

**INTERNAL REVENUE SERVICE**  
**NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM**  
March 30, 2001

Number: **200129002**  
Release Date: 7/20/2001  
Index (UIL) No.: 172.07-00  
CASE MIS No.: TAM 104399-00/CC:ITA:B6

**District Director**

Taxpayer's Name:  
Taxpayer's Address:

Taxpayer's Identification No:  
Years Involved:  
Date of Conference: July 25, 2000

LEGEND: Taxpayer =

Year 1 =

Year 2 =

\$A =

\$B =

\$C =

\$D =

\$E =

\$F =

\$G =

\$H =

\$I =

\$J =

\$K =

Date1 =

Date2 =

Date3 =

Date4 =

Date5 =

#### ISSUES:

- (1) May deductions for payments of self-insured workers' compensation liabilities generate a section 172(f)(1)(B)<sup>1</sup> specified liability loss?
- (2) May deductions for legal fees, and state filing fees and other transaction costs incurred in determining self-insured workers' compensation liabilities generate a section 172(f)(1)(B) specified liability loss?
- (3) May deductions for payments to a qualified pension plan generate a section 172(f)(1)(B) specified liability loss?

#### CONCLUSIONS:

- (1) Deductions for self-insured workers' compensation liabilities may generate a section 172(f)(1)(B) specified liability loss. To do so such liabilities must first become due in a taxable year beginning at least three years after the act or failure to act giving rise to the liability. In applying the preceding sentence the effect of any contest with regard to a taxpayer's liability to make any payment of workers' compensation shall be disregarded in determining the initial due date of that payment.
- (2) Deductions for legal fees and state filing fees and other transaction costs incurred in determining self-insured workers' compensation liabilities cannot generate a section 172(f)(1)(B) specified liability loss.

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<sup>1</sup> Unless specifically provided otherwise, all references to sections refer to sections of the Internal Revenue Code as in effect for the taxable years at issue or under discussion.

- (3) Deductions for payments to a qualified pension plan cannot generate a section 172(f)(1)(B) specified liability loss.

FACTS: Taxpayer incurred net operating losses (NOLs) for Year 1 and Year 2. Taxpayer claims that \$A of the Year 1 loss and \$B of the Year 2 loss qualify as specified liability losses within the meaning of section 172(f)(1)(B). Taxpayer contends that several classes of deductions generated Year 1 and Year 2 specified liability losses. The propriety of treating two of these classes of deductions as generating specified liability losses falls within the scope of this technical advice memorandum.

Taxpayer claims that \$C of its Year 1 deductions attributable to self-insured workers' compensation liabilities and legal fees and administrative costs incurred in determining such liabilities generated a specified liability loss for that year. Taxpayer claims that \$D of the same types of deductions generated a specified liability loss for Year 2.

State statutes impose the workers' compensation liabilities at issue. Each liability can be associated with an employment related death or personal injury occurring at least three years before the beginning of the taxable year of the liability's deduction.

Taxpayer also claims that deductions for certain contributions it made to its pension plan for hourly workers (the Hourly Plan) in Years 1 and 2 generated specified liability losses for those years, specifically \$E for Year 1 and \$F for Year 2.

The Hourly Plan has a plan year that begins on Date1 and ends on the subsequent Date2. The Hourly Plan is maintained pursuant to collective bargaining. The valuation date of the Hourly Plan for purposes of sections 404 and 412 is Date1, which is the first day of the plan year.

#### Year 1 Calculation

On its Year 1 tax return Taxpayer apparently deducted \$G with respect to the Hourly Plan.<sup>2</sup> The \$E of these deductions asserted to generate a specified liability loss was determined by allocating the \$G deduction to unfunded liabilities determined using the priority categories of section 4044 of title IV of the Employee Retirement Income Security Act of 1974 ("ERISA") (hereinafter referred to as "PBGC Priority Categories").

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<sup>2</sup> We do not have a copy of the income tax returns, or a detailed accounting of the source of deductions with respect to the pension plans on the returns. However, the material supplied by Taxpayer with respect to the determination of the specified liability loss applicable to the Hourly Plan suggests that this was the deducted amount.

To make this allocation, the deductible amount was allocated to the unfunded termination liability as described below.

The termination liability as of Date3, attributable to service performed 3.75 years ago (i.e., performed prior to Date4), and service performed within 3.75 prior years (i.e., after Date4), was determined for each PBGC Priority Category.<sup>3</sup> The amount of the termination liability for service performed 3.75 years ago was based upon the plan provisions in effect at that time. The amount of the termination liability for service within 3.75 years was determined using the plan provisions as amended through Date3. The actuarial assumptions used to determine the termination liability are those used by the Pension Benefit Guaranty Corporation (“PBGC”) with respect to retirement incidence, rates of mortality, and interest discount to value trusteed plans as of Date3, and differ from the actuarial assumptions used for purposes of sections 404 and 412.

Once the termination liability as of Date3 was allocated to each PBGC Priority Category and further subdivided by service 3.75 years ago, the market value of the assets as of Date3 (less any contributions that had not yet been deducted) was allocated by PBGC Priority Category. The allocation of assets covered all the termination liability allocated to PBGC Priority Category 3, but did not cover all of the termination liability allocated to PBGC Priority Category 4. The remaining assets after satisfaction of PBGC Priority Category 3 were allocated to PBGC Category 4 and split on a pro-rata basis between liabilities in that category for service 3.75 years ago and service within 3.75 years. From the allocation of assets, the total unfunded termination liability for service 3.75 years ago, and service within 3.75 years was determined.

After the allocation of assets, the remaining unfunded termination liability in PBGC Priority Category 4 was \$H for service 3.75 years ago, and \$I for service within 3.75 years for a total of \$J. The \$G deduction was allocated to PBGC Priority Category 4 on a pro-rata basis using the unfunded termination liability. This resulted in \$E being allocated to service 3.75 years ago (\$G multiplied by the ratio of \$H to \$J). The \$E amount was then carried back as a specified liability loss.

### Year 2 Calculation

On its Year 2 tax return Taxpayer apparently deducted \$K with respect to the Hourly Plan.<sup>4</sup> The \$F of these deductions asserted to generate a specified liability loss was determined by allocating the \$K deduction to unfunded liabilities determined using

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<sup>3</sup> Because Date4 was 3.75 years prior to Date3, the calculation of the termination liability involved an interpolation between values determined with respect to service prior to three years ago and service prior to four years ago.

<sup>4</sup> As was the case for Year 1 we do not have the tax return or the detail of the deductions taken. See footnote 2.

the PBGC Priority Categories. To make this allocation, the deductible amount was allocated to the unfunded termination liability in the same manner as for Year 1. However, relevant determinations (plan provisions, market value of assets, undeducted contributions, PBGC assumptions, etc.) were made as of Date5, instead of Date3. The end result of the calculations for Year 2 was that an amount of \$F was carried back as a specified liability loss.

## LAW AND ANALYSIS:

### The Statute

Prior to its amendment in section 3004(a) of the Tax and Trade Relief Extension Act of 1998, section 172(f)(1)(B)<sup>5</sup> 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] 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.

### 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 described in section 172(f)(1)(B) as specified

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<sup>5</sup> Section 172(f)(1)(A) also treats the portion of a net operating loss 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).

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liability losses were originally described in section 172(k) as deferred statutory or tort liability losses.

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 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>6</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. 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).

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<sup>6</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.

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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.<sup>7</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 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

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<sup>7</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. 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).

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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<sup>8</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 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

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<sup>8</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.

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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 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.

Sealy

In Sealy Corp. v. Commissioner, 107 T. C. 177 (1996), aff'd, 171 F.3d 655 (9<sup>th</sup> Cir. 1999)<sup>9</sup> 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

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<sup>9</sup> 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 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).

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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 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. *Id.* 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 *Sealy* were routine costs not like those identified in the statute. *Id.* at 186.

### Liability Arising Under Federal or State Law

#### a. Narrow Class

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), 98<sup>th</sup> Cong., 2d Sess. 1256 (1984)

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(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.

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. We will refer to these liabilities as inherent delay liabilities. An example of such a liability is the obligation to decommission a nuclear plant. 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.<sup>10</sup>

Act or Failure to Act

By using the phrase "the act or failure to act"<sup>11</sup> 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

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<sup>10</sup> 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.

<sup>11</sup> 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).

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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 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 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.

#### Self-insured Workers’ Compensation

For Year 1 and Year 2 Taxpayer deducted workers’ compensation benefits paid to employees or their beneficiaries attributable to claims arising from employment related deaths or other personal injuries occurring at least three years before the beginning of the taxable year of the deduction. The submission notes four types of benefits: (1) death benefits, (2) dismemberment benefits (related to the loss of a limb or bodily function in connection with employment activities), (3) disability benefits, and (4) medical and hospital benefits.

Taxpayer contends that employment related injuries constitute the acts, within the meaning of section 172(f)(1)(B)(i), giving rise to the workers’ compensation liabilities. Because these injuries occurred at least three years before the beginning of the taxable year of the related deduction, Taxpayer contends that it has satisfied the three-year test of section 172(f)(1)(B)(i) (the three-year test), namely, that the acts or failures to act giving rise to the liabilities occur at least three years before the beginning of the taxable year of the deduction.

With regard to disability benefits, which are paid on a periodic basis, the examining agents contend that the continued disability of the recipient constitutes the

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act giving rise to the obligation to make such payments. Therefore, such benefits cannot satisfy the three-year test. The examining agents also contend that in the case of a contested workers' compensation liability resolution of the contest by entry of judgment or settlement constitutes the act giving rise to the liability within the meaning of section 172(f)(1)(B)(i).

Taxpayer contends that because state statutes impose the workers' compensation liabilities at issue, such liabilities arise under state law within the meaning of section 172(f)(1)(B). The examining agents contend that to arise under state law within the meaning of section 172(f)(1)(B), a liability must not only be directly imposed by state law but must also constitute an inherent delay liability. The agents contend that the workers' compensation liabilities at issue do not qualify as inherent delay liabilities. The agents recognize that there may be delays between a compensable employment-related injury and the payment of any workers compensation benefits related thereto. However, the agents do not view such delays as inherent in the nature of workers' compensation liabilities because "Taxpayer need not extend the time between the injury and payment because of litigation and investigation or through structured settlement arrangements."

As previously discussed, the question of when workers' compensation liabilities satisfy the pre-economic performance two-pronged all-events test has received judicial consideration. In Crescent Wharf & Warehouse Co. v. Commissioner, 59 T.C. 751 (1973), rev'd & remanded, 518 F.2d 772 (9<sup>th</sup> Cir. 1975), a case involving both California and federal workers' compensation law, the taxpayer retained an outside administrator to estimate the maximum amount of its exposure for self-insured workers' compensation liabilities.

The Tax Court concluded that worker injury did not constitute all of the events necessary to fix all of the worker's compensation liabilities claimed as deductions by the taxpayer. On appeal the Ninth Circuit agreed with the taxpayer's assertion that in an uncontested case a work-related employee injury constituted the only event necessary to establish workers' compensation liability attributable to that injury. In that Circuit's view, if an injury occurs so that economic consequences ensue to the employer under the statutes, the only relevant remaining consideration to the accrual question is whether the amount of the liability may be reasonably estimated. 518 F.2d at 774.

In Wien, a case involving workers' compensation survivor benefits, an Alaskan airline elected to be self-insured under the Alaska Workmen's Compensation Act. For the taxable year at issue and other taxable years affecting the tax liability for that year because of carryback and carryover provisions, a total of three of the taxpayer's pilots were killed in airplane crashes. The taxpayer did not contest its workers' compensation

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liabilities attributable to those deaths. Alaskan law required the taxpayer to make periodic payments to each pilot's widow until her death or remarriage. It also required the taxpayer to make periodic payments to each of the minor children of the deceased pilots until the child's death or the attainment of age nineteen. The Tax Court and Ninth Circuit determined that all the events fixing the taxpayer's liability occurred when the pilots were killed.

In Rev. Rul. 80-191, 1980-2 C.B. 168, the Service announced it would not follow Crescent Wharf and Wien, and would continue to disallow accruals of workers' compensation liabilities subject to the types of contingencies in those cases. Following the issuance of that revenue ruling, the Service lost each litigated case addressing the accrual of workers' compensation liabilities.

In Kaiser Steel Corp. v. United States, 717 F.2d 1304 (9<sup>th</sup> Cir. 1983) the Ninth Circuit reaffirmed its conclusion that "under California law once a worker injury has occurred in course of employment and liability is not contested by the employer, all events have occurred determining the fact of liability and the first prong of the all-events test has been met." Id. at 1306.

