INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

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District Director

Taxpayer's Name:
Taxpayer's Address:

Taxpayer's Identification No:
Years Involved:
Date of Conference:

LEGEND: Taxpayer =

Date A =

Date B =

Date C =

Date D =

Date E =

Date F =

Date G =

Date H =

Year A =

$A =

ISSUE: May a § 165(a)[1] loss deduction for capitalized legal and other professional fees generate a specified liability loss as defined in § 172(f)(1)(B)?

CONCLUSION: A § 165(a) loss deduction for capitalized legal and other professional fees cannot generate a specified liability loss as defined in § 172(f)(1)(B).

FACTS: In Year A Taxpayer altered its capital structure resulting in increased debt service requirements. On Date A Taxpayer filed a voluntary chapter 11 bankruptcy petition (the first bankruptcy). The court confirmed Taxpayer's reorganization plan on Date B and Taxpayer emerged from bankruptcy on Date C. Pursuant to this bankruptcy Taxpayer incurred $A of legal and other professional fees (fees) which Taxpayer capitalized under § 263(a). The fees fell within one of two classes: (1) fees Taxpayer incurred for its own benefit and (2) fees incurred for the benefit of the unsecured creditor's committee but imposed upon Taxpayer.

On Date D Taxpayer filed another chapter 11 bankruptcy petition (the second bankruptcy). By Date E any possibility of successful reorganization vanished and Taxpayer converted its reorganization into liquidation. The court approved the sale of all of Taxpayer's inventory and the closing of Taxpayer's businesses. Taxpayer liquidated its entire inventory by Date F and disposed of its other personal and real property during the taxable year ended Date G.

For its taxable year ended Date G Taxpayer deducted the fees capitalized during the first bankruptcy and incurred a net operating loss (NOL). Taxpayer treated the portion of the NOL generated by the deduction for the capitalized fees as a specified liability loss as defined in § 172(f)(1)(B). Taxpayer has filed a refund claim for its taxable year ended Date H based on carrying back the asserted specified liability loss 10 taxable years.

LAW AND ANALYSIS:

The Statute

Generally a taxpayer may carry a NOL back 3 taxable years before the loss year and forward 15 taxable years after the loss year. § 172(b)(1)(A).[2] A "specified liability

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[1] Unless specifically provided otherwise, citations to sections which omit the title of the United States Code refer to sections of the Internal Revenue Code of 1986. Likewise, citations to the Code refer to the Internal Revenue Code of 1986.

[2] This is the rule applicable to the years at issue in this memorandum. Section 172(b)(1)(A) was amended in 1997 to provide 2-year carryback and 20-year carryforward periods, effective for NOLs arising in taxable years beginning after August

loss," however, may be carried back to each of the 10 taxable years preceding the loss year. § 172(b)(1)(C). Prior to its amendment in § 3004(a) of the Tax and Trade Relief Extension Act of 1998, § 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[3]] allowable as a deduction under [chapter 1 of the 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-
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> (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.

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

Section 165(a) allows a deduction for any loss sustained during the taxable year and not compensated for by insurance or otherwise. Section 1.165-1(b) of the Income Tax Regulations generally provides that to be allowable as a deduction under § 165(a), a loss must be evidenced by closed and completed transactions, fixed by identifiable events, and, actually sustained during the taxable year. Only a bona fide loss is allowable.

Because the capitalized fees became deductible as a loss under § 165(a) when Taxpayer liquidated, Taxpayer has met the § 172(f)(1)(B) requirement that a deduction be allowable under chapter 1 of the Code. It is also clear that Taxpayer's legal obligation to pay the capitalized fees at issue constitutes a liability within the meaning of the statute. At issue is whether the deduction for the capitalized fees was allowable "with respect to" a liability "arising under federal or state law" and if so whether "the act or failure to act" giving rise to such liability occurred at least 3 years before the beginning of the taxable year of the deduction. To make this determination one must examine the legislative history of § 172(f)(1)(B).

5, 1997. § 1082(a) and (c) of the Taxpayer Relief Act of 1997.

[3] Certain deductions attributable to product liability and the determination thereof may also generate a specified liability loss. See § 172(f)(1)(A).

