OFFICE OF
CHIEF COUNSEL

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

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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR:

FROM: Deborah A. Butler
Assistant Chief Counsel (Field Service)
CC:DOM:FS

SUBJECT: Ten-Year Carryback Under I.R.C. § 172(f)

This Field Service Advice responds to your request of March 30, 1999. It is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND:

Year 1 =
Year 2 =
Year 3 =
Year 4 =
Year 5 =
Year 6 =
Date 1 =
Amount 1 =
Amount 2 =
Amount 3 =
Amount 4 =
Amount 5 =
Amount 6 =
Taxpayer =

ISSUE:

Whether a payment to settle various lawsuits constitutes a specified liability loss within the meaning of section 172(f)(1) and is, therefore, eligible for a ten-year carryback.

CONCLUSION:

Taxpayer's payment in settlement of various lawsuits fails to meet the three-year rule under section 172(f)(1)(B)(i) and is, therefore, not a specified liability loss eligible for a ten-year carryback.

FACTS:

Taxpayer owns a professional sports team. The league in which Taxpayer's team competes has been involved in extensive labor disputes with its players. These disputes have lead to numerous lawsuits, certain of which underlie Taxpayer's claim for a ten-year carryback.

One action against the league sought injunctive relief for alleged antitrust violations and damages stemming from the operation of certain contracts. The suit also alleged the league illegally fixed players' medical insurance benefits and tortiously interfered with contracts.

The lawsuit eventually settled. The settlement consisted of both structural and monetary relief. The structural relief involved the reduction or elimination of contract restrictions. The monetary relief consisted of damages and reimbursement of costs totaling Amount 1 to be paid by the league. Of the Amount 1 settlement, Amount 2 was to be distributed as damages resulting from the contract restrictions, pursuant to an agreed upon formula. The balance of the monetary relief, or Amount 3, was to be paid as reimbursement of attorneys fees and other costs and in settlement of related litigation. Amount 4 of the Amount 1 settlement was to be paid in Year 4 and the balance of the settlement, or Amount 5, was to be paid in annual installments through Year 6.

According to Taxpayer's representative, the league established a contingency fund (or "strike fund") to provide loans to its member clubs in the event of a player strike. Each member club contributed Amount 6 to the strike fund. Also according to Taxpayer's representative, the league later passed a resolution authorizing the use of the strike fund assets to satisfy a portion of its settlement payment obligations. Taxpayer claimed a deduction for these payments in Year 4. Taxpayer filed claims in Year 5 carrying back to Years 1 and 2 the portion of the

Year 4 net operating loss attributable to the settlement payments deducted in that year.

LAW AND ANALYSIS:

In prior field service advice concerning this issue, dated December 1, 1998, we addressed whether Taxpayer's contributions to a strike fund were qualifying tort liabilities under section 172(f)(1)(B) for purposes of the ten-year carryback provision. In your current request for advice, you inquired whether Taxpayer's payments to settle various lawsuits brought against the league[1] were qualifying liabilities under the "arising under federal or state law" test of section 172(f)(1)(B).

It is Service position that section 172(f) is a narrow exception to the general three-year carryback rule.[2] The reasoning underlying this position is set forth in respondent's opening brief (copy attached) filed in the case of Intermet Corporation and Subsidiaries v. Commissioner, Docket No. 8246-97, a case involving application of section 172(f) to state tax liabilities and interest on state and federal tax liabilities.[3] The arguments set forth in the Intermet brief expand upon the framework for analysis adopted by the Tax Court in Sealy Corp. v. Commissioner, 107 T.C. 177 (1996), aff'd, 171 F.3d 655 (9th Cir. 1999). In Sealy, the Tax Court applied the ejusdem generis rule of statutory construction and concluded that Congress intended the ten-year carryback rule to apply to a narrow class of liabilities. 107 T.C. at 186. Under the doctrine of ejusdem generis, general words that follow the enumeration of specific classes are construed as applying only to things of the same general class as those enumerated.

In the Intermet brief, the government expanded upon the Tax Court's Sealy analysis by identifying the distinguishing trait of liabilities that qualify for the ten-

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[1] As noted above, Taxpayer's representative has informed you that the amounts contributed to the strike fund were ultimately used to pay, in part, the settlement amount.

[2] Section 172(b)(1)(A) was amended in 1997 to provide two-year carryback and twenty-year carryforward periods, effective for net operating losses for taxable years beginning after August 5, 1997. Pub. L. 105-34, § 1082(a), 111 Stat. 788.

[3] The Tax Court rendered an opinion in Intermet late last year (111 T.C. 294 (1998), appeal docketed, No. 99-1046 (6th Cir. January 6, 1999)), however, the court did not reach the government's "narrow class of liabilities" argument. Instead, the court disallowed the claimed ten-year carryback based on its finding that the expenses at issue were not specified liability losses because they were not taken into account in computing the consolidated group's NOL for the year as required by section 172(f)(1).

year carryback, namely, liabilities that inherently involve 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. An example of a qualifying "inherent delay" type of liability is the cost of land reclamation associated with mining activities. A taxpayer's deduction for these costs is inherently delayed in that a substantial number of years necessarily will expire between the act giving rise to the liability (the mining activity) and the time when the taxpayer will be entitled to a deduction for its costs to reclaim the land, because generally land used for mining purposes cannot be reclaimed environmentally during the time which it is actually being mined. In TAM 9840003, the "inherent delay" standard was relied upon to disallow a ten-year carryback for interest on a federal tax liability and legal fees incurred to contest a federal tax liability and a related state tax liability.

It is also Service position that liabilities for which deductions are delayed by a contest are not "inherent delay" liabilities that qualify for a ten-year carryback. As discussed in the Intermet brief, the statutory context in which section 172(f)(1) was enacted, and its legislative history, establishes that Congress intended the ten-year carryback provision to apply to certain liabilities *delayed by the economic performance rules*. Deductions for contested liabilities are delayed under tax accrual principles that predate the 1984 enactment of the economic performance rules. Dixie Pine Products Co. v. United States, 320 U.S. 516 (1944)(accrual basis taxpayer cannot deduct state taxes for which he denies liability and which he has not paid pending the outcome of proceedings to adjudicate the liability); Consolidated Industries, Inc. v. Commissioner, 82 T.C. 477, aff'd, 767 F.2d (2d Cir. 1985).

Section 172(f) does not explicitly refer to deductions inherently or substantially delayed by the operation of the economic performance rules. Instead, the provision accomplishes Congressional intent in this regard by permitting a ten-year carryback only for liabilities arising out of a federal or state law or out of certain torts, where the act (or failure to act) giving rise to such liability[4] occurs at least three years before the beginning of the taxable year. Section 172(f)(1)(B). In other words, a ten-year carryback is permitted where the timing of the act giving rise to liability vis a' vis the timing of the allowable deduction for that liability is such that the taxpayer will be barred by the operation of the normal carryback rules from offsetting substantial costs associated with a particular activity against the income generated by that activity. We refer to this aspect of the provision as the "three-year rule."

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[4] In the case of a qualifying tort, the liability must arise out of a series of actions (or failures to act) over an extended period of time, a substantial portion of which occurs at least three years before the beginning of the taxable year. Section 172(f)(1)(B)(ii).

Application of the three-year rule requires a determination of what is the “act (or failure to act)” with respect to a given type of liability. By using the phrase "*the* act or failure to act," section 172(f)(1)(B)(i) requires identification of a particular act or failure to act giving rise to the liability. The creation of a liability, however, 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. In general, taxpayers have taken a broad view of this term, in some cases arguing that the act giving rise to liability was the incorporation of the business or the original hiring of employees. Consistent with our overall narrow interpretation of this provision, however, we believe the final act or failure to act 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 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 Congressional intent 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 a deduction for amounts paid with respect to the liability.

Applying these principles to the facts of this case, we have substantial doubt as to Taxpayer’s entitlement to a ten-year carryback for the settlement payments. To date, the Service has not specifically considered whether an antitrust violation, under any circumstances, falls within the narrow class of liabilities entitled to a ten-year carryback. Regardless of the answer to that question, however, we do not believe that Taxpayer is entitled to a ten-year carryback under the Service’s interpretation of the three-year rule. We emphasize that our views in this regard are only advisory, based on the aspects of this issue that the Service has considered and taken a position on, to date. In order to obtain a determination of the application of section 172(f) to Taxpayer’s specific facts, it will be necessary for you to seek formal technical advice.

Taxpayer asserts the act or failure to act giving rise to liability, for purposes of applying the three-year rule, was the league’s failure to act in securing a new collective bargaining agreement in Year 3. We disagree. We do not believe that the league’s failure to act in this regard was the final act or failure to act in the chain of causation leading to the creation of the league’s liability for alleged antitrust violations and damages. The structure of the damages portion of the settlement provides a reasonable basis for asserting that the act giving rise to liability for this purpose was application of the contract restrictions to given players as their individual contracts expired. According to the terms of the settlement, it was the timing of the expiration of individual player contracts and the time frame during which such players were restricted subsequent to their contracts being renegotiated, that determined the allocation of the settlement fund (Amount 2)

among the fund recipients. To a large extent, the stipulated damage amounts relate to a time frame subsequent to Date 1, the date three years prior to the beginning of the taxable year in which Taxpayer's claimed ten-year carryback arose. Based on this analysis, it appears that most of Taxpayer's claimed deductions for settlement payments fail to qualify for a ten-year carryback under the three-year rule, regardless of whether an antitrust violation would otherwise qualify as an "inherent delay" liability.

It is not clear from your memorandum whether Taxpayer is claiming a ten-year carryback for settlement amounts attributable to the related litigation and reimbursement of litigation costs (Amount 3). We note that at least some of the claims involved in the related litigation involve contractual liabilities. It is Service position that contractual liabilities do not qualify for a ten-year carryback. It also Service position that attorneys fees and other incidental costs paid in connection with otherwise qualifying specified liability losses are not, themselves, entitled to ten-year carryback treatment.

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CASE DEVELOPMENT, HAZARDS, AND OTHER CONSIDERATIONS:

Additional factual development in this case would be desirable. Exam should request Taxpayer to [redacted].

To pursue [redacted]

[5]Norwest involved section 172(l) bank bad debt losses, whereas Intermet involved section 172(f) SL losses. However, both types of losses are subject to special 10–year carryback rules involving similar stacking and NOL limitation rules.

[redacted]

We must advise you, however, that the Service may [redacted]. It may be advisable to submit a request for technical advice in order to receive definitive Service position on the issue in this case.

[redacted]. No Code or consolidated return provision addresses this matter. However, the Norwest court, in treating only a pro rata share of a member's SL deduction portion of its separate NOL as contributing to the CNOL, implicitly adopted an approach in which the net losses of members having net losses should be considered as proportionately offsetting the net income of the members having net income. In determining the pro rata share of a member under this approach, the court used an apportionment formula similar to that under Treas. Reg. § 1.1502-79.

If you have any questions, please call 202-622-7820.

DEBORAH A. BUTLER

By: /s/ Teri A. Culbertson
TERI A. CULBERTSON
Technical Assistant to the
Assistant Chief Counsel
(Field Service)

Attachment (1)