INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM
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CASE MIS No.: TAM-115291-99/CC:ITA:B6

Taxpayer's Name:
Taxpayer's Address:

Taxpayer's Identification No:
Years Involved:

Date of Conference:

LEGEND: Taxpayer =

Division =

Date A =

Date B =

Date C =

Year A =

Year B =

Month A =

A$ =

ISSUES: (1) May the following items generate a specified liability loss within the meaning of section 172(f)(1)(B):

(A) deductions for sales and use tax deficiencies,
(B) deductions for federal tax deficiency interest,
(C) deductions for certain priority tax claims and interest thereon,

(D) deductions for self-insured workers' compensation costs,
(E) deductions for increases in state unemployment insurance attributable to layoffs resulting from closing a massive number of stores,
(F) legal and other professional fees incurred by Taxpayer on its own behalf or on behalf of the creditors' committee during the course of a bankruptcy,
(G) various costs incurred in complying with a bankruptcy reorganization plan (including severance pay and related payroll taxes, professional fees, inventory write-offs and leasehold improvement write-offs), and
(H) legal fees incurred to pursue litigation against the chairman of Taxpayer's board of directors and an investment advisory firm?

(2) May a section 172(f)(1)(B) specified liability loss be carried back to a taxable years beginning before January 1, 1984?

CONCLUSIONS

(1) We are returning item (F) to the Field for further development. Of the remaining items only the workers' compensation liabilities may generate a specified liability loss within the meaning of section 172(f)(1)(B) provided the liabilities satisfy certain requirements as discussed below.

(2) A section 172(f)(1)(B) specified liability loss may not be carried back to a taxable year beginning before January 1, 1984.

FACTS: Taxpayer acquired Division on Date A in a highly leveraged transaction when Division was in financial distress. As a result of the acquisition, by Year A Taxpayer experienced severe cash flow problems prompting suppliers to stop the flow of new merchandise to its stores. On Date B Taxpayer filed a voluntary chapter 11 bankruptcy petition. Taxpayer emerged from bankruptcy in Month A of Year B.

Taxpayer incurred net operating losses (NOLs) for its taxable years ended 9201, 9301, 9401, and 9501. Taxpayer treated a portion of these losses as specified liability losses as defined in section 172(f). On Date C Taxpayer filed refund claims for its taxable years ended 8201, 8301, 8501, 8601, and 8701 based on the purported specified liability losses.

LAW AND ANALYSIS:

<u>The Statute</u>

Prior to its amendment in section 3004(a) of the Tax and Trade Relief Extension

Act of 1998, section 172(f)(1)(B)[1] 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-
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> (i) in the case of a liability arising out of a [f]ederal or [s]tate law, the act (or failure to act) giving rise to such liability occurs at least 3 years before the beginning of the taxable year, or
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> (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 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
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> (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

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[1] 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).

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.[2] 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).

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.[3]

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[2] 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.

[3] Decommissioning a nuclear power plant requires reducing the level of radioactivity in the plant to a level considered safe for unrestricted use. Some methods

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 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[4]. To remedy this potentially unfavorable result, Treasury officials proposed

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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).

[4] 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

liberalizing the NOL carryback provisions for deductions deferred because of economic performance:

> We recognize that requiring deductions for future expenses to be taken in the year of economic performance also requires that the net operating carryback rules be amended to insure that taxpayers are not overtaxed. Our proposals provide for extension of the carryback period in appropriate circumstances to insure that the deferred expenses will be able to be fully utilized.
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> Generally expenses attributable to liabilities arising more than 3 years prior to economic performance will be permitted to be carried back for a period not to exceed 10 years, subject to certain transition rules. Special carryback rules might be appropriate for certain expenses to be paid in the future such as the nuclear powerplant decommissioning costs.

Id. at 7 (statement of Ronald A. Pearlman, Deputy Assistant Secretary for Tax Policy, U.S. Treasury).

Congress adopted the Administration's proposed economic performance requirement by enacting 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 10-year carryback for deferred statutory or tort liability losses. Furthermore, the discussion of the new 10-year carryback provision appears in the same section of the committee reports where section 461(h) is discussed.

Although the House and Senate Reports to the 1984 Act describe the operation of the proposed new 10-year NOL carryback provision, neither of these reports 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. ...
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> The provisions of the bill apply generally to expenses incurred (without regard to the economic performance requirement) after the date of enactment. ...
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> Conference agreement
>
> The conference agreement generally follows the House bill, ...

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deduction might be carried for the normal NOL carryback period.

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

Sealy

In Sealy Corp. v. Commissioner, 107 T. C. 177 (1996), aff'd, 171 F.3d 655 (9th Cir. 1999)[5] 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 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

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[5] On appeal the Ninth Circuit focused on the fact that the acts giving rise to the liabilities at issue in Sealy did not occur at least 3 years before the beginning of the taxable year of the related deductions as required by 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).

liabilities, and torts. Invoking the statutory construction rule of ejusdem generis, the court concluded that Congress intended the 10-year carryback to apply to a relatively narrow class of liabilities similar to those identified in the statute. The court thought the costs at issue in Sealy were routine costs not like those identified in the statute. Id. at 186.

Discussion of Sub-issues under Issue 1

(A) Sales and use tax deficiencies

Taxpayer deducted sales and use tax deficiencies attributable to calendar year 1988 on its 9301 federal income tax return. Taxpayer notes that state statutes impose the liabilities for the sales taxes and interest at issue, leading Taxpayer to conclude that these liabilities arise under state or federal law within the meaning of section 172(f)(1)(B). Taxpayer also points out that the sales that gave rise to the tax liabilities at issue occurred in 1988, more than 3 years before the beginning of the taxable year for which Taxpayer deducted the amounts at issue. Therefore, Taxpayer asserts that the acts giving rise to these liabilities occurred at least 3 years before the beginning of the taxable year of the deduction therefore, as required by section 172(f)(1)(B)(i) (the 3-year test).

1. Liability Arising Under Federal or State Law

a. Narrow Class

In contrast to the fact pattern in Sealy, state statutes directly impose the sales tax and interest liability thereon at issue. 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 10-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 10-year carryback provision is for "certain deferred liability losses"). Based on the foregoing, it is clear that Congress intended to enact a limited exception to the normal 3-year carryback rule for a narrow class of liabilities 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 state sales taxes and liabilities for interest thereon 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.[6]

In contrast to the types of liabilities arising under federal or state law identified in the statute and the legislative history to the 1984 Act, a state sales tax liability constitutes a routine cost that does not involve an inherent substantial delay between the time the events giving rise to the liability occur and when the deduction for such liability becomes allowable. There may be substantial delays between the events giving rise to a state sales tax liability and the time when such liability becomes an allowable deduction. For example, an accrual method taxpayer may report too little state sales tax liability on its tax return and then may unsuccessfully contest the assertion of a greater tax liability. In this case, assuming that the taxpayer does not pay the tax liability pending resolution of the contest, the tax deduction will be delayed until resolution of the contest and payment of the liability. Such a delay, however, is not part of the inherent nature of the liability. A taxpayer need not report and pay less than the proper amount of its state sales tax liability. Thus, a state sales tax liability does not have the inherent delay feature required to qualify for the narrow class of liabilities that arise under federal or state law within the meaning of section 172(f)(1)(B).

Likewise, it follows that an interest liability[7] imposed as part of a state sales tax

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[6] 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.

[7] Moreover, in the case of interest economic performance occurs as the interest economically accrues. Section 1.461-4(e). Thus, the economic performance rules cannot cause a delay between the events giving rise to an interest liability and the time

deficiency does not possess the inherent delay characteristics necessary to qualify as arising under federal or state law within the meaning of section 172(f)(1)(B). Consequently, the deductions at issue cannot generate a specified liability loss within the meaning of section 172(f)(1)(B).

2. Act or Failure to Act

We also disagree with Taxpayer's assertion that the "act or failure to act" giving rise to all of the interest liabilities at issue satisfies the 3-year test of section 172(f)(1)(B)(i). Therefore, even if the liabilities at issue did arise under state law within the meaning of section 172(f)(1)(B), some of the interest deductions still would not generate a specified liability loss.

By using the phrase "the act or failure to act"[8] 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 10-year NOL carryback. Thus, Congress only meant to provide relief for existing liabilities the deduction of which is deferred for a

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such interest becomes an allowable deduction for federal income tax purposes.

[8] 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).

prescribed period.

To effectuate this intent, we believe the final act or failure to act[9] 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.

Each of the states imposing the sales tax liabilities at issue also impose interest on those liabilities if not paid by the due date. Some of the states impose interest on a daily basis and some impose it based on the months or any portion thereof that the liability upon which the interest accrues remains unpaid. However, in each case a taxpayer does not become liable for a given interest liability until that interest liability economically accrues, that is, until time passes and the underlying liability upon which the interest is based remains unpaid. Thus, the final failure to act, within the meaning of section 172(f)(1)(B)(i), giving rise to a given interest liability on unpaid sales tax or unpaid sales tax and accumulated interest thereon is the passage of time without payment of the liability upon which the interest liability economically accrues. To the extent that any of the interest liabilities at issue economically accrued within 3 years of the beginning of the taxable year such liabilities became deductible, deductions for those liabilities also fail the 3-year test of section 172(f)(1)(B)(i).

(B) Federal tax deficiency interest

On its tax return for the taxable year ending 9401, Taxpayer deducted $A of federal tax deficiency interest. The deficiencies were for Taxpayer’s taxable years ending in 8601 and 8801. For the reasons set forth in the discussion of the sales tax

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[9] Under this view if a taxpayer contests a liability, resolution of the contest against the taxpayer does not constitute the final act or failure to act giving rise to the taxpayer’s liability. "The principal function of a judgment is to adjudicate the existence or nonexistence of the right or liability in question." 46 Am. Jur. 2d Judgments § 8 (1969). "A judgment or decree duly entered, establishes in the most authentic form, that which had theretofore been in dispute, or unsettled or uncertain." Adams v. 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 should not be considered the act or 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(l)(1).

deficiencies the interest liabilities could not generate a specified liability loss within the meaning of section 172(f)(1)(B).

(C) Priority tax claims and interest thereon

Taxpayer claimed deductions on its federal income tax returns for the taxable years ending 9401 and 9501 for certain deductible taxes imposed for Taxpayer's taxable years ended 8901 and 9001. Taxpayer also paid interest on these taxes. These liabilities qualified for priority treatment under the Bankruptcy Code. Pursuant to the confirmed chapter 11 bankruptcy plan, Taxpayer paid the taxes and interest in installments and deducted such amounts when paid.

Although the facts in the submission are extremely sparse, based on conversations with Taxpayer and its representatives at the adverse conference it appears that the original due dates of the taxes at issue predate the filing of the bankruptcy petition and that such liabilities were uncontested. It also appears that the interest at issue is pre-petition interest.

At the outset we note that under the accrual accounting method Taxpayer generally would be entitled to deduct the taxes and interest at issue when those liabilities arose rather than when paid. Section 1.446-1(c)(1)(ii)(A) provides that under the accrual accounting method "a liability is incurred, and generally is taken into account for [f]ederal income tax purposes, in the taxable year in which all the events have occurred that establish the fact of the liability, the amount of the liability can be determined with reasonable accuracy, and economic performance has occurred with respect to the liability." No provision of section 461(h) specifically requires the payment of tax liabilities to satisfy the economic performance requirement. This requirement appears in section 1.461-4(g)(6)(i) which generally provides that economic performance with regard to the types of taxes at issue occurs upon payment. However, section 1.461-4(k)(3) provides that this regulatory provision only applies to tax liabilities that would, but for the enactment of section 461(h), be allowable as a deduction or otherwise incurred for taxable years beginning after December 31, 1991.

Likewise, economic performance with regard to the pre-petition interest at issue occurred prior to the filing of the bankruptcy petition as that interest economically accrued. See 1.461-4(e). Because the uncontested tax and interest liabilities at issue also satisfied the first two-prongs of the all-events test pre-petition, such liabilities generally would have been deductible under the accrual accounting method when they arose rather when they were paid.

When the liabilities at issue arose, however, Treasury had not issued final regulations under section 461(h), and it was not clear how to treat tax liabilities arising in the period following the enactment of section 461(h) (the gap period) and the promulgation of final regulations thereunder. Therefore, it was reasonable for Taxpayer

to assume that under the accrual accounting method it was not proper to deduct such taxes until paid. It was probably unreasonable for Taxpayer to assume that interest on taxes accruing during the gap period had to be paid to satisfy the economic performance requirement. Nevertheless, without deciding that issue, for purposes of the following analysis we will assume that Taxpayer's deduction of both the taxes and interest at issue when paid was proper under an accrual accounting method.

As already noted because a taxpayer need not underreport and underpay its tax liabilities such liabilities and interest thereon do not satisfy the inherent delay test and therefore cannot arise under federal or state law within the meaning of section 172(f)(1)(B). It appears that Taxpayer properly reported the tax liabilities at issue prior to filing the voluntary chapter 11 bankruptcy petition on Date B. Moreover the filing of the bankruptcy petition on Date B caused the automatic stay of section 362(a) of the Bankruptcy Code to come into effect, thereby delaying the payment of the taxes and interest until provided for under the confirmed chapter 11 plan. The question is whether these differences justify the conclusion that the liabilities for taxes and interest satisfy the inherent delay test and therefore arise under federal or state law within the meaning of section 172(f)(1)(B).

In our view they do not. Taxpayer's failure to pay the taxes and interest at issue prior to filing the bankruptcy petition may have been attributable to its cash flow problems. However, Taxpayer's inability or unwillingness to timely pay the tax liabilities at issue constitute circumstances unique to Taxpayer. Failure to timely pay taxes does not result because of the inherent nature of tax liabilities.

With the filing of the bankruptcy petition section 362(a)(6) of the Bankruptcy Code stayed any action by the taxing authorities to collect the taxes and interest at issue, effectively preventing Taxpayer from paying the amounts at issue after the petition date without a court order. Taxpayer's bankruptcy, however, constituted a circumstance unique to Taxpayer rather than a circumstance inherently associated with tax liabilities and interest thereon. Thus, the priority taxes and interest thereon do not constitute inherent delay liabilities and therefore do not arise under federal or state law within the meaning of section 172(f)(1)(B).

(D) Self-insured workers' compensation costs

For its taxable years ended 9201, 9301, and 9401, as a self-insurer Taxpayer paid workers' compensation claims of its employees attributable to injuries occurring at least 3 years before the beginning of the taxable year of the payments. Taxpayer contends that self-insured workers' compensation liabilities arise under state law within the meaning of section 172(f)(1)(B) and further contends that employee injuries constitute the acts giving rise to such liabilities. Workers' compensation benefits

generally fall into the following classes: medical expenses, full and partial disability benefits including amounts paid for specific types of injuries such as the loss of a limb, and survivor benefits.

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 (9th 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, "[i]f an injury occurs so that economic consequences ensue to the employer under the statutes" 518 F.2d at 774, the only relevant remaining consideration to the accrual question is whether the amount of the liability may be reasonably estimated.

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 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 19. 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 (9th 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 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 specified liability losses within the meaning of section 172(f)(1)(B), assuming such deductions generate NOLs.

In the 1984 Act Congress amended section 461 to specifically require that

accrual method taxpayers not be able to deduct 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.

For the foregoing reasons, for section 172(f)(1)(B) purposes we 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 on the job 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.

Although the states were not identified in the request for technical advice, the instant case involves the application of workers' compensation statutes in multiple states. We anticipate that for most of the liabilities at issue the act giving rise to the liability will be a work-related injury or the satisfaction of some procedural requirement shortly after the injury. However, each state's law must be examined to ensure that at

least 3 years before the beginning of the taxable year of the deduction of the liability at issue the necessary statutory requirements from which liability could have been determined had been satisfied.

