OFFICE OF
CHIEF COUNSEL

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

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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

FROM: DEBORAH A. BUTLER
ASSISTANT CHIEF COUNSEL (Field Service)
CC:DOM:FS

SUBJECT:

This Field Service Advice responds to your memorandum dated May 5, 1999. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

<u>LEGEND:</u>

Taxpayer =
Shareholder =
Law Firm =
Partnership =
Lessor =
Partner 1 =
Sublessee =
Property A =
Year 1 =
Year 2 =
Year 3 =
Year 4 =
Year 6 =
Year 7 =
Year 8 =
Year 9 =
FY =

Date 1 =
Date 2 =
Date 3 =
Date 4 =
Date 5 =
Date 6 =
Date 7 =
Date 8 =
Date 9 =
Date 10 =
Date 11 =
Date 12 =
Date 13 =
Date 14 =
n =
o =
p =
q =
r =
s =
t =
u =
v =
w =
x =
y =
z =

ISSUE(S):

1. Whether the amounts paid to settle a lawsuit are specified liability losses within the meaning of I.R.C. § 172(f)(1).

2. Whether legal expenses incurred in the lawsuit are specified liability losses.

CONCLUSION:

1. Amounts paid to settle the lawsuit are not specified liability losses.

2. The legal expenses are not specified liability losses.

FACTS:

The facts are stated in detail in your request for Field Service Advice. Some of the dates, however, are relevant to this matter and are restated here. Taxpayer, a domestic corporation, was the general partner of Partnership. There were seven limited partners. Partnership had a long-term ground lease on Property A and subleased the property to Sublessee. In Year 1, it began negotiations with Sublessee to sell the ground lease. On Date 1, Shareholder decided to sell Partnership's rights in the ground lease to Sublessee in exchange for $n and an assumption of the leasehold mortgage. How this decision was reached was apparently at issue; the limited partners claimed that Taxpayer reached this decision without their consent.

Lessor offered to exchange the property with Partnership through a like-kind exchange. On Date 2, Shareholder contacted Law Firm regarding purchase of Property A. Also on Date 2, Taxpayer, not Partnership, attempted to enter into a purchase agreement for Property A with an intermediary selected by Lessor. In Date 3, Taxpayer, acting on Partnership's behalf, agreed to an increase in rent due Lessor, which it passed through to Sublessee.

On Date 4, Taxpayer sent letters to the partners offering to purchase their interest in Partnership. All the partners except Partner 1 assigned their interests in Partnership to Taxpayer.

During Date 3, Sublessee sued Partnership for breach of the agreement to sell the ground lease. During the litigation, Sublessee accused Taxpayer of breaching its fiduciