INTERNAL REVENUE SERVICE

NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM April 27, 2001

Number: Release Date: Index (UIL) No.: CASE MIS No.:	
National Progran LMSB	n Director–Financial Products

Taxpayer's Name: Taxpayer's Address:

Taxpayer's Identification No:

Years Involved:

Date of Conference: No Conference Held

LEGEND: Taxpayer =

State A =

Date A =

Date B =

Date C =

Date D =

Date E =

Χ% =

Court A =

Court B =

\$A =

\$B =

\$D =

\$E

\$F \$G = \$H = \$1 \$J \$K = \$L Month A = Month B = Year A = Year B = Year C = Year D = Year E = Year F TimeA

ISSUE: May a deduction attributable to a liability to refund insurance premiums generate a specified liability loss within the meaning of section 172(f)(1)(B)¹?

CONCLUSION: If the taxpayer does not have to satisfy the economic performance requirement with regard to the liability in order to deduct it for federal income tax purposes, the liability does not fall within the narrow class of liabilities that arise under state law within the meaning of section 172(f)(1)(B).

¹ Unless stated otherwise, cited sections are sections of the Internal Revenue Code (the Code) as applicable to the taxable years at issue.

FACTS: Taxpayer, a consolidated group that includes insurance companies, sells property and casualty insurance to residents of State A. State A law requires Taxpayer to file an annual statement with the State A Insurance Commissioner (the Insurance Commissioner) which consists of financial statements and various schedules containing detailed information concerning Taxpayer's insurance business. Taxpayer must prepare the financial statements on forms prescribed by the National Association of Insurance Commissioners (NAIC) in accordance with accounting principles prescribed by that body as modified by State A law (statutory accounting principles or SAP).

State A law was amended on Date A requiring insurers to reduce their rates for certain property and casualty insurance to amounts at least X% less than what they charged for such insurance as of Date B, effective for policies issued or renewed on or after Date A. The new law generally required the insurance companies to keep the reduced rates in effect for a prescribed period (the rollback period) and thereafter required them to obtain the Insurance Commissioner's prior approval for any rate increases.

The insurance industry brought an action challenging the constitutionality of the rate rollback provisions. Court A found the law's restrictions on the Insurance Commissioner's power to approve rate increases for insurance companies during the rollback period to be unconstitutional, but severable from constitutional provisions of the law. Court A concluded that during the rollback period any insurer could apply for relief from the rate rollback as confiscatory and upon application therefore could immediately begin charging rates in accordance with its application, subject to later approval by the Insurance Commissioner. If such rates exceeded those ultimately approved as fair and reasonable, Court A provided that the insurer would be required to refund any overcharges, including interest thereon, to customers.

In accordance with the Court A decision, during the rollback period Taxpayer applied for an exemption from the rate rollback and for an increase in insurance rates. The Insurance Commissioner challenged the requested rates. Because Taxpayer anticipated that it would be required to refund some of the premiums collected during the rollback period, Taxpayer accrued and deducted for federal income tax purposes an estimated premium refund liability of \$A for its Year A taxable year and an additional \$B liability for its Year B taxable year.

Subsequent to the Court A decision the Insurance Commissioner and others engaged in a number of administrative actions designed to determine fair and reasonable insurance rates under State A law. This process eventually culminated in Year C with the Insurance Commissioner ordering Taxpayer to refund \$D (plus interest thereon) attributable to alleged insurance premium overcharges attributable to the rollback period. Taxpayer litigated the validity of this order which was eventually upheld by Court A on Date C. Following the Court A decision, Taxpayer requested that Court B consider its challenge to the Insurance Commissioner's order. Following the adverse

Court A decision, however, Taxpayer accrued an additional insurance premium refund liability of \$E both for federal income tax and statutory accounting purposes for Year D.

In Month A of Year D, during the period that Taxpayer was challenging the Insurance Commissioner's order to refund insurance premiums, a natural disaster (the natural disaster) occurred in State A causing Taxpayer to incur a large amount of losses. In Month B of Year E Taxpayer and the Insurance Commissioner entered into a settlement agreement concerning Taxpayer's liability to refund insurance premiums attributable to the rollback period. Under that agreement Taxpayer agreed not to further contest the Insurance Commissioner's determination of its premium refund liability but Taxpayer was relieved of any obligation to pay interest on that liability. The agreement required Taxpayer to refund \$F\$ within TimeA. The agreement also required Taxpayer to refund an additional \$G\$ to policyholders by Date D unless the sum of Taxpayer's payments for losses attributable to the natural disaster and payments for certain Year E reinsurance premiums exceeded \$H.