The Legislative History

Congress first enacted the statutory language pertinent to this case in the Tax Reform Act of 1984 (1984 Act) when it enacted § 172(k) of the Internal Revenue Code of 1954. The amounts described in § 172(f)(1)(B) as specified liability losses were originally described in § 172(k) as deferred statutory or tort liability losses.

Prior to the enactment of the economic performance requirement in § 461(h), §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 (the all-events test) 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.

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.[4] The Treasury Department's concern became particularly acute in the early 1980s with the advent of historically high United States interest rates.

For example, state and/or federal laws generally require miners to restore the surface of land which they strip mine to a condition comparable to its pre-mined 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 strip miners failed to reasonably estimate 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. See e.g. 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. See e.g. Harrold v. Commissioner, 192

[4] For example, in an extreme case the present value of the tax savings attributable to an accrued liability could exceed the present value of the liability, transforming the creation of a liability into a profitable event for the taxpayer.

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).

Likewise, Treasury became concerned when 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, thereby allowing taxpayers that 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. See, e.g., 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 concerned Treasury and 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.[5]

The Administration decided to seek a legislative solution to the problem caused by cases such as Ohio River Collieries. 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.

In February 1984, 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

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[5] Decommissioning a nuclear power plant requires reducing the level of radioactivity in the plant to a level considered safe for unrestricted use. Some methods of decommissioning may take over 100 years to complete. 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. 112 (February 24, 1984) (statement of Donald W. Kiefer, Congressional Research Service, Library of Congress).

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 Administration's proposal because in their view, it would result in a mismatching of revenue and expenses.

For example, in the case of mining reclamation 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 gross income they helped to generate. On the other hand, as Treasury officials pointed out, because of the time value of money, immediately deducting the total estimated cost of restoring the land overstates the true economic cost to the taxpayer.

To eliminate the distortions caused by the time value of money, Treasury officials advocated deferring deductions through the addition of an economic performance requirement. The potential mismatching resulting from imposing an economic performance requirement, however, could result in overtaxing taxpayers in certain situations[6]. To remedy this potentially unfavorable result Treasury officials proposed liberalizing the NOL carryback provisions for deductions deferred because of economic performance:

> We recognize that requiring deductions for future expenses to be taken in the year of economic performance also requires that the net operating carryback rules be amended to insure that taxpayers are not overtaxed. 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.
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> 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 Administration's proposed economic performance requirement by enacting § 461(h) in § 91(a) of the 1984 Act, and in § 91(d) of that act

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[6] For example, suppose that when an expense satisfies the economic performance requirement, and thus is allowed as a deduction, there is no gross income for it to offset for the taxable year allowable nor for any of the taxable years to which the deduction might be carried for the normal NOL carryback period.

Congress simultaneously enacted the provision allowing the 10-year carryback for deferred statutory or tort liability losses. Furthermore, the discussion of the new 10-year carryback provision appears in the same section of the committee reports where § 461(h) is discussed.

Although the House and Senate Reports to the 1984 Act describe the operation of the proposed new 10-year NOL carryback provision, neither of these reports discuss the reason for its enactment. The Conference Report, however, states:

> The House bill provides a 10-year carryback for net operating losses attributable to certain liabilities deferred under these provisions. ...
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> The provisions of the bill apply generally to expenses incurred (without regard to the economic performance requirement) after the date of enactment. ...
>
> Conference agreement
>
> The conference agreement generally follows the House bill, ...

H.R. (Conf.) Rep. No. 861, 98th Cong., 2d Sess. 872-73 (1984). Examination of the quoted language's context makes clear that the reference to provisions deferring liabilities refers to the economic performance requirement.

Sealy

In Sealy Corp. v. Commissioner, 107 T. C. 177 (1996), aff'd, 171 F.3d 655 (9th Cir. 1999)[7] the petitioners asserted that a portion of a NOL generated by deductions for the following items constituted a specified liability loss within the meaning of § 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 § 172(f)(1)(B). The Tax Court gave three reasons for its conclusion.

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[7] 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 3 years before the beginning of the taxable year of the related deductions as required by § 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 § 172(f)(1)(B).

First, the court noted that the federal law cited by the petitioners did not establish the petitioners' liability to pay the amounts at issue. The petitioners' liability did not arise until the services were contracted for and received and the petitioners' choice of the means of compliance, rather than the cited regulatory provisions, determined the nature and amount of their costs. If the petitioners had failed to comply with the auditing and reporting requirements or had not obtained the particular services in issue, their 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 court read the legislative history of § 172(f)(1)(B) 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 petitioners' accrual of the deductions at issue, the court concluded that Congress did not intend for NOLs generated by those deductions to qualify as specified liability losses. Id. at 185-86.

