Specified Liability Losses

Notice 2005–20

PURPOSE

This notice addresses several questions of statutory interpretation arising under § 172(f)(1)(B) of the Internal Revenue Code prior to its amendment by § 3004(a) of the Tax and Trade Relief Extension Act of 1998 (former § 172(f)(1)(B)). The amendment to former § 172(f)(1)(B) is effective for net operating losses (NOLs) arising in taxable years ending after October 21, 1998.

BACKGROUND

The Statute

Section 172(b)(1)(C) provides that the portion of any NOL that qualifies as a specified liability loss may be carried back to each of the 10 taxable years preceding the taxable year of the loss. For NOLs arising in taxable years ending prior to October 22, 1998, former § 172(f)(1)(B) treats as a specified liability loss the portion of the NOL generated by:

> (B) [a]ny 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 Federal or State law or out of any tort of the taxpayer if—
>
> (i) in the case of a liability arising out of a Federal or State 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.

For this purpose, a liability is not taken into account unless the taxpayer used an accrual method of accounting throughout the period or periods during which the acts or failures to act giving rise to the liability occurred.

The Sealy Decisions

In *Sealy Corp. v. Commissioner*, 107 T. C. 177 (1996), *aff'd*, 171 F.3d 655 (9th Cir. 1999), the Tax Court held that the portion of NOLs generated by deductions for the following liabilities did not result in former § 172(f)(1)(B) specified liability losses:

(1) professional fees incurred to comply with current reporting, filing, and disclosure requirements imposed by the Securities and Exchange Act of 1934;

(2) professional fees incurred to comply with current ERISA reporting requirements; and

(3) professional fees incurred in connection with an income tax audit by the Service for a prior taxable year.

The Tax Court gave three reasons for its conclusion that these liabilities did not arise under a federal or state law within the meaning of former § 172(f)(1)(B). First, the federal laws cited by the taxpayers did not establish their liability to pay the amounts at issue. Instead, the taxpayers' liabilities did not arise until the services were contracted for and received and the taxpayers' choice of the means of compliance, rather than the cited provisions, determined the nature and amount of their costs. *Sealy* at 184. Second, Congress intended former §172(f)(1)(B) to apply only to liabilities for which a deduction is deferred because of the economic performance requirement of § 461(h). The economic performance requirement did not delay the taxpayers' accrual of the deductions at issue. *Sealy* at 185–86. Third, 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 other liabilities referred to in former § 172(f). *Sealy* at 186.

In affirming the Tax Court's judgment, the Ninth Circuit stated that the acts giving rise to the liabilities at issue in *Sealy* were contractual acts by which Sealy engaged lawyers or accountants and did not occur at least 3 years before the beginning of the taxable year of the related deductions as required by former § 172(f)(1)(B)(i).

The Host Marriot and Intermet Decisions

In *Host Marriott Corp. v. United States*, 113 F. Supp. 2d 790 (D. Md. 2000), *aff'd*, 267 F.3d 363 (4th Cir. 2001), the district court concluded that interest liabilities on federal tax deficiencies arise under federal law within the meaning of former §172(f)(1)(B). The court pointed out that § 6601(a) imposes interest on due but unpaid federal taxes. The court noted that, in contrast to the situation in *Sealy*, the interest liabilities were set by federal law, not by the taxpayer's choice.

In *Intermet Corp. v. Commissioner*, 117 T.C. 133 (2001), the Tax Court cited *Host Marriot* and concluded that liabilities for state tax deficiencies, interest on state tax deficiencies, and interest on a federal income tax deficiency arise under federal or state law within the meaning of former § 172(f)(1)(B). In distinguishing *Sealy*, the Tax Court only referred to the first reason (*i.e.*, federal law did not establish the liability to pay the amounts at issue) that it gave in *Sealy* for concluding that the professional fee liabilities at issue in that case did not arise under federal or state law.

In addition, in both *Host Marriot* and *Intermet*, the courts concluded that the filing of an erroneous tax return, resulting in the initial failure to timely pay the entire amount of tax due, constitutes the act giving rise to the entire compound interest liability on unpaid tax.