At the close of Year D the sum of Taxpayer's payments for losses attributable to the natural disaster did not exceed \$H. At the time of the settlement agreement Taxpayer made no change to the insurance premium refund liability of \$E accrued in Year D. In Year E the sum of Taxpayer's payments for losses attributable to the natural disaster and payments for certain Year E reinsurance premiums exceeded \$H and Taxpayer included in gross income the resulting reduction in the accrued liability to refund insurance premiums.

Taxpayer incurred a net operating loss (NOL) for Year D. Taxpayer claimed that \$I of this loss constituted a specified liability loss². Whether \$L of this loss constitutes a specified liability loss, within the meaning of section 172(f)(1)(B), constitutes the issue to be resolved.

² The \$I includes the \$E accrual, plus \$J of legal fees incurred in contesting the Insurance Commissioner's order, plus a \$K "adjustment". Prior to submission of the request for technical advice Taxpayer conceded that the deduction for legal fees does not generate a section 172(f)(1)(B) specified liability loss. The \$K adjustment appears to represent a portion of the total premium refund liability ordered by the Insurance Commissioner, accrued for book purposes for Year F but deducted for federal income tax purposes for Year D. If Taxpayer is correct in asserting that SAP must be followed for federal income tax purposes in accounting for the premium refund liability, this raises the question of whether Taxpayer should have taken the \$K adjustment into account for federal income tax purposes for Year F rather than Year D. We do not resolve that question here because (1) we have not received sufficient information concerning the \$K adjustment to determine the proper tax accounting therefore, and (2) a favorable conclusion with regard to Taxpayer's accounting for such adjustment would not change our ultimate conclusion regarding the application of section 172(f)(1)(B).

LAW AND ANALYSIS:

Statutory Overview

Section 831(a) generally subjects the taxable income of an insurance company other than a life insurance company (a non-life insurance company) to income tax as computed under section 11. Section 832(a) provides that in the case of an insurance company subject to the tax provided by section 831(a), the term "taxable income" means the gross income as defined in section 832(b)(1) less the deductions allowed by section 832(c). The NOL deduction is one of the deductions allowed under section 832(c).

Section 832(b) defines gross income as the sum of several items including, under section 832(b)(1)(A), the following amounts:

the combined gross amount earned during the taxable year, from investment income and from underwriting income as provided in this subsection, computed on the basis of the underwriting and investment exhibit of the annual statement approved by the National Association of Insurance Commissioners[.]

Section 832(b)(2) through (6) provides more detailed definitions of the components of gross income referred to in section 832(b)(1). Section 832(b)(3) defines the term "underwriting income" as the premiums earned on insurance contracts during the taxable year less losses incurred and expenses incurred.

Section 832(b)(4)(A) provides that the term "premiums earned on insurance contracts during the taxable year" shall be computed in part by deducting from the amount of gross premiums written on insurance contracts during the taxable year return premiums and premiums paid for reinsurance. Section 832(b)(4)(B) requires the result obtained under section 832(b)(4)(A) to be either decreased by 80 percent of the net increase in unearned premiums for the taxable year or increased by 80 percent of the net decrease in unearned premiums for the taxable year.

Under section 172(a), a NOL deduction, which equals the sum of the NOL carryovers and carrybacks to a taxable year, may be claimed in computing taxable income for that year. Under section 172(b)(1)(A), a NOL, until absorbed in reducing taxable income, may generally be carried back three taxable years and carried forward fifteen taxable years. Section 172(b)(1)(C), however, generally provides for a ten taxable year carryback period for the portion of a NOL that qualifies as a specified liability loss.