Finally, in determining the scope of liabilities arising under either federal or state law within the meaning of § 172(f)(1)(B), the court considered the specific types of liabilities referred to in §172(f): 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.

Agent's Argument

Taxpayer's obligation to pay the fees at issue arose pursuant to contracts. According to the Tax Court's decision in Sealy contractual obligations do not arise under federal or state law within the meaning of § 172(f)(1)(B). Furthermore, Congress did not intend for deductions for capitalized costs to generate specified liability losses. Therefore, the portion of the NOL generated by the deduction for the capitalized fees does not qualify as a specified liability loss.

Taxpayer's Argument

The obligation to pay the capitalized fees arose not from private contracts but constituted an obligation imposed under federal law. Section 1102(a)(1) of the Bankruptcy Code requires the United States trustee, as soon as practicable after the filing of a voluntary chapter 11 bankruptcy petition, to appoint an unsecured creditors committee. Section 1103(a) of the Bankruptcy Code gives that committee, subject to

court approval[8], the authority to employ one or more attorneys, accountants, or other agents to represent the committee. The Bankruptcy Code requires the debtor to pay the fees of the professionals employed by the unsecured creditors committee even though these professionals are employed by the committee rather than the debtor and even though these professionals essentially act in an adversarial capacity to the debtor by representing the interests of the unsecured creditors. Moreover, the fee amount must be approved by the court. 11 U.S.C. § 330(a). Therefore, the obligation to pay the fees of the unsecured creditors committee did not arise under a simple contract but rather under federal law.

With regard to the fees incurred on behalf of Taxpayer, while recognizing that theoretically Taxpayer could have decided not to incur such fees, Taxpayer points out that as a practical matter all debtors going through chapter 11 reorganization incur such fees. Taxpayer, pointing to the control exercised by the court over any agreements to incur those fees and the amount of those fees, contends that the obligation to pay its own fees also arose under federal law rather than pursuant to contracts.

Taxpayer contends that one of two alternative acts gave rise to the obligation to pay the fees. First, Taxpayer points to the changes it made to its capital structure in Year A which saddled it with increased debt service costs. Second, Taxpayer points to the filing of the petition in the first bankruptcy. Because each of these events occurred at least 3 years before the beginning of the taxable year of the deduction of the capitalized fees, Taxpayer contends it has met the 3-year act or failure to act test of § 172(f)(1)(B)(i). Therefore, Taxpayer contends any NOL generated by the deduction for the capitalized fees qualifies as a specified liability loss under § 172(f)(1)(B). Taxpayer did not state its rationale for treating either the change in capital structure or the filing of the first bankruptcy petition as the relevant act for § 172(f)(1)(B)(i) purposes.

<u>Response</u>

We do not find it necessary to determine whether Taxpayer's obligation to pay

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[8] Section 328(a) of the Bankruptcy Code allows, with the court's approval, the employment of a professional person under 11 U.S.C. § 1103 on any reasonable terms and conditions of employment, including on a retainer, on an hourly basis, or on a contingent fee basis. Section 328(a) of the Bankruptcy Code goes on to provide that the court may allow compensation different from the compensation provided under the agreement after the conclusion of employment if the agreed upon terms and conditions prove to have been improvident in light of developments not capable of being anticipated when the terms and conditions were fixed. The court applies 11 U.S.C. § 330(a) subject to 11 U.S.C. § 328. Thus, agreements may be entered into for the incurrence of professional fees in bankruptcy but such agreements are subject to court approval.

the fees at issue arose under federal law within the meaning of § 172(f)(1)(B), nor do we find it necessary to determine whether "the act" giving rise to the obligation to pay those fees occurred at least 3 years before the beginning of the taxable year of the deduction of the capitalized fees as required by § 172(f)(1)(B)(i). Because the deduction for the capitalized fees was not allowable "with respect to" a liability within the meaning of § 172(f)(1)(B), assuming, arguendo, that all other statutory requirements were met, the portion of Taxpayer's NOL generated by the deduction for the capitalized fees still would not qualify as a specified liability loss.