Finally, to satisfy the requirements of the 1984 Act version of section 172(f)(1)(B) the liability at issue must involve an inherent substantial delay between the act giving rise to the liability and the deduction therefore. Most workers' compensation liabilities involve periodic payments. Because workers' compensation liabilities cannot be deducted until paid, liabilities for periodic payments due a substantial amount of time after the act giving rise to the liability, that is, those liabilities that satisfy the 3-year test, possess the inherent delay characteristic. However, some workers' compensation liabilities may by their nature be payable in a lump sum, such as a lump sum payment for the loss of a limb. These are not inherent delay liabilities because a substantial delay between the creation of the liability and its payment is not an inherent characteristic of the liability. Although the deduction for such a liability may be delayed because a taxpayer contests the liability, contesting a liability does not convert it into an inherent delay liability. Only a liability whose inherent nature causes its deduction to be substantially deferred because of the economic performance requirement qualifies as an inherent delay liability.[10]

(E) Increases in state unemployment insurance attributable to layoffs resulting from store closings

As a result of its bankruptcy caused by its financial distress following the acquisition of Division, Taxpayer closed many stores. The store closings resulted in the layoff of a large number of Taxpayer employees, many of whom claimed unemployment compensation. The approval and payment of such a large number of claims, in comparison to Taxpayer's prior claims history, had an adverse effect on Taxpayer's unemployment experience rating in the states in which Taxpayer operated. The downgrading of Taxpayer's experience rating caused it to be liable for unemployment taxes on unemployment taxable wages paid or incurred following the downgrading in excess of the amounts for which it otherwise would have been liable in the absence thereof (excess unemployment taxes).

Taxpayer asserts that the excess unemployment taxes it deducted for 9301, 9401, and 9501 generated specified liability losses for those years. Taxpayer asserts that because state statutes imposed the excess unemployment taxes at issue such taxes constitute liabilities arising under state law within the meaning of section 172(f)(1)(B). Taxpayer asserts that the acquisition of Division constituted the act giving rise to the excess unemployment tax liabilities. Because the acquisition occurred at

[10] A periodic payment liability that would satisfy the 3-year test if uncontested does not lose its status as an inherent delay liability if its deduction is further delayed because of a contest.

least 3 years prior to the beginning of any of the taxable years at issue, Taxpayer contends such liabilities also satisfy the 3-year test of section 172(f)(1)(B)(i).

We recognize that Taxpayer's acquisition of Division constituted an important link in the chain of causation leading to the eventual imposition of the excess unemployment taxes. However, Taxpayer had no liability for such taxes on the date of the acquisition. The final act from which it could be determined that Taxpayer had a legal obligation for the excess unemployment taxes, depending on the particular state law at issue, could have occurred no earlier than when Taxpayer either incurred or paid the wages constituting the tax base for the imposition of such taxes.

State unemployment taxes are due shortly after the incurrence of the liability therefore. No substantial inherent delay exists between the events giving rise to such liabilities and the allowance of the deduction therefore because of the economic performance requirement. Therefore, state unemployment tax liabilities, although literally imposed by state law, do not arise under state law within the meaning of section 172(f)(1)(B). Moreover, assuming that such liabilities did arise under state law within the meaning of section 172(f)(1)(B), Taxpayer has not demonstrated that the acts giving rise to such liabilities occurred at least 3 years before the beginning of the taxable year such liabilities were deductible. Thus, deductions for the excess unemployment taxes do not generate specified liability losses.

(F) Legal and other professional fees incurred by Taxpayer on its own behalf or on behalf of the creditors' committee during the course of a bankruptcy

During the course of its bankruptcy Taxpayer became liable for legal and other professional fees. The fees fell into two classes: (1) those incurred for services rendered to Taxpayer, and (2) fees incurred for the benefit of the unsecured creditor's committee but imposed upon Taxpayer. Taxpayer asserts that the fees it deducted for the taxable years ending in 9301, 9401, and 9501 generated specified liability losses for those years. Taxpayer contends that the act which gave rise to its liability for the fees occurred when it acquired Division on Date A.

At the outset we note that the request for technical advice did not address the issue of whether the legal and professional fees, when properly accrued under section 1.461-1(a)(2), qualified for immediate deduction or rather should have been capitalized under section 263(a). Only deductible liabilities may generate a specified liability loss. Therefore, we are returning the fee issue for further development to afford both the Field and Taxpayer an opportunity to address the deduction/capitalization issue. Such fees may have been incurred for a variety of purposes and all of the facts must be taken into account to determine the status of the fees as immediately deductible or capital items. See Hillsborough Holdings Corp. v. United States, 83 AFTR2d 99-2382 (Bankr. M.D. Fla. 1999).

In Sealy the Tax Court concluded that the petitioners' obligations to pay the professional fees at issue did not arise until the petitioners contracted for and received the services. 107 T.C. at 184. Because the Tax Court concluded that the obligations at issue did not arise under federal or state law, it follows that the Tax Court viewed contractual obligations as not arising under federal or state law, either literally or within the meaning of section 172(f)(1)(B). In our view contractual obligations do not actually arise under either federal or state law but rather arise pursuant to the agreement of the contracting parties. Therefore, such obligations also do not arise under federal or state law within the meaning of section 172(f)(1)(B).

The legal and other professional fees incurred on behalf of Taxpayer[11] and the creditors' committee differ from professional fees incurred outside of the context of bankruptcy in several respects. For example, the employment of the particular professionals who render the services is subject to court approval. Sections 327(a), 1103(a), and 1107(a) of the Bankruptcy Code. Both a debtor in possession and the creditors' committee may enter into agreements with the professionals to be employed on any reasonable terms and conditions, including on a retainer, on an hourly basis, or on a contingent fee basis. Sections 328(a) and 1107(a) of the Bankruptcy Code. However, entering into these agreements is subject to court approval. Furthermore, after the conclusion of the employment the court may allow compensation different from that agreed to if the agreement's terms and conditions prove to have been improvident in light of developments not capable of being anticipated upon the fixing of those terms and conditions. Section 328(a) of the Bankruptcy Code. Finally, subject to section 328 of the Bankruptcy Code, after notice to parties in interest and a hearing, if required, pursuant to section 330 of the Bankruptcy Code the court may award a professional person employed under section 327 or section 1103 of the Bankruptcy Code (1) reasonable compensation for actual, necessary services rendered by the professional person and any paraprofessional in that person's employ, and (2) reimbursement for actual, necessary expenses. Various statutory standards govern the determination of reasonable compensation for professional services and the amount of compensation awarded by the court may be less than that requested by the professional.