The Major Paint Decision

In *Major Paint Co. v. United States*, 334 F.3d 1042 (Fed. Cir. 2003), *aff'g Standard Brands Liquidating Creditor Trust v. United States*, 53 Fed. Cl. 25 (2002), the Federal Circuit held that liabilities for capitalized legal, accounting, and other professional fees and expenses incurred pursuant to a reorganization bankruptcy under Chapter 11 of Title 11 of the United States Code did not arise under federal law for purposes of former § 172(f)(1)(B). The fees included those incurred by the taxpayer on its own behalf as well as fees incurred on behalf of the unsecured creditors' committee but required to be paid from the bankruptcy estate. The taxpayer capitalized a portion of the fees incurred as a result of the reorganization bankruptcy and later deducted the capitalized fees upon a subsequent voluntary liquidating bankruptcy.

The Bankruptcy Code requires the appointment of an unsecured creditors' committee and allows the committee, with court approval, to employ various professionals to perform services for the committee. The Bankruptcy Code also requires the bankruptcy court to approve the employment of the professionals, the terms of their employment, and the amounts paid to them. In *Major Paint*, a local court rule required the bankrupt taxpayer to employ counsel.

The Federal Circuit analyzed the opinions in *Sealy*, *Host Marriot*, and *Intermet*, from which it concluded two principles could be derived. First, "'arising out of a federal law' means more than just that the liability is incurred with respect to an obligation under a federal law." 334 F.3d at 1046. Second, "the nature and amount of the liability must be traceable to a specific law and cannot be the result of choices made by the taxpayer or others." *Id.* As in *Sealy*, the statutory provisions did not establish a liability to pay the amounts at issue. Rather, the decisions of the taxpayer and the creditors' committee, subject to final approval by the bankruptcy judge, as to the means of compliance determined the nature and amount of the costs. The court concluded that the connection between the Bankruptcy Code and the liabilities for the fees was "too attenuated to meet the level of 'arise under' necessary to qualify as a specified liability loss." *Id.* at 1047.

QUESTIONS AND ANSWERS

The "Arises Under a Federal or State Law" Requirement

Q–1. What tests must a liability satisfy to arise under federal or state law within the meaning of former § 172(f)(1)(B)?

A–1. To arise under federal or state law the liability must be directly imposed by federal or state law and must not be the result of decisions made by the taxpayer or others. *See Sealy* and *Major Paint*.

Q–2. May a tort liability satisfy the requirements of former § 172(f)(1)(B)(i)?

A–2. Yes. A tort liability may be directly imposed under either federal or state law. If the act or failure to act giving rise to the tort liability occurs at least 3 years before the beginning of the taxable year of the liability's deduction, the requirements of former § 172(f)(1)(B)(i) are satisfied.

Multiple Act Torts

Q–3. What is a tort liability that arises out of a series of actions (or failures to act) over an extended period of time?

A–3. A tort liability that arises out of a series of actions (or failures to act) over an extended period of time within the meaning of former § 172(f)(1)(B)(ii) is a liability that arises only from multiple acts or failures to act over an extended period of time. An example is a tort liability for causing someone to develop a disease because of repeated exposures to chemicals or other toxic substances. This liability would be a tort liability within the meaning of former § 172(f)(1)(B)(ii) if a substantial portion of the exposures occur at least 3 years before the beginning of the taxable year of the liability's deduction.

On the other hand, what may appear to be a tort liability involving multiple acts, such as a tort liability arising from a continuing trespass, is actually a number of separate liabilities, each arising from separate acts or failures to act resulting in separate causes of action. The Internal Revenue Service will not treat this type of liability as a multiple act or failure to act liability that satisfies the requirements of former § 172(f)(1)(B)(ii). Instead, to generate a specified liability loss, the separate liabilities must independently satisfy the 3-year act or failure to act requirement of former § 172(f)(1)(B)(i).

The "Act or Failure to Act" Requirement

Q–4. Which act in the chain of causation leading to the creation of a liability constitutes "the act or failure to act" giving rise to that liability within the meaning of former § 172(f)(1)(B)(i)?

A–4. The act or failure to act resulting in the establishment of a legal liability constitutes the act or failure to act within the meaning of former § 172(f)(1)(B)(i). For example, in the case of a trespass, the act of trespassing constitutes the relevant act for purposes of former § 172(f)(1)(B)(i), not the judgment of a court.