Ambiguity exists regarding what deductions are allowable "with respect to" a liability. One might interpret "with respect to" as meaning "related to in some manner". Under this 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. On the other hand, one might interpret "with respect to" as equivalent to the simple preposition "for". Resolution of this ambiguity requires examining the legislative history of § 172(f)(1)(B).

As noted above, the legislative history indicates that Congress' primary concern when it enacted the § 172(f)(1)(B) language pertinent to this case was to ensure that taxpayers, whose deduction of certain liabilities was deferred because of the economic performance requirement, be able to use those deductions when finally allowable to reduce taxable income, either in the taxable year allowable or in prior taxable years through the vehicle of the new 10-year NOL carryback. Thus, Congress only meant to provide relief for existing liabilities the deduction of which is deferred for a prescribed period. To effectuate this intent the phrase "with respect to" as used in § 172(f)(1)(B) must be interpreted as equivalent to the simple preposition "for".

This interpretation raises the question of whether the loss deduction for the capitalized fees was for a liability. We think not. When Taxpayer took the liability to pay the fees into account for federal income tax purposes, Taxpayer was required to capitalize the fees. Thus, no deduction for the obligation to pay the fees existed. Rather, the deduction at issue is for the worthlessness of an asset, the capitalized fees. Therefore, the portion of any NOL generated by the § 165(a) deduction for the capitalized fees does not qualify as a specified liability loss.

As previously noted, to resolve this case we do not find it necessary to determine if the obligation to pay the fees arose under federal law within the meaning of § 172(f)(1)(B) nor to determine whether "the act" giving rise to the obligation to pay the fees occurred at least 3 years before the beginning of the taxable year of the relevant deduction. However, if such fees had been deductible, we would have disagreed with Taxpayer's choice of the appropriate event to treat as "the act" giving rise to the liability for purposes of § 172(f)(1)(B)(i).

By using the phrase "the act or failure to act"[9] rather than say "an act or failure to act" § 172(f)(1)(B)(i) requires identifying a particular act or failure to act giving rise to the liability. However, the occurrence of a given event, such as the creation of a liability, generally results from an infinite series of necessary preceding causes. Because a number of acts or failures to act may satisfy a "but for" test with regard to causation of a given liability, the phrase "act or failure to act" cannot be said to be free from ambiguity.

We believe the final act or failure to act[10] in the chain of causation leading to the creation of a given liability from which it can be determined that the taxpayer has a legal obligation qualifies as "the act or failure to act" within the meaning of § 172(f)(1)(B)(i).[11] Treating an act or failure to act occurring any earlier than this as the relevant act or failure to act for § 172(f)(1)(B)(i) purposes could frustrate the intent of Congress by allowing an extended carryback period for deductions for liabilities involving little or no deferral between the actual creation of the liability and the allowance of the deduction therefore.

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[9] Section 1 of Title 1 of the United States Code provides that "[i]n determining the meaning of any Act of Congress, unless the context indicates otherwise words importing the singular include and apply to several persons, parties, or things; ..." In this case, the legislative history to § 172(f)(1)(B) indicates that the term "act or failure to act" as used in that section should not be construed to include any number of acts or failures to act. See First National Bank v. Missouri, 263 U.S. 640 (1924) (rule providing that words importing the singular number may extend and be applied to several persons or things is not one to be applied except where it is necessary to carry out the evident intent of the statute).

[10] Under this view if a taxpayer contests a liability, resolution of the contest against the taxpayer does not constitute the final act or failure to act giving rise to the taxpayer's liability. "The principal function of a judgment is to adjudicate the existence or nonexistence of the right or liability in question." 46 Am. Jur. 2d Judgments § 8 (1969). "A judgment or decree duly entered, establishes in the most authentic form, that which had theretofore been in dispute, or unsettled or uncertain." Adams v. Davis, 156 P.2d 207, 209 (Sup. Ct. Utah 1945). 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 should not be considered the act or failure to act which gives rise to a liability for purposes of § 172(f)(1)(B). This view is also consistent with the meaning of the phrase "act or failure to act" as used in § 6501(l)(1).

[11] It appears that neither of the acts pointed to by Taxpayer satisfies this test.

CAVEAT

A copy of this technical advice memorandum is to be given to Taxpayer. Section 6110(k)(3) provides that it may not be used or cited as precedent.