Any future submission regarding the legal and other professional fees incurred on behalf of Taxpayer should address the question of whether the fee obligations actually arise under federal law or rather whether the fee obligations are essentially

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[11] For purposes of this memorandum we have assumed that Taxpayer incurred professional fees on its own behalf in its capacity as a debtor in possession. For the treatment of professional fees incurred in the capacity of a debtor see sections 329 and 330 of the Bankruptcy Code. We noted, however, that some of the fees at issue were deductible for taxable years following the effective date of Taxpayer's bankruptcy reorganization plan. To the extent such fees did not require court approval the liability therefore would be contractual and deduction of the fees would not generate a specified liability loss.

contractual in nature and therefore would not generate a specified liability loss even if such fees were deductible when accrued for federal income tax purposes.[12] The discussion of this issue should take into account the effect, if any, of the bankruptcy provisions on the essential nature of the fees. Any future submission should also address the question of whether, assuming arguendo that the obligations for the legal and other professional fees incurred on behalf of Taxpayer actually arise under federal law, whether the liability for those fees and fees incurred on behalf of the creditors' committee also meet the inherent delay test and therefore arise under federal law within the meaning of section 172(f)(1)(B).

Finally, we disagree with Taxpayer's assertion that the acquisition of Division on Date A constituted the act giving rise to the fee liabilities at issue. On that date the final acts from which it could be determined that Taxpayer had a professional fee liability had not occurred. Although we do not find it necessary to determine what particular acts gave rise to the liabilities for professional fees at this time, in our view the act giving rise to a professional fee obligation of Taxpayer could occur no earlier than the rendering of the professional services that were ultimately approved for compensation by the court. Any future submission regarding the legal and other professional fees incurred on behalf of Taxpayer or the creditors' committee should address the question of when the act giving rise to the obligation for such fees occurred.

(G) Other Items

Taxpayer asserts that during the course of its bankruptcy reorganization it incurred a number of deductible liabilities, denominated statutory closing costs in the request for technical advice, which generated specified liability losses. Based on discussions at the adverse conference Taxpayer apparently asserts the acquisition of Division constituted the act giving rise to these liabilities. The items are as follows:

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[12] Section 1102(a)(1) of the Bankruptcy Code requires the United States trustee, as soon as practicable after the filing of a voluntary chapter 11 bankruptcy petition, to appoint an unsecured creditors' committee. Section 1103(a) of the Bankruptcy Code gives that committee, subject to court approval, the authority to employ one or more attorneys, accountants, or other agents to represent the committee. The Bankruptcy Code requires the debtor to pay the fees of the professionals employed by the unsecured creditors' committee even though these professionals are employed by the committee rather than the debtor and even though these professionals essentially act in an adversarial capacity to the debtor by representing the interests of the unsecured creditors. We view these fees as literally imposed on the debtor under federal law. However, we express no opinion regarding whether the debtor's obligation to pay the fees meets the inherent delay test and therefore arises under federal law within the meaning of section 172(f)(1)(B).

a. Payments to Employees Required by WARN Act

Section 3(a) of the Worker Adjustment and Retraining Notification Act (Pub. L. No. 100-379 (WARN Act) (29 U.S.C. § 2102(a)) generally directs certain employers not to order a plant closing or mass layoff prior to the end of a 60-day period beginning when the employer serves written notice of its intention to issue such an order. If employees who may reasonably be expected to experience an employment loss as a result of the plant closing or mass layoff (affected employees) belong to a union, the employer must notify the union. If the affected employees do not belong to a union, the employer must notify each affected employee. The WARN Act also requires the employer to issue written notice to certain state and local officials.

Under section 5(a) of the WARN Act (29 U.S.C. § 2104(a)) an employer that orders a plant closing or mass layoff without giving appropriate written notice as required by section 3(a) of the WARN Act becomes liable to each aggrieved employee who suffers an employment loss as a result of such closing or layoff for--

(A) back pay for each day of violation at a rate of compensation not less than the higher of--

> (i) the average regular rate received by such employee during the last 3 years of the employee's employment; or
>
> (ii) the final regular rate received by such employee' and

(B) benefits under an employee benefit plan described in section 3(3) of ERISA, (29 U.S.C. § 1002(3)), including the cost of medical expenses incurred during the employment loss which would have been covered under an employee benefit plan if the employment loss had not occurred.

The liability is calculated for the period of the violation, up to a maximum of 60 days, but in no event for more than one-half the number of days the employee was employed by the employer. The liability may also be reduced in certain circumstances, for example, by wages paid by the employer to the employee for the period of the violation.

Taxpayer incurred liability pursuant to section 5(a) of the WARN Act which was described as severance pay in the request for technical advice. Although section 5(a) of the WARN Act refers to back pay for aggrieved employees, in most cases this back pay effectively constitutes federally mandated severance pay because the calculation period for the pay includes periods during which the aggrieved employee worked for and earned wages from the employer.

We disagree with Taxpayer's assertion that the acquisition of Division on Date A constituted the act giving rise to the WARN Act liabilities at issue. The final act from

which it could be determined that Taxpayer had a liability under section 5(a) of the WARN Act did not occur until Taxpayer either ordered a plant closing or mass layoff without giving proper written notice. Therefore, none of the deductions for the WARN Act liabilities at issue satisfy the 3-year test of section 172(f)(1)(B)(i).

Additionally, although WARN Act liabilities are actually imposed by federal law, in our view such liabilities do not arise under federal law within the meaning of section 172(f)(1)(B) because the nature of the liability does not entail an inherent substantial delay between the act giving rise to the liability and the allowance of the deduction therefore. Because WARN Act liabilities arise from violations of federal law, section 1.461-4(g)(2) requires payment of such liabilities to satisfy the economic performance requirement. However, the inherent nature of the liability does not ordinarily require a taxpayer to substantially delay its payment. Moreover, even if the payment of a WARN Act liability were delayed somewhat because of bankruptcy, the delay would arise from circumstances unique to the taxpayer rather than to the inherent nature of the liability. Therefore, Taxpayer's WARN Act liability deductions do not generate specified liability losses.

Taxpayer also asserts that deductions for the payroll taxes it incurred because of the WARN Act payments generated a specified liability loss. As previously noted, tax liabilities do not arise under either federal or state law within the meaning of section 172(f)(1)(B). In addition, Taxpayer had no liability for the payroll tax liabilities when it acquired Division. Therefore, the acquisition of Division cannot be the act giving rise to the liabilities. In the absence of an extraordinary delay between the creation of the payroll tax liabilities and the allowance of the deduction therefore such liabilities would also fail to satisfy the 3-year test of section 172(f)(1)(B)(i).

b. Inventory Write-offs

Taxpayer asserts that deductions it claimed for various inventory write-offs generated specified liability losses. Section 1.446-1(c)(ii)(B) provides in part that "[t]he term "liability" includes any item allowable as a deduction, cost, or expense for [f]ederal income tax purposes." To the extent the inventory write-offs at issue qualify for federal income tax deductions such write-offs constitute amounts allowable as deductions for federal income tax purposes. However, section 1.446-1(c)(ii)(B)'s broad definition of the term "liability" does not apply for all purposes of the Code. Rather it applies only to ensure that accrual method taxpayers satisfy all the requirements of the accrual method with regard to items that fall both within and outside of the class of items normally considered to be liabilities before taking those items into account for federal income tax purposes.

To satisfy the requirements of section 172(f)(1)(B) a deduction must be allowable with respect to a liability within the ordinary meaning of that term. An inventory write-off allowable for federal income tax purposes constitutes one of the few instances in which

a taxpayer is allowed to recognize a loss in the value of property for tax purposes without entering into a realization transaction with a third party, such as the sale of the property. A loss in the value of property does not constitute a liability for purposes of section 172(f)(1)(B). Therefore, deductions attributable to inventory write-offs cannot generate specified liability losses within the meaning of section 172(f)(1)(B).

c. Leasehold Improvement Write-offs

Pursuant to its bankruptcy plan Taxpayer closed a large number of leased stores from which it operated its retail business and as a result incurred losses with regard to leasehold improvements Taxpayer made at those stores. The submission does not show the amount of losses for any particular taxable year. The submission does indicate, however, that pursuant to its bankruptcy Taxpayer incurred liability for lease rejection costs. Therefore, it appears Taxpayer generally incurred the losses either when the store leases terminated according to their original or modified terms or when Taxpayer, with the court's approval, opted to terminate unexpired leases pursuant to section 365(a) of the Bankruptcy Code, or when such leases were deemed terminated by the Bankruptcy Code.

The submission provides no details regarding the character of the leasehold improvements. However, considering the nature of Taxpayer's business, those improvements have to fall into one of two categories: (1) trade fixtures which Taxpayer could remove from the leased stores upon lease termination, or (2) other improvements all rights to which vested in the lessor upon lease termination (category 2 leasehold improvements).

Taxpayer could incur a write-off loss with regard to trade fixtures either by abandoning them or by permanently retiring them from use in its business (for example, by treating the fixtures as scrap). Section 1.167(a)-(8)(a)(3)-(4). If a taxpayer voluntarily abandons an asset or permanently retires it from the taxpayer's trade or business, any loss recognized with regard to that asset is not incurred with respect to a liability. Losses incurred with regard to the trade fixtures were voluntary and thus not incurred with respect to a liability. Although as an economic matter Taxpayer may have been compelled to abandon or retire the trade fixtures from its business upon lease termination, it was under no unilaterally imposed legal obligation to do so. Thus, not being allowed with respect to a liability, the losses cannot generate a specified liability loss within the meaning of section 172(f)(1)(B).

With regard to any losses for category (2) leasehold improvements, when Taxpayer made those improvements Taxpayer retained a possessory interest in the improvements pursuant to the lease. By complying with the lease terms, Taxpayer could maintain possession of the improvements for the duration of the lease. Upon the attachment of the improvements to the leased premises, however, the lessor obtained the right to take possession of the improvements at the end of the lease or earlier upon

certain breaches of the lease.

At the end of a real estate lease a taxpayer may have unrecovered basis in category (2) leasehold improvements subject to the lease. This may occur because the Code requires a taxpayer to recover basis in leasehold improvements subject to MACRS using recovery periods that may exceed the remaining term of the lease when the improvements are made. See section 168(i)(8)(A). If the parties do not extend the lease or enter into a new lease covering the improvements, at the end of the lease the taxpayer will be entitled to a loss deduction equal to its unrecovered basis in the improvements.