In the case of interest on unpaid federal or state taxes, the Service continues to believe that a taxpayer's use of the government's money over discrete periods, such as days, months or portions of a month, is an essential element that creates the liability. Therefore, the Service believes that the courts in *Host Marriott* and *Intermet* incorrectly concluded that the initial failure to pay the taxes when due constituted the act or failure to act giving rise to any interest that economically accrued during the taxable year such interest was deductible and the 3-year period prior to the beginning of that taxable year. Consequently, the Service will continue to assert that interest that economically accrues on a liability for unpaid taxes in the taxable year such interest is deductible and the 3-year period prior to the beginning of that taxable year does not satisfy the 3-year act or failure to act requirement of former § 172(f)(1)(B)(i).

The "With Respect To" Requirement

Q–5. For purposes of former § 172(f)(1)(B), does a deduction allowable "with respect to" a liability include other items, such as legal and professional fees to contest the liability or court costs incurred to litigate the liability?

A–5. A deduction allowable with respect to a liability includes only a deduction for the liability itself. Therefore, legal fees, court costs, and similar items do not generate a former § 172(f)(1)(B) specified liability loss even if the liabilities are incurred in determining the amount of a liability that does satisfy the requirements of former § 172(f)(1)(B).

In *Sealy*, the Tax Court and Ninth Circuit held that deductions for accounting and legal fees incurred in connection with a federal income tax audit did not generate a specified liability loss under former § 172(f)(1)(B). Federal law directly imposed only the federal income tax liability and did not impose the taxpayer's liability for the accounting and legal fees. The taxpayer's liabilities for the accounting and legal fees arose as a result of decisions made by the taxpayer, and such liabilities were incurred when the services were contracted for and performed. Implicit in the Tax Court's holding is the conclusion that the deduction for the legal and professional fees was not, within the meaning of § 172(f)(1)(B), allowable "with respect to" the federal tax liability that was the subject of the audit.

Depreciation Deductions

Q–6. For purposes of § 172(f)(1)(B), are depreciation deductions allowable with respect to the liability giving rise to the depreciable basis of a depreciable asset?

A–6. Depreciation deductions are not allowable with respect to the liability giving rise to the depreciable basis of a depreciable asset. Depreciation deductions may be allowable with respect to liabilities satisfied through the use of the depreciable asset.

Liabilities arising under federal or state law may be treated as part of the cost basis of property if the liabilities are properly chargeable to a capital account. For example, § 164(a) requires sales taxes imposed on the purchase of equipment used in a taxpayer's trade or business to be capitalized into the cost basis of the equipment. If an NOL is incurred for a taxable year and the sales tax liability was incurred at least 3 years before the beginning of that taxable year, some taxpayers have asserted that any portion of the NOL generated by depreciation deductions for the portion of the property's depreciable basis attributable to the capitalized sales tax constitutes a former § 172(f)(1)(B) specified liability loss irrespective of how the property is used. Likewise, taxpayers may be required to place certain equipment into service to comply with requirements of federal or state law, for example, clean water standards. Some of these taxpayers have asserted that if the equipment was acquired by the taxpayer at least 3 years prior to the beginning of the taxable year, the portion of any NOL generated for the taxable year by depreciation deductions attributable to the equipment qualifies as a former § 172(f)(1)(B) specified liability loss. The Service disagrees with both of these assertions.

Section 167(a) allows a depreciation deduction only for property that is either used in a trade or business or held for the production of income. Whether a depreciation deduction is allowable "with respect to" a liability depends upon the property's actual use. For example, if a taxpayer uses equipment to satisfy an environmental cleanup liability imposed by federal law, the portion of the equipment's depreciation allocable to satisfying the environmental cleanup liability is allowable with respect to the environmental cleanup liability. If the environmental cleanup liability arose as a result of a chemical spill that occurred at least 3 years before the beginning of the taxable year and the environmental cleanup liability is otherwise deductible, the depreciation deductions may generate a specified liability loss. However, if a taxpayer uses equipment to satisfy environmental cleanup liabilities that arise during the same taxable year the depreciation deductions are allowable, for example, by preventing the discharge of pollutants resulting from manufacturing activities during the current taxable year, the act giving rise to the taxpayer's environmental cleanup liability will not satisfy the 3-year act or failure to act requirement of former § 172(f)(1)(B)(i), irrespective of when the taxpayer placed the cleanup equipment in service.

DRAFTING INFORMATION

The principal author of this notice is Forest Boone of the Office of Associate Chief Counsel (Income Tax and Accounting). For further information regarding this notice, contact Mr. Boone at 202–622–4960 (not a toll-free call).