Section $172(f)(1)(B)^3$ treats as a specified liability loss the portion of a 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 [f]ederal or [s]tate law or out of any tort of the taxpayer if-
- (i) in the case of a liability arising out of a [f]ederal or [s]tate law, the act (or failure to act) giving rise to such liability occurs at least 3 years before the beginning of the taxable year, or
- (ii) in the case of a liability arising out of a tort, such liability arises out of a series of actions (or failures to act) over an extended period of time a substantial portion of which occurs at least 3 years before the beginning of the taxable year.

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.

Nature of Liability

Taxpayer contends that its obligation to refund insurance premium overcharges constitutes an obligation to refund return premiums, within the meaning of section 832(b)(4)(A). The statutory language used in section 832(b)(4)(A) traces its origins to the Revenue Act of 1921. Neither section 832(b)(4)(A) nor the regulations in effect for the taxable year at issue define the term "return premium". The term, however, has been construed more broadly than the refund of premiums allocable to the unexpired portion of the original term of a canceled insurance policy.

In <u>County Fire Insurance Co. v. Commissioner</u>, 45 B.T.A. 482 (1941), the Superintendent of the Missouri Insurance Department (the Superintendent) ordered a rate reduction in the premiums charged on certain insurance policies written in that state by all stock fire insurance companies doing business in Missouri. Several insurance companies challenged the rate reduction in court. The parties stipulated that the insurance companies would be allowed to continue charging the prior unreduced rates pending final resolution of the matter but would be required to post bond, per court order, to secure any refund obligation ultimately determined.

³ Section 172(f)(1)(A) also treats the portion of a NOL generated by deductions for product liability expenses and certain expenses related thereto as a specified liability loss. However, the instant case only raises the question of whether certain items generate a specified liability loss as defined by section 172(f)(1)(B).

The Supreme Court of Missouri held valid a reduction in insurance rates. In an attempt to avoid the reduction, the insurance companies then pursued federal litigation that ultimately proved unsuccessful. Thereafter, the insurance companies attempted to notify policyholders of the overcharges and refunded overcharges to policyholders who filed refund claims. The insurance companies claimed ownership of funds not claimed by policyholders. The Superintendent filed a restitution motion seeking recovery of the unclaimed funds on behalf of policyholders. This ultimately resulted in a judgment requiring the insurance companies to transfer the unclaimed funds into court custody.

Whether the insurance companies properly deducted the court payments for the taxable year made or should have deducted the premium refund liability in a prior taxable year constituted the issue to be decided. In conjunction with making that determination, the Board of Tax Appeals had to determine whether the amounts at issue qualified as return premiums or losses incurred under section 204(b)(5) or 204(b)(6) respectively of the Revenue Act of 1934 (the 1934 Act). The Board concluded that the refunded amounts constituted return premiums.

The instant case also involves a contested state-imposed reduction in insurance rates, insurance premium overcharges arising during the pendency of the contest, and a resolution of the contest finding insurance companies liable to refund the overcharges. There has been no statutory or regulatory change since the 1934 Act requiring a different conclusion than that reached in <u>County Fire Insurance</u>. We agree with Taxpayer's assertion that the liabilities at issue constitute liabilities to return premiums within the meaning of section 832(b)(4)(A).

<u>Deduction or Adjustment to Gross Receipts</u>

The reach of a statute that by its express terms applies only to deductions does not extend to items taken into account in determining gross income. Max Sobel Wholesale Liquors v. Commissioner, 69 T.C. 477 (1977), aff'd, 630 F.2d 670 (9th Cir. 1980) (Section 162(c)(2)'s disallowance of deductions for illegal bribes, kickbacks, or other illegal payments not a bar to increasing cost of goods sold by cost of extra merchandise illegally sent to customers without charge-cost of goods sold is not a deduction but affects the amount of gross income); Wicor Inc. v. United States, 117 F. Supp. 2d 855 (E.D. Wis. 1999); MidAmerican Energy Co. v. Commissioner, 114 T.C. 570 (2000); Florida Progress Corp. & Subs. v Commissioner, 114 T.C. 587 (2000) (Public utilities not allowed section 1341 tax treatment for overcharges returned to ratepayers through downward adjustments in billing rates, section 1341 only applies to deductions and the rate adjustments did not constitute deductions).

