

## Internal Revenue Service

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Date:

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Legend:

X =

Y =

Year A =

Year B =

Dear

Section 12.04 of Rev. Proc. 99-1, 1999-1 I.R.B. 6, 47 provides that unless it was part of a closing agreement, a letter ruling found to be in error or not in accordance with the current views of the Service may be revoked or modified. If a letter ruling is revoked or modified, the revocation or modification applies to all taxable years open under the statute of limitations unless the Service uses its discretionary authority under § 7805(b)<sup>1</sup> of the Internal Revenue Code of 1986 to limit the retroactive effect of the revocation or modification.

In PLR 9105022 the Service ruled that any assessment of state tax in a taxable year beginning after December 31, Year A, that is attributable to the Year B taxable year of X and Y will constitute a “deferred statutory loss” within the meaning of § 172(k)(1),<sup>2</sup> and is eligible for the 10-year carryback period as provided in

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<sup>1</sup> Hereafter, unless expressly provided otherwise, references to sections refer to sections of the Internal Revenue Code of 1954 or 1986 as applicable.

<sup>2</sup> In the course of deleting obsolete provisions from § 172 in the Revenue Reconciliation Act of 1990 (the 1990 Act), Congress consolidated the provisions previously defining product liability losses and deferred statutory or tort liability losses in new section 172(f). Both product liability losses and deferred statutory or tort liability losses qualify for 10-year carrybacks. In the 1990 Act Congress dropped the moniker statutory or tort liability losses and defined both product liability losses and what had formerly been known as deferred statutory or tort liability losses as specified liability

§ 172(b)(1)(J), as limited by § 172(k)(4), provided the net operating loss (NOL) for the taxable year determined under § 172(k)(1)(A) is not less than the amount determined under § 172(k)(1)(B), and provided the state tax assessment that created the NOL is attributable to a liability that arose out of a federal or state law. The purpose of this letter is to inform you that PLR 9105022 is hereby revoked.

When X and Y submitted their ruling request no additional Year B state tax liability had been asserted against X or Y. In 1998 Congress materially amended § 172(f)(1)(B). Because it is not known if or when X or Y incurred an allowable deduction for any additional Year B state taxes, two different versions of § 172(f)(1)(B) are potentially relevant to the question of whether a NOL generated by a deduction for such additional taxes qualifies as a specified liability loss. This letter considers seriatim whether a state tax deduction can generate a specified liability loss under the version of § 172(f)(1)(B): (1) in effect prior to the 1998 amendment, or (2) in effect after the 1998 amendment.

#### Application of § 172(f)(1)(B) Prior to 1998 Amendment

##### A. Sealy

To date, only the Tax Court has judicially interpreted in any detail the statutory language of § 172(f)(1)(B) as in effect prior to the 1998 amendments. In Sealy Corp. v. Commissioner, 107 T. C. 177 (1996), appeal docketed, No. 98-70369, et seq. (9<sup>th</sup> Cir. March 31, 1998) 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

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losses. After the 1990 Act § 172(f)(1)(A) defined product liability losses and § 172(f)(1)(B) defined what had formerly been known as deferred statutory or tort liability losses. The legislative history to the 1990 Act indicates that Congress did not intend to make any substantive changes to the prior provisions. See H.R. Rep. No. 894, 101<sup>st</sup> Cong., 2d Sess. 36 (1990).

The 1990 Act changes are effective for NOLs arising in taxable years beginning after December 31, 1990. In the remainder of this letter we are assuming that any additional Year B state tax liability will be deductible by X or Y for a taxable year beginning after December 31, Year A. Therefore, henceforth we will refer to the relevant provisions of § 172(f).

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.

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 have been in amounts not measured by the value of the services they actually contracted for and received. Id. 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.

In contrast to the fact pattern in Sealy, state statutes directly impose a taxpayer's state tax liability. However, we agree with the Tax Court that Congress intended § 172(f)(1)(B) to apply to deductions allowable for a relatively narrow class of liabilities rather than to deductions allowable for any liability literally imposed under federal or state law. Moreover, when we examine the legislative history to the Tax Reform Act of 1984 (the 1984 Act) (the act in which Congress first provided for a 10-year carryback for deferred statutory or tort liabilities) as well as the characteristics of the specifically enumerated liabilities in § 172(f) to determine the characteristics of the liabilities for which Congress intended § 172(f)(1)(B) to apply, we conclude that Congress did not intend state tax liabilities to be included within that class.

## B. The Legislative History

Prior to the enactment of the economic performance requirement in § 461(h), §1.461-1(a)(2) of the Income Tax Regulations 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.<sup>3</sup> 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 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).

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

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<sup>3</sup> 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.

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.<sup>4</sup>

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 Future, Hearing Before the Subcommittee on Oversight of the Committee on Ways and Means House of Representatives, 98th Cong., 2d Sess. (February 24, 1984). Most 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

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<sup>4</sup> 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).

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<sup>5</sup>. 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.

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 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.

The House and Senate Reports to the 1984 Act both provide only the same single specific example of a type of deduction, for a tort, that could generate a NOL eligible for the proposed new 10-year carryback. The House Report provides:

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<sup>5</sup> 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.