The loss, however, does not result from any liability imposed on the taxpayer. Rather, the loss arises because the taxpayer's time-limited property interest has expired and owing to the nuances of the basis recovery rules the taxpayer has unrecovered basis in the property upon lease expiration. Because any loss Taxpayer may have incurred at the normal expiration of a lease with regard to category (2) leasehold improvements results from the expiration of its time-limited property rights in the improvements rather than from a liability, such a loss cannot generate a specified liability loss within the meaning of section 172(f)(1)(B).

Regarding the liability question, we reach the same conclusion for category (2) leasehold improvement losses associated with prematurely terminating leases due to the lessee's failure to comply with the lease requirements ("material breach"). As in the case of a termination of the right to leasehold improvements that occurs at the normal expiration of a lease, the expiration of a lessee-taxpayer's interest in category (2) leasehold improvements because of a material breach involves no transfer of property rights from lessee to lessor. Thus, any loss incurred with regard to the improvements cannot be incurred with respect to a liability and therefore cannot generate a specified liability loss within the meaning of section 172(f)(1)(B).

We reach the same conclusion with regard to prematurely terminating leases in the context of bankruptcy. With the approval of the court a debtor in possession generally may assume or reject an unexpired lease. Sections 365(a) and 1107(a) of the Bankruptcy Code. If the debtor in possession does not assume or reject an unexpired lease of nonresidential real property within certain time limits, the lease is deemed rejected, and the law requires the debtor in possession to immediately surrender the property. Section 365(d)(4) and 1107(a) of the Bankruptcy Code. The rejection of an unexpired lease, however, generally constitutes a breach of the lease. Section 365(g) of the Bankruptcy Code. Liability for the breach constitutes a pre-petition liability. Section 502(g) of the Bankruptcy Code.

The filing of a bankruptcy petition operates as an automatic stay to any act to obtain possession of bankruptcy estate property. Section 362(a)(3) of the Bankruptcy Code. For this purpose estate property includes the bankrupt's actual possession of

nonresidential realty leased to the bankrupt provided the lease term has not expired.

The automatic stay will prevent eviction actions regardless of whether a material breach of an unexpired lease of nonresidential real property is committed prior to the lessee's filing of a bankruptcy petition or after that date. The stay applies until the lease term expires or until the lease is rejected or deemed rejected under section 365 of the Bankruptcy Code.

Unexpired leases that were deemed rejected or that Taxpayer rejected pursuant to section 365(a) may have fallen into one of three groups: (1) those which Taxpayer materially breached prior to bankruptcy, (2) those which Taxpayer materially breached subsequent to bankruptcy but prior to rejection of the lease under section 365 of the Bankruptcy Code, and (3) those the terms of which Taxpayer materially complied with prior to the rejection of such leases under section 365 of the Bankruptcy Code. With regard to the first two categories of leases, as in the previously discussed lease termination situations, the rejection of the leases resulted in the expiration of any interests that Taxpayer may have had in the leased premises and did not involve a transfer of rights from Taxpayer to the lessor. Thus, any loss incurred with regard to category (2) leasehold improvements associated with the rejected leases cannot be incurred with respect to a liability and therefore cannot generate a specified liability loss within the meaning of section 172(f)(1)(B).

The same is true for such losses associated with leases with regard to which Taxpayer materially complied prior to rejection thereof under section 365 of the Bankruptcy Code. Rejection of such leases constituted a material breach of the leases not protected by the automatic stay, resulting in expiration of all of Taxpayer's rights in the leased premises without a transfer of any Taxpayer rights to the lessors.

We have concluded that Taxpayer's losses with regard to leasehold improvements were not incurred with respect to a liability within the meaning of section 172(f)(1)(B). Therefore, we do not find it necessary to examine the application of the other requirements of section 172(f)(1)(B) to such losses.

d. Professional Fees

Without going into any detail, the submission indicates that Taxpayer incurred various professional fees as part of its "statutory" closing costs. There is no indication that these obligations arose from anything other than contractual agreements, and as previously noted, contractual obligations do not constitute liabilities arising under federal or state law within the meaning of section 172(f)(1)(B). Thus, deductions for such fees cannot generate a specified liability loss within the meaning of section 172(f)(1)(B).

Moreover, Taxpayer had no legal obligation for such fees when it acquired Division. Thus, that acquisition cannot be the act giving rise to the liabilities at issue.

Although it is not clear from the submission precisely when Taxpayer became liable for the fees, to the extent the fees were based on hourly charges for services rendered no liability therefore could arise until the rendering of professional services. Economic performance for service liabilities occurs with the rendering of services. Section 1.461-4(d)(2). Thus, deductions for uncontested fees would not satisfy the 3-year test.

(H) Legal fees incurred to pursue litigation against the chairman of Taxpayer's board of directors and an investment advisory firm

Taxpayer's board of directors failed to perform basic due diligence regarding the acquisition of Division. In addition, individuals with clear conflicts of interest decided key acquisition issues. For example, the chairman of Taxpayer's board of directors (the chairman) also served as a director of the investment firm (the investment advisor) that advised the owner of Division with regard to the acquisition of Division by Taxpayer. Despite this, the chairman was allowed to negotiate the acquisition of Division by Taxpayer. The submission also indicates that the investment advisor provided services to Taxpayer.

Subsequent to the acquisition of Division Taxpayer filed a lawsuit against the chairman and the investment advisor alleging breach of fiduciary duty, professional malpractice, and negligent misrepresentation. Taxpayer's bankruptcy plan required 50% of any recovery attributable to the lawsuit to be used to pay pre-bankruptcy petition creditors.

Taxpayer contends that legal fees it incurred in prosecuting the lawsuit constituted liabilities arising under federal law because the Bankruptcy Code required it to pursue its claims against the defendants. However, Taxpayer cites no specific statutory provision in support of this assertion. Taxpayer contends that the acquisition of Division constituted the act giving rise to the legal fee liabilities.