Imperial Colliery Co. v. United States, 599 F.Supp. 653, 654 (S.D. W. Va. (1984), involved uncontested self-insured workers' compensation liabilities for permanent disability and survivor benefits. The court adopted the Ninth Circuit's reasoning, concluding that all the events necessary to fix the liabilities at issue occurred upon worker injuries suffered during the course of employment.

In United States v. Hughes Properties, Inc., 476 U.S. 593 (1986) the Supreme Court concluded that a casino could deduct amounts not yet won but guaranteed for payment on progressive slot machines even though such amounts might never have to be paid if the casino went out of business, surrendered or lost its license, or went into bankruptcy before a patron won the guaranteed jackpot.

In United States v. General Dynamics, 6 Cl. Ct. 250 (1984), aff'd, 773 F.2d 1224 (Fed. Cir. 1985), rev'd, 481 U.S. 239 (1987) the taxpayer provided medical benefits to its employees and their qualified dependents through a self-insured plan administered in part by two insurance companies. When an employee or qualified dependent received medical treatment covered by the plan, the employee sought payment therefore by submitting a claim form to the taxpayer's employee-benefits personnel office at the appropriate facility. The claim form, with itemized bills attached, contained information about the employee and the treatment, including the date and cost of each medical treatment for which payment was sought. After verifying that the person who filed the claim qualified as eligible for reimbursement under the plan at the time of

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treatment, employee-benefits personnel forwarded the claim form to one of the insurance companies for final processing and payment. 6 Cl. Ct. at 252.

The Supreme Court did not consider the receipt of medical care by covered individuals as the last event necessary to fix the taxpayer's liability. In its view the filing of a claim was not a mere technicality. Rather, it concluded, as a matter of law, that the filing of a claim was necessary to create liability. The Supreme Court noted that employees were informed that submission of satisfactory proof of charges claimed would be necessary to obtain payment. It also observed that some covered individuals, through oversight, procrastination, confusion over the coverage provided, or fear of disclosure to the employer of the extent of the services provided, might not file claims for reimbursement to which they were entitled. The Court did not consider the failure to file a claim as the type of "extremely remote and speculative possibility" that it had previously held in Hughes did not render an otherwise fixed liability contingent. 481 U.S. at 244-45.

We believe that the legislative record supports the conclusion that Congress intended for many workers' compensation deductions to generate section 172(f)(1)(B) specified liability losses to the extent such deductions generate NOLs. In the 1984 Act Congress amended section 461 to specifically prohibit accrual method taxpayers from deducting workers' compensation liabilities until paid. Section 461(h)(2)(C)(i). From the standpoint of when workers' compensation liabilities may be accrued, this legislative fix prospectively changed the result that otherwise would have been required by a number of prior Service-adverse cases.

Congress enacted section 172(f)(1)(B) primarily to ensure that taxpayers, that had certain deductions deferred because of the economic performance requirement, be able to immediately offset gross income with those deductions when finally allowable. The targeted deductions include those for liabilities actually arising under federal or state law and involving an inherent substantial delay between the act or failure to act giving rise to such liabilities and the allowance of the deductions therefore because of the economic performance requirement.

Workers' compensation liabilities actually arise under federal or state law because they are solely the creation of federal or state statutes. As the cases cited above indicate, some courts believed that the fact of liability was determined at the time of injury and the amount of the liability could be reasonably estimated in many cases at the time of injury. After the enactment of section 461(h)(2)(C)(i), which required payment to deduct a workers' compensation liability, it was clear that there would be an inherent substantial delay between the act giving rise to such liabilities under prior case law and the allowance of the deductions therefore because of the economic performance requirement.

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The instant case involves workers' compensation liabilities imposed under the laws of multiple states. Therefore, to the extent a particular state's law is inconsistent with the following general conclusions, such conclusions must be modified to reflect the nuances of when a particular state's law imposes workers' compensation liabilities. However, based on the manner in which most states impose such liabilities, for section 172(f)(1)(B) purposes we generally conclude that once a person is disabled by a compensable on the job injury and meets any required procedural conditions, such as the reporting of the injury to the employer, necessary to make the employer liable for the injury, the act giving rise to any liability for future disability payments attributable to the injury has occurred. Likewise, we conclude that when an employee dies because of a compensable on the job injury and any required procedural conditions necessary to make the employer liable for the injury have been satisfied, the act giving rise to the employer's obligation to pay any future survivor benefits attributable to that injury has occurred. Finally, in instances in which workers' compensation statutes make an employer liable for an employee's medical expenses attributable to an employment related injury, we conclude that once the injury has occurred and the employee has satisfied any required procedural conditions, such as the reporting of the injury to the employer, necessary to make the employer liable for the injury, the act giving rise to the employer's obligation to pay the employee's medical expenses has occurred.

