve an inherent substantial delay between the act giving rise to the liability and the deduction therefore. It is uncontested that state law directly imposes the workers' compensation liabilities at issue here. Taxpayer apparently asserts as inappropriate as a matter of statutory interpretation the addition of an inherent delay requirement for a liability to arise under federal or state law within the meaning of section 172(f)(1)(B)(i). See Host Marriott, supra.

Most workers' compensation liabilities involve periodic payments and these liabilities cannot be deducted until paid because of the economic performance requirement. Consequently, such liabilities that are inherently due a substantial time after the liability arises have the inherent delay characteristic. Inherently due, means the due date of the liability provided by federal or state law disregarding any effect on the actual payment date that might arise as the result of the liability being contested. The application of these rules is illustrated by the following two examples.

(A) On the last day of 1994 an employee becomes totally disabled as a result of a job related injury on that day and the employee also takes whatever procedural steps are necessary to make the employer liable for the injury, such as notifying the employer of the injury. Under state law the employee is entitled to disability payments of $300 every two weeks until death or the end of the disability, such payments to begin two weeks after the date of injury. Rather than make the payments, the employer contests the liability. In 2000 a final judgment is entered in favor of the employee and the employer makes all of the payments for 1995 through 2000. Payments allocable to 1998 through 2000 are made with respect to inherent delay liabilities. The original due date for such payments falls in taxable years beginning at least three years after the date of injury. The payments allocable to 1995 through 1997 are not made with respect to inherent delay liabilities and cannot generate a specified liability loss.

(B) An employee loses an arm in a job-related injury on the last day of 1994. For the loss of the arm the employee is entitled to a single workers' compensation payment of $10,000 due three weeks after the loss of the arm. Rather than paying, the employer contests the liability. In 2000 a final judgment is entered in favor of the employee and the employer pays the $10,000. The effect of the contest on the actual payment date is disregarded in determining if the payment qualifies as an inherent delay liability. Because the liability's original due date falls in 1995, the $10,000 deduction cannot generate a specified liability loss.

On the basis of the foregoing, for section 172(f)(1)(B)(i) purposes, we conclude that once a person is disabled by a compensable on-the-job injury and meets any required procedural conditions, such as the reporting of the injury to the employer, necessary to make the employer liable for the injury, the act giving rise to any liability for future workers' compensation disability payments attributable to the injury has occurred. Similarly, we conclude that when an employee dies because of a compensable on the job injury and any required procedural conditions necessary to make the employer liable for the injury have been satisfied, the act giving rise to the employer's obligation to pay any future workers' compensation survivor benefits attributable to that injury has occurred. Finally, in instances in which workers' compensation statutes make an employer liable for an employee's medical expenses attributable to an on the job injury, we conclude that once the injury has occurred and the employee has satisfied any required procedural conditions, such as the reporting of the injury to the employer, necessary to make the employer liable for the injury, the act giving rise to the employer's obligation to pay the employee's medical expenses has occurred.

4. Certain Environmental Remediation Costs

As a general proposition, in light of the legislative history to the 1984 Act, it is the Service position that environmental remediation costs should be recognized as specified liability losses under section 172(f); yet, this is not to say that the other elements of the section are in any way waived. In short, to qualify, such expenses must still be with respect to a federal or state law liability that arose, or a tort which occurred, at least three years before the beginning of the tax year for which the expenses are incurred. Section 172(f)(1)(B). As a factual matter, simply put, whether Taxpayer gets a ten-year carryback for cleanup costs is a function of whether it is cleaning up contamination that occurred at least three years prior to the beginning of its Tax Year 1. To the extent it has allocable costs cleaning up environmental damage that occurred within the immediately preceding three years or during Tax Year 1 itself, such costs fail the three-year test element of section 172(f) and are not specified liability losses.

Rev. Rul. 94-38, 1994-1 C.B. 35 (1994), holds that costs incurred to clean up land and to treat groundwater that a taxpayer has contaminated with hazardous waste from its business are deductible by the taxpayer as current expenses under section 162. Costs properly allocable to the construction of groundwater treatment facilities, however, are capital expenditures under section 263(a) and are subject to depreciation only.

Taxpayer's Form 1139 claimed an amount for "state mandated environmental cleanup payments for contamination occurring in years prior to [Tax Year 1]." Although several sites are listed, apparently over 97 percent of the deduction is related to just four sites. With respect to these various sites, there are apparently some factual questions as to acquisition dates and knowledge as to extent of contamination.

Whether Taxpayer has a current deduction or must capitalize its expenditures for the various costs in issue here is of only limited relevance to the section 172(f) inquiry. The key is determining when the contamination that is being remedied occurred. If the underlying remediation expenditure must be capitalized, then only that portion of the depreciation allowance (a current deduction) for Tax Year 1 which is properly allocable to contamination occurring at least three years earlier can be classified as a specified liability loss. Consequently, subsequent factual development, as well as the Taxpayer's substantiation burden, should focus on this aspect of the contamination. Whether there is a current deduction or capital expenditure in and of itself is not dispositive of the specified liability loss issue. As with other factual determinations, we defer to the field offices here as well.