Only deductions, provided for under chapter 1 of the Code and allowable with respect to certain liabilities, may generate a section 172(f)(1)(B) specified liability loss. Therefore, if the premium refund liability at issue generates an adjustment to gross income rather than a deduction, even if it satisfies all the other requirements of section

172(f)(1)(B) it cannot generate a specified liability loss. Taxpayer notes that to compute premiums earned for a taxable year section 832(b)(4)(A) provides "[f]rom the amount of gross premiums written on insurance contracts during the taxable year, deduct return premiums and premiums paid for reinsurance." From this Taxpayer summarily concludes that the premium refund liability at issue constitutes a deductible liability under chapter 1 of the Code.

Section 832(a), however, defines taxable income as gross income as defined in section 832(b)(1) less the deductions allowed in section 832(c). Underwriting income constitutes one of the elements of gross income as defined in section 832(b)(1), premiums earned constitute one of the components of underwriting income, and return premiums must be taken into account in determining premiums earned. Therefore, notwithstanding section 832(b)(4)'s directive to deduct return premiums from premiums written to determine premiums earned, an argument may be made that return premiums constitute adjustments in determining gross income rather than deductions.

In the request for technical advice the parties assumed that the liabilities at issue gave rise to deductions. Neither party addressed the question of whether the return premiums at issue instead constituted adjustments in determining gross income, and the resolution of that question appears uncertain. For these reasons and because we have concluded that the premium refund liabilities, even if deductible, do not generate specified liability losses, we do not find it necessary in this technical advice memorandum to resolve the question.

The need to resolve other issues of section 172(f)(1)(B) statutory interpretation arises only if the premium refund liability at issue results in a deduction. For purposes of the analysis which follows we have assumed the allowance of a deduction. However, we express no opinion regarding whether the premium refund liability at issue results in a deduction or an adjustment to gross income.

Proper Taxable Year for Deduction

Prior to the enactment of the economic performance requirement in section 461(h), section 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

⁴ Although in <u>County Fire Insurance</u> both the parties and the court assumed that the insurance premium refund liability at issue generated a deduction, whether the liability resulted in a deduction or an adjustment to gross income was irrelevant to the primary issue to be resolved, namely, the proper taxable year to take the liability into account. We do not view <u>County Fire Insurance</u> as having any relevance to the deduction versus adjustment to gross income issue.

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.

In the Tax Reform Act of 1984 (1984 Act) Congress enacted section 461(h) of the Code, thereby requiring that a liability also satisfy an economic performance requirement before being taken into account for federal income tax purposes. Section 1.461-4(g)(3) provides that "[i]f the liability of a taxpayer is to pay a rebate, refund, or similar payment to another person ... economic performance occurs as payment is made to the person to which the liability is owed."

In the request for technical advice the examining agents pointed out that Taxpayer did not pay any portion of the premium refund liability at issue until Year E. Because Taxpayer did not satisfy the economic performance requirement until Year E, the agents contended that the liability generated no deduction for Year D thereby generating no specified liability loss for that year. We also note that because of the request for Court B review, Taxpayer was still contesting the premium refund liability at the close of Year D, thereby also failing to satisfy the first prong of the all-events test. Consequently, under normal federal tax accrual accounting rules Taxpayer would not be entitled to take the premium refund liability into account for Year D.

In its submission Taxpayer countered with the assertion that normal federal tax accrual accounting rules do not apply to a premium refund liability. Rather, section 832(b)(1)(A) requires it to accrue the liability for tax purposes for the same period that it reports the liability on the underwriting and investment exhibit of its annual statement (hereinafter referred to as the annual statement). Taxpayer contends that pursuant to SAP it properly reported the premium refund liability on its annual statement for Year D and therefore properly accrued the liability for federal income tax purposes.

Following submission of the request for technical advice, the examining agents agreed not to challenge Taxpayer's assertion that SAP should be followed for federal income tax purposes to account for the premium refund liability. They have formally withdrawn the normal federal tax accrual accounting versus SAP issue from their request for technical advice. In the analysis that follows we will assume that SAP control when the premium refund liability must be taken into account and that Taxpayer properly followed those principles in reporting the liability for federal income tax purposes for Year D. However, we express no opinion regarding whether SAP or normal federal tax accrual accounting rules apply to the premium refund liability. Nor, assuming that SAP control for federal income tax purposes, do we express an opinion as to whether Taxpayer properly applied SAP to the premium refund liability.

To generate a specified liability loss within the meaning of section 172(f)(1)(B),

any deduction for the premium refund liability must also be allowable "with respect to a liability which arises under a federal or state law" within the meaning of the statute, and "the act or failure to act" giving rise to that liability must occur at least three years before the beginning of the taxable year of the deduction (the three-year test). To properly interpret these statutory requirements we must examine the relevant legislative history and judicial opinions interpreting section 172(f)(1)(B).

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 section 172(k) of the Internal Revenue Code of 1954. The amounts in section 172(f)(1)(B) described as specified liability losses were originally described in section 172(k) as deferred statutory or tort liability losses.

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.⁵ 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. 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).

⁵ 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.

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 workers' compensation liabilities, thereby allowing taxpayers that could reasonably estimate liabilities to be paid well in the future, such as workers' compensation disability or survivor annuities, to deduct such amounts currently rather than when actually paid. Crescent Wharf & Warehouse Co. v. Commissioner, 518 F.2d 772 (9th Cir. 1975); Wien Consolidated Airlines, Inc. v. Commissioner, 60 T.C. 13 (1973), aff'd, 528 F.2d 735 (9th Cir. 1976).

Another situation that 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.⁶

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 workers' 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). Many of the taxpayers and tax practitioners who testified at the hearing objected to the

⁶ 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. <u>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).</u>

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 situations⁷. 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.

<u>Id</u>. 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 section 461(h) of the Internal Revenue Code of 1954 in section 91(a) of the 1984 Act, and in section 91(d) of that act Congress simultaneously enacted the provision allowing the ten-year carryback for deferred statutory or tort liability losses. Furthermore, the discussion of the new ten-year carryback provision appears in the

⁷ 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.

same section of the committee reports where section 461(h) is discussed.

Although the House and Senate Reports to the 1984 Act describe the operation of the proposed new ten-year NOL carryback provision, neither of these reports discusses 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 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.

<u>Sealy</u>

In <u>Sealy Corp. v. Commissioner</u>, 107 T. C. 177 (1996), <u>aff'd</u>, 171 F.3d 655 (9th Cir. 1999)⁸ the petitioners asserted that the portion of NOLs generated by deductions for the following items constituted specified liability losses 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 specified liability losses because the liabilities 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 petitioners did not establish the petitioners' liability to pay the amounts at issue. The petitioners' liability did not

⁸ On appeal the Ninth Circuit focused on the fact that the acts giving rise to the liabilities at issue in <u>Sealy</u> did not occur at least three years before the beginning of the taxable year of the related deductions as required by section 172(f)(1)(B)(i). The Ninth Circuit did not expressly address the Tax Court's conclusion that the liabilities at issue did not arise under federal or state law within the meaning of section 172(f)(1)(B).

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 at 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 section 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. <u>Id</u>. at 185-86.

Finally, 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): product liability, nuclear decommissioning liabilities, and torts. Invoking the statutory construction rule of ejusdem generis, the court concluded that Congress intended the ten-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 <u>Sealy</u> were routine costs not like those identified in the statute. <u>Id</u>. at 186.

<u>Liability Arising Under Federal or State Law</u>

a. Narrow Class

In contrast to the fact pattern in <u>Sealy</u>, state law directly imposes the premium refund liabilities at issue in this case. However, we agree with the Tax Court 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.

The Tax Court's opinion is supported by the statutory construction rule of ejusdem generis and the legislative history to the 1984 Act. The Conference Report states that a ten-year carryback is provided for "net operating losses attributable to certain liabilities deferred under these provisions" H.R. (Conf.) Rep. No. 861, 98th Cong., 2d Sess. 872 (1984) (emphasis added), and the report's context makes clear that the provisions referred to encompass the economic performance requirement. Also see H.R. Rep. No. 432 (Part 2), 98th Cong., 2d Sess. 1256 (1984) (the ten-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 three-year carryback rule for a narrow class of liabilities when it enacted the statutory language pertinent to this case.