We disagree with the examining agents contention that in the case of a contested liability, the act, within the meaning of section 172(f)(1)(B)(i), giving rise to that liability does not occur until resolution of the contest. In our view 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. Davies, 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 or other settlement of a contested claim should not be considered the act or failure to act which gives rise to a liability for purposes of section 172(f)(1)(B). Our view is also consistent with the meaning of the phrase "act or failure to act" as used in section 6501(l)(1).

Finally, to satisfy the requirements of the 1984 Act version of section 172(f)(1)(B) any liability at issue must be directly imposed under federal or state law and must involve an inherent substantial delay between the act giving rise to the liability and the deduction therefore. Both the examining agents and Taxpayer agree that state law directly imposes the workers' compensation liabilities at issue. Taxpayer asserts as inappropriate as a matter of statutory interpretation the addition of an inherent delay

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requirement for a liability to arise under federal or state law within the meaning of section 172(f)(1)(B). Nevertheless, Taxpayers contends that the liabilities at issue satisfy an inherent delay test because of the passage of time between the injuries and the periodic payment of the workers' compensation benefits.

Our conclusion with regard to which workers' compensation liabilities satisfy the inherent delay requirement differs from either position advocated by the parties. Most workers' compensation liabilities involve periodic payments and these liabilities cannot be deducted until paid because of the economic performance requirement. Consequently, such liabilities that are inherently due a substantial time after the liability arises have the inherent delay characteristic. By inherently due we mean the due date of the liability provided by federal or state law disregarding any effect on the actual payment date that might arise as the result of the liability being contested. The application of these rules is illustrated by the following two examples.

Example 1. On the last day of 1994 an employee becomes totally disabled as a result of a job related injury on that day and the employee also takes whatever procedural steps are necessary to make the employer liable for the injury, such as notifying the employer of the injury. Under state law the employee is entitled to disability payments of \$300 every two weeks until death or the end of the disability, such payments to begin two weeks after the date of injury. Rather than make the payments, the employer contests the liability. In 2000 a final judgment is entered in favor of the employee and the employer makes all of the payments for 1995 through 2000. Payments allocable to 1998 through 2000 are made with respect to inherent delay liabilities. The original due date for such payments falls in taxable years beginning at least three years after the date of injury. The payments allocable to 1995 through 1997 are not made with respect to inherent delay liabilities and cannot generate a specified liability loss.

Example 2. An employee loses an arm in a job related injury on the last day of 1994. For the loss of the arm the employee is entitled to a single workers' compensation payment of \$10,000 due three weeks after the loss of the arm. Rather than paying, the employer contests the liability. In 2000 a final judgment is entered in favor of the employee and the employer pays the \$10,000. The effect of the contest on the actual payment date is disregarded in determining if the payment qualifies as an inherent delay liability. Because the liability's original due date falls in 1995, the \$10,000 deduction cannot generate a specified liability loss.

#### Host Marriott

During the consideration of this request for technical advice, Host Marriott Corp. v. United States, 113 F. Supp. 2d 790 (D. Md. 2000) was decided. In Host Marriott, the taxpayer claimed the portion of its NOL generated by deductions for workers'

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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 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 the workers' compensation and federal tax deficiency interest liabilities arose under federal or state law within the meaning of the statute. 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.

As noted in this technical advice memorandum and also in TAM 200043018, we now recognize 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). However, notwithstanding the Service-adverse decision in Host Marriott, 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 have only appealed the portion of the Host Marriott judgment pertaining to the federal tax deficiency interest to the Fourth Circuit.

#### Legal Fees, State Filing Fees, and Other Transaction Costs

Taxpayer claims that legal fees it incurred in contesting or investigating workers' compensation claims and certain other expenses associated with such claims, such as state filing fees, also generated specified liability losses for Year 1 and Year 2. We agree with the examining agents that deductions for such items do not generate specified liability losses within the meaning of section 172(f)(1)(B).

Turning first to the legal fees, there are two possible ways that deductions for such fees might qualify to generate a section 172(f)(1)(B) specified liability loss. First, the fee liability could arise under either federal or state law, within the meaning of section 172(f)(1)(B), and the act giving rise to that liability could occur at least three years before the beginning of the taxable year of the deduction.