At the outset we note that because this cause of action relates to activity associated with the acquisition of assets, an issue arises concerning both the characterization of any recovery attributable to the action and the proper characterization of the legal fees incurred to prosecute the action. For purposes of this memorandum we have assumed that the legal fees at issue were deductible when incurred. However, we express no opinion on this question.

Section 1107(a) of the Bankruptcy Code generally requires a debtor in possession to perform duties similar to those performed by a trustee. These duties make the debtor in possession accountable for all property received. Section 704(a)(2) of the Bankruptcy Code. Property of a bankrupt's estate includes all legal and equitable interests held by the bankrupt at the commencement of the case. Section 541(a)(1) of the Bankruptcy Code. Thus, any causes of action held by the bankrupt that could lead to a recovery of monetary damages constitute property of the bankruptcy estate. Thus,

broadly construed, the mandate to account for estate property includes a duty to prosecute any cause of action which provides a net benefit to the bankruptcy estate.

Although the debtor in possession has a general obligation under the Bankruptcy Code to pursue claims that will likely provide a net benefit to the estate, as was the case in Sealy, the obligation to incur legal fees to pursue those claims is not directly imposed by statute. A debtor in possession has some discretion in deciding whether to incur legal fees to pursue a claim. Where a debtor in possession unreasonably fails to bring an action to pursue a claim, in certain circumstances the creditors' committee or one or more creditors may receive court approval to pursue the action. However, the creditor's committee may agree to bear the burden of any fees incurred in excess of any recovery. See In re Stn Enterprises, 779 F.2d 901, 905-06 (2d Cir. 1985). Thus, had Taxpayer opted not to incur the legal fees at issue, it is not clear such fees would have been imposed upon Taxpayer. As in Sealy, Taxpayer had no liability for the legal fees at issue until it contracted for the services and such services were rendered. Such fees do not constitute deductions allowed with respect to a liability arising under federal or state law and therefore cannot generate a specified liability loss within the meaning of section 172(f)(1)(B).

Discussion of Issue 2-Carrybacks to Taxable Years Beginning before January 1, 1984

Taxpayer filed refund claims for its taxable years ended 8201, 8301, 8501, 8601, and 8701 based on the purported specified liability losses. To the extent Taxpayer did incur specified liability losses within the meaning of section 172(f)(1)(B), a further question remains as to whether the carryback period of such losses includes Taxpayer's taxable years ended 8301 and 8201.[13]

As originally enacted in the 1984 Act, section 172(k)(4) prevented a deferred statutory or tort liability loss from being carried back to a taxable year beginning before January 1, 1984, unless such loss could be carried back to such year without regard to the special 10-year carryback period provided for deferred statutory or tort liability losses. In the Revenue Reconciliation Act of 1990 (the 1990 Act) Congress, in the course of eliminating expired and obsolete provisions from section 172, placed under section 172(f) both the statutory language defining product liability losses[14] and the statutory language defining what had previously been called deferred statutory or tort

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[13] The request for technical advice indicates that Taxpayer claims portions of the NOLs at issue qualify as specified liability losses within the meaning of section 172(f)(1)(A) (product liability losses). To the extent the losses qualify as product liability losses, the Revenue Reconciliation Act of 1990, discussed infra, would not prohibit such losses from being carried to Taxpayer's taxable years ended 8301 and 8201.

[14] Congress originally enacted the provisions providing for 10-year carrybacks for product liability losses in the Revenue Act of 1978.

liability losses, most likely because both types of losses generally qualify for a 10-year carryback. In that act Congress attached the new name "specified liability loss" to both product liability losses and what had formerly been called deferred statutory or tort liability losses. The legislative history to the 1990 Act indicates that these amendments were not intended to produce any substantive changes. See H.R. Rep. No. 894, 101st Cong., 2d Sess. 36 (1990).

Section 11811(b)(2)(B) of the 1990 Act, an uncodified provision enacted as a note to section 172, provides:

> [t]he portion of any loss which is attributable to a deferred statutory or tort liability loss (as defined in section 172(k) of the Internal Revenue Code of 1986 as in effect on the day before the date of the enactment of this Act) may not be carried back to any taxable year beginning before January 1, 1984, by reason of the amendment made by subparagraph (A).

In section 11811(b)(1) of the 1990 Act Congress struck certain subsections of section 172 and redesignated others. Section 11811(b)(2)(A) of the 1990 Act, the subparagraph referred to in the above-quoted text, is the section in which Congress actually amended section 172(f). In section 11811(c) of the 1990 Act Congress made the amendments enacted in section 11811 of the 1990 Act applicable to NOLs for taxable years beginning after December 31, 1990.

As amended in the 1990 Act, section 172(b)(1)(C) provides a 10-year carryback period for specified liability losses. Section 11811(b)(2)(B) of the 1990 Act only applies to NOL carrybacks attributable to NOLs arising in taxable years beginning after December 31, 1990. Thus, in light of the statutory language itself, the legislative history thereto, and the historical limitation on the carrying back of deferred statutory or tort liability losses, one may only logically conclude that Congress enacted section 11811(b)(2)(B) of the 1990 Act to ensure that the portion of any specified liability loss that would have met the definition of a deferred statutory or tort liability loss under pre-1990 Act law not be eligible to be carried back to any taxable year beginning before January 1, 1984. Therefore, Taxpayer cannot carry the portion of any of its NOLs for the loss years at issue that qualify as specified liability losses within the meaning of section 172(f)(1)(B) to its taxable years ended 8301 and 8201.