Moreover, when we examine the legislative history to 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 conclude that Congress did not intend the premium refund liability at issue to be included within that class.

b. 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 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 the decommissioning liability is created and the actual decommissioning of the plant.⁹

To take a liability into account under SAP does not require satisfaction 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, if SAP control the federal tax accrual of the premium refund liability at issue, Congress' 1984 addition of an economic performance for most accrual method taxpayers had no effect on the federal tax accounting for this type of liability. Therefore, such a liability cannot be inherently delayed because of the economic performance requirement. Indeed, in the instant case Taxpayer deducted part of the liability at issue for the taxable year prior to satisfying the economic performance requirement and never satisfied the economic performance requirement for the portion of the liability that it was relieved of the obligation to pay. Therefore, if SAP control the federal tax accrual of the premium refund liability at issue, it does not fall within the narrow class of liabilities arising under federal or state law within the meaning of section 172(f)(1)(B) and cannot generate a specified liability loss.

⁹ However, under section 468A an electing taxpayer may get deductions for certain amounts paid into a nuclear decommissioning reserve fund before beginning the decommissioning process.

Act or Failure to Act

By using the phrase "the act or failure to act" rather than say "an act or failure to act" section 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. Therefore, one must examine the legislative history of section 172(f)(1)(B) to determine which act or failure to act in the chain of causation leading to the creation of a given liability to treat as "the" act or failure to act for purposes of section 172(f)(1)(B)(i).

As noted above, the legislative history indicates that Congress' primary concern when it enacted the section 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 offset gross income, either in the taxable year allowable or in prior taxable years through the vehicle of the new ten-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, we believe the final act or failure to act¹¹ in the chain of

¹⁰ 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 section 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).

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 <u>Judgments</u> § 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." <u>Adams v. Davies</u>, 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

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 section 172(f)(1)(B)(i). Treating an act or failure to act occurring any earlier than this as the relevant act or failure to act for section 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.

Taxpayer points to a number of potential acts as candidates for "the act", within the meaning of section 172(f)(1)(B)(i), giving rise to the liability at issue, only the latest of which we see as holding any potential merit. Taxpayer asserts that the premium refund liability relates solely to overcharges for the period beginning on Date A and ending on Date E. Because this period predates the beginning of Year D by more than three years, Taxpayer contends that all of the liability at issue satisfies the three-year test.

It seems clear that Taxpayer could incur no liability to refund an excessive premium until actual collection of the excessive premium. Taxpayer does not define the term "overcharge " in its submission. However, to the extent that the premium refund liability at issue consists of premiums collected by Taxpayer prior to the beginning of Year F, and determined to be excessive because of the rate rollback, we agree with Taxpayer that such liability satisfies the three-year test. As previously noted, however, none of the liability generates a specified liability loss.

Supplemental Submission

In its supplemental submission Taxpayer asserts that its position is supported by the recent decision in <u>Host Marriott Corp. v. United States</u>, 113 F. Supp. 3d 790 (D. Md. 2000). In <u>Host Marriott</u>, 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 court rejected the Service's argument that the ejusdem generis statutory construction principle applies to limit liabilities that arise under federal or state law within the meaning of section 172(f)(1)(B) to those involving inherent delay. Because the

failure to act which gives rise to a liability for purposes of section 172(f)(1)(B). This view is also consistent with the meaning of the phrase "act or failure to act" as used in section 6501(I)(1).

court found the statutory language to be clear, it also considered as inappropriate any resort to legislative history to determine the meaning of the phrase "liability which arises under federal or state law". The court concluded that workers' compensation and federal tax deficiency interest liabilities arise under federal or state law within the meaning of the statute.¹² 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.

Notwithstanding the Service-adverse decision in <u>Host Marriott</u>, we continue to believe that the Tax Court correctly concluded that only a narrow class of liabilities arise under federal or state law within the meaning of section 172(f)(1)(B). We continue to believe that a liability for federal tax deficiency interest, although literally imposed under federal law, does not arise under federal law within the meaning of the statute.

We have appealed the portion of the <u>Host Marriott</u> judgment pertaining to the federal tax deficiency interest to the Fourth Circuit. We decline Taxpayer's invitation to render our decision in this technical advice memorandum based on the district court's reasoning in <u>Host Marriott</u>.

CAVEAT(S)

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

In TAM 200043018 we recently recognized 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).