In Sealy, the Tax Court concluded that the federal law cited by the petitioners did not establish their liability to pay the professional fees at issue, which included legal fees. Rather, the court concluded that the obligations to pay the fees did not arise until

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the petitioners contracted for and received the services. 107 T.C. at 184. It follows that the Tax Court concluded that contractual obligations do not arise under federal or state law. Likewise, in the instant case the obligation to pay the legal fees arose pursuant to contracts rather than under federal or state law. Furthermore, economic performance with regard to liabilities arising from the provision of services to a taxpayer occurs as the services are rendered. Section 1.461-4(d)(2). Thus, deductions for legal fees are generally deductible for the taxable year in which the liability for the services arises, meaning that deductions for such liabilities generally do not satisfy the three-year test.

Second, deductions for the legal fees could generate a section 172(f)(1)(B) specified liability loss if the fees are allowable “with respect to” workers’ compensation liabilities that satisfy the three-year test and also arise under state law within the meaning of section 172(f)(1)(B) (qualifying liabilities). The meaning of the compound preposition “with respect to” as used in section 172(f)(1)(B) is ambiguous. For example, it could mean “related to in some manner”. If this were the case it would appear that legal fees incurred to determine the amount of a qualifying liability could generate a specified liability loss. On the other hand, one might interpret “with respect to” as used in section 172(f)(1)(B) as equivalent in meaning to the simple preposition “for”. Resolution of this ambiguity requires resort to the legislative history.

The legislative history to section 172(f)(1)(B) indicates that Congress enacted the predecessor to section 172(f)(1)(B) in the 1984 Act to provide extended carryback periods for NOLs generated by deductions involving a substantial delay between the creation of a liability and the allowance of the deduction therefore because of the economic performance requirement. Even if one views section 172(f)(1)(B)’s benefits as extending to liabilities whose deduction is deferred for reasons other than the failure to satisfy the economic performance requirement, the legislative history makes clear that Congress intended to provide relief for deferred deductions.

To effectuate this intent it is necessary to interpret “with respect to” narrowly, that is, as equivalent in meaning to the simple preposition “for”. To adopt the contrary view would allow extended carrybacks for NOLs generated by deductions involving little or no deferral between the creation of a liability and the allowance of a deduction therefore, for example, legal fees deductible in the same year incurred. For these reasons we conclude that the legal fees at issue cannot generate a section 172(f)(1)(B) specified liability loss.

Liabilities for state filing fees, which are due upon filing particular documents in conjunction with contesting or otherwise processing workers’ compensation claims, although directly imposed by state law, do not qualify as inherent delay liabilities and likely would never satisfy the three-year test. Likewise, deductions for such liabilities are not allowable “with respect to” qualifying workers’ compensation liabilities.

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Therefore, deductions of state filing fees cannot generate a section 172(f)(1)(B) specified liability loss. The other transaction costs are not identified in the submission but to the extent they are similar to the state filing fees the same analysis applies.

### Pension Contributions

If any part of the deduction taken with respect to contributions to the Hourly Plan (hereafter referred to as the “pension deduction”) is to be considered as a specified liability loss, such amount would have to fall within the meaning of section 172(f)(1)(B)(i). Thus, the pension deduction would have to qualify as an amount allowable as a deduction under chapter 1 with respect to a liability “arising out of a federal” law (it is clear that the liability could not possibly arise under state law)<sup>12</sup> for which the “act (or failure to act) giving rise to such liability” occurs at least three years before the beginning of the taxable year.

The liability that Taxpayer views as a specified liability loss is the liability for unfunded accrued benefits.<sup>13</sup> Even though the Hourly Plan is maintained voluntarily pursuant to collective bargaining, and under the plan Taxpayer’s liability for pension benefits is limited to the amounts it had contributed, Taxpayer asserts that the liability arises under federal law. Taxpayer bases its assertion on the minimum funding requirements of section 412 and section 302 of ERISA and upon the plan termination provisions of title IV of ERISA.