5. <u>Litigation Settlement Payment to Former Employee</u>

In Tax Year (1-2), a former employee filed a state court action against Taxpayer and one of its supervisory managers alleging age discrimination under two state statutes as well as infliction of emotional distress. Against the manager individually, the employee also asserted interference with contractual relations. In Tax Year 1, Taxpayer reached an agreement with the former employee–while admitting no wrongdoing or liability–settling all claims against it and the manager.

Specific monetary apportionments were included in the agreement as to each allegation.[8]

As to the age discrimination counts specifically, whether such a liability would have an inherent delay factor at all is highly questionable. An unlawful discriminatory employment practice (which may be subject to punitive action or damages)[9] in the hiring process or employee retention situation is not somehow inherent in the act of assembling or maintaining a workforce. Consequently, that particular liability would not be within the narrow class reached by the specified liability provisions and–strictly speaking–would be outside of section 172(f). Nevertheless, it is possible that a cause of action couched primarily in age discrimination terms may actually have a tort aspect that would support a separate section 172(f) applicability argument. This case offers a variation on that possibility.

The former employee also asserted separate specific tort counts (infliction of emotional distress and interference with contractual relations), albeit that these arose essentially from the same set of facts as the age discrimination counts. Moreover, the alleged torts here do not appear to be the so-called “single act” torts that the Office has taken the position are not within the ambit of section 172(f). Common sense likely tells us that the putative acts complained of here would necessarily result from “a series of actions . . . over an extended period of time” within the meaning of section 172(f)(1)(B)(ii). We will concede that there may be some factual disagreement on what critical events occurred and when; once again, we defer to field development of this area. In our view, however, it appears to overstate the case for holding that it is a single act tort to focus purely on the “single” act of Taxpayer’s demotion of the employee alone. Even that purported “single” act, just standing alone, could reasonably be viewed as having multiple facets (e.g., reduction in pay, changed office space, lowered fringe benefits, or other adverse results brought to bear on the complaining employee).

According to the submitted facts, any relevant acts or failures to act indeed appear to have occurred by the end of Tax Year (1-5), which puts those acts or failures well outside the applicable required three-year period. Assuming that such a scenario has been factually demonstrated, a multiple act “tort” within the meaning of section 172(f)(B)(ii) probably does exist and the 10-year carryback should be allowed for the tort settlement payments.

---

[8] Although there appears to be none here, to the extent that legal or other professional fees represent a part of the total outlay, on the basis of Sealy, it is our position that these fees are not specified liability losses.

[9] These include age, race, religion, or sex.

Consequently, while the age discrimination counts may fail to be specified liability losses since these lack the necessary inherent delay character, the cost of separately alleged multiple act torts can qualify without that element. Assuming, of course, that the three-year test is also met. That element seems not wanting here.

6. Federal Insurance Act Contributions (FICA) in Conjunction with Issue 5 Settlement Payment

This expense is essentially identical to those discussed under Issue 2 (Payroll Taxes); consequently, the same rationale for disallowing those routine costs as was elucidated above in respect to state taxes (Issue 1) also applies here for purposes of section 172(f).

7. Contract Settlement Payment to Public Entity

In Tax Year (1-10), Taxpayer contracted with Public Entity to provide certain finished products to the latter. Taxpayer warranted that the products would conform to certain specifications and particulars. The contract provided for an election of various remedies if Taxpayer failed to meet these requirements, including ones which called for an adjustment of the purchase price or a payment of costs to Public Entity to make corrective actions. Public Entity accepted the products as delivered and retained these, despite the purported deviance from the contract specifications. There is no evidence of injury as to persons or property as a result of the use of these products.

Although formal legal action was never taken, Taxpayer settled the matter with respect to the products supplied by a cash payment to Public Entity in Tax Year 1. Taxpayer now asserts that this payment was for a product liability and, as such, it qualifies as a specified liability loss. Taxpayer's position is incorrect.

Section 172(f)(4) defines product liability as 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, but only if 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) excludes warranties, which are "essentially contract liabilities," from coverage under the statutory definition.

In our view, the payment in issue here is clearly not one that Congress meant to include and is unquestionably covered by the proscription of a contract warranty claim barred from specified liability loss treatment under Treas. Reg. § 1.172-13(b)(2)(ii). It merits no further serious discussion.

CASE DEVELOPMENT, HAZARDS, AND OTHER CONSIDERATIONS:

[redacted]

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney-client privilege. If disclosure becomes necessary, please contact this office for our views.

HEATHER C. MALOY
By:CLIFFORD M. HARBOURT
Senior Technician Reviewer
Branch 1