This rule applies in the case of a liability under Federal or State law, if the act (or failure to act) occurs at least 3 years before the beginning of the taxable year; and in the case of a tort liability, if the 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 year. For example, this rule would apply if a taxpayer incurred a tort liability for failure to protect another person from a hazardous substance, such as chemical waste, over an extended period of time.

H.R. Rep. No. 432 (Part 2) 98th Cong., 2d Sess. 1256 (1984).

Although the House and Senate Report 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, provides:

The House bill provides a 10-year carryback for net operating losses attributable to certain liabilities deferred under these provisions. ...

The provisions of the bill generally apply 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 references to provisions deferring liabilities are the economic performance requirements.

The legislative history of § 172(f)(1)(B) establishes that Congress intended the 10-year carryback rule to apply to some, but not all, of the types of liabilities with which Congress was concerned when it enacted the economic performance rules. The Conference Report states that a 10-year carryback is provided for "net operating losses attributable to certain liabilities deferred under these provisions." Id. ; See also H.R. Rep. No. 432 (Part 2) 1256 (1984) (the 10-year carryback provision is for "certain deferred liability losses"). Based on the foregoing, it is clear that Congress intended to enact a limited exception to the normal 3-year carryback rule for a narrow class of liabilities.

This conclusion is further supported by the fact that the legislative history contains only one, narrowly drawn example of a qualifying liability. The only example given is contained in the House and Senate Reports and involves a situation where a taxpayer incurs a tort liability for failing to protect another person from a hazardous substance, such as chemical waste, over an extended period of time. Congress' use of

a single example of limited application to illustrate the scope of § 172(f)(1)(B) demonstrates that Congress viewed this provision as a limited exception to the normal carryback rule.

### C. Characteristics of the 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 time the act giving rise to the liability occurs and the time a deduction may be claimed for the liability. 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 will expire between the time a nuclear power plant is commissioned and when it is decommissioned.<sup>6</sup>

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 delay between the time the events giving rise to the liability occur and when the deduction for such liability becomes allowable. There may be 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 the tax deduction will be delayed from the time of the events creating the liability until resolution of the contest. Such a delay, however, is not part of the inherent nature of the liability. A taxpayer need not report less than the proper amount of its state tax liability. Thus, a state tax liability does not constitute an inherent delay liability and therefore does not arise under a state law within the meaning of § 172(f)(1)(B). Therefore, a deduction for a state tax liability cannot generate a specified liability loss.

### Application of § 172(f)(1)(B) After 1998 Amendment

Congress made major changes to § 172(f)(1)(B) in section 3004(a) of the Tax and Trade Relief Extension Act of 1998 (the 1998 Act), effective for NOLs arising in taxable years ending after October 21, 1998. After the 1998 Act, § 172(f)(1) generally defines a specified liability loss as the portion of a NOL generated by certain deductions attributable to product liability and other deductions allowable under Chapter 1 of the

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<sup>6</sup> However, under § 468A an electing taxpayer may get deductions before actually incurring any decommissioning expenses for certain amounts paid into a nuclear decommissioning reserve fund.



Code (except for deductions allowable under § 468(a)(1) or § 468A(a)) allowable in satisfaction of a liability arising under a federal or state law requiring:

- (1) the reclamation of land,
- (2) the decommissioning of a nuclear power plant (or any unit thereof),
- (3) the dismantlement of a drilling platform,
- (4) the remediation of environmental contamination, or
- (5) a payment under any workers compensation act (within the meaning of section 461(h)(2)(C)(i).

As under prior law, to be taken into account as a federal or state law liability the liability must result from an act (or failure to act) occurring at least 3 years before the beginning of the taxable year of the allowable deduction and the taxpayer must use an accrual accounting method throughout the period or periods during which such act or failure to act occurred.

Section 12.04(2) of Rev. Proc. 99-1 provides that a letter ruling may be revoked because of the enactment of legislation. Because a state tax liability is not one of the qualifying liabilities under § 172(f)(1)(B), as amended by the 1998 Act, the portion of a NOL arising in a taxable year ending after October 21, 1998, that is generated by a state tax deduction cannot qualify as a specified liability loss.

#### Section 7805(b) Relief

Section 12.11 of Rev. Proc. 99-1 provides that a taxpayer may request that the Associate Chief Counsel (Domestic) limit the retroactive effect of any revocation or modification of a letter ruling issued by this branch to the taxpayer. See § 12.11(1) of Rev. Proc. 99-1 regarding how to make a request to limit the retroactive revocation or modification of a letter ruling.

This revocation is directed only to the taxpayers who requested the original letter ruling. Section 6110(k)(3) provides that it may not be used or cited as precedent. A copy of this revocation is also being sent to X and Y's district director. Questions regarding this revocation may be directed to the contact person listed above.

Sincerely yours,

Assistant Chief Counsel  
(Income Tax & Accounting)

/s/ William A. Jackson

By \_\_\_\_\_  
William A. Jackson  
Chief, Branch 6

Enclosures:

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