### Minimum Funding Argument

We believe that the pension deduction does not satisfy the requirements to be considered a specified liability loss. First, Taxpayer does not have a liability for the pension benefits directly. It is only the plan that has a liability. If the plan runs out of money, the plan participants do not have a direct claim against Taxpayer under either the terms of the plan or federal law. Or, to put it another way, any obligation that Taxpayer might have to provide pension benefits directly to participants arises because of collective bargaining not because of federal law. As will be discussed further, federal law is concerned with the plan and the requirements with respect to the plan.

We agree that, given that Taxpayer maintains a pension plan, the company has an obligation to put funds into the plan pursuant to the minimum funding standards in

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<sup>12</sup> ERISA provides for the federal regulation of employee benefit plans and generally preempts state law with respect to such plans.

<sup>13</sup> We do not consider the nuances of whether accrued benefits as opposed to termination liability or some other (possibly distinct) figure is the “proper” term. Suffice it to say that employees have accrued benefits through some date and it is the liability for these benefits that is at issue.

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federal law. These funds will be used to pay plan benefits and expenses. The minimum funding standards are determined on a year by year basis. The amount of the contribution required to satisfy the minimum funding standard is determined with respect to all projected benefits using a reasonable funding method and reasonable actuarial assumptions (see, for example, section 412(c)(3)). It is possible that an employer can be required to make contributions to satisfy the minimum funding requirements for a plan year even though the plan has enough funds to provide the benefits that have been accrued to date.

However, regardless of the manner in which the minimum funding standard is determined, the requirement to make a contribution for a specific plan year to satisfy the minimum funding standard is a current year requirement, not a liability from earlier years. The “liability” (the amount of the current year’s contribution) is not known until the current year and cannot even be determined until the current year (in part, because the experience gains and losses must be reflected in the calculation).<sup>14</sup> Furthermore, if the plan is terminated, the minimum funding requirement ceases to apply (Rev. Rul. 79-237, 1979-2 C.B. 190) even though the plan has unfunded accrued benefits and the liability to make contributions to satisfy the minimum funding standard no longer applies.

While an argument could be made that where there is an accumulated funding deficiency the current year’s required contribution is attributable to earlier years, that is not the situation here. There is no accumulated funding deficiency for the Hourly Plan. That the determination of the contribution required to satisfy the minimum funding standard for the current year is based, in part, upon the amount of unfunded accrued benefits does not alter the fact that the contribution requirement is a current year requirement and cannot even be measured before the current year.

Accordingly, we do not believe that any amount of the pension deduction is a specified liability loss.

#### The Plan Termination Argument

Taxpayer argues that they have a liability for unfunded accrued benefits under title IV of ERISA. However, any liability that might exist would apply only if Taxpayer terminated the plan. In order to terminate the plan in a standard termination, Taxpayer would have to give notice to employees, get the union to agree to the termination, and

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<sup>14</sup> Other factors not known in advance are the actuarial assumptions used for the current year and the demographics of the participants. In particular, if participants (such as retirees or beneficiaries) pass away, there may be no liability for those individuals even though at one time in the past there was a liability.

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provide all plan benefits through single-sum distributions and/or the purchase of contracts from a life insurance company. In particular, without union agreement there could not be termination, and the additional money needed to terminate the plan, if any, would depend upon the elections of participants as to single-sum distributions or contracts from a life insurance company and the cost of those contracts. See section 4041(a) and 4041(b) of ERISA. Alternatively, to terminate the plan in a distress termination, Taxpayer would have to be in bankruptcy (or the equivalent) in order for the title IV values to apply. See section 4041(c) of ERISA. None of these actions have been taken. Indeed, it is possible and even probable that the plan will never be terminated.

The amount of the liability would be determined at the plan termination date. If the plan assets at that time were sufficient to provide all plan benefits, there would be no liability even though the plan had unfunded benefits in the past. The “termination liability” is a function of plan funding and experience in all years prior to the date of an actual plan termination.<sup>15</sup>

Given that a plan termination is required to create any actual liability to the PBGC pursuant to title IV, and that the events allowing a plan termination have not taken place, any termination liability is a contingent liability. Coupled with the fact that the termination liability, if any, depends upon future events prior to the plan termination, such liability is not one for prior years, but is a liability in the year of plan termination. Accordingly, we believe that the liability that might exist on plan termination is not a specified liability loss.

#### CAVEAT(S)

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.

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<sup>15</sup> As previously noted, the liability upon plan termination is affected by events occurring before the date of an actual plan termination. A liability that might be there if the plan terminated today may not be there at the time of a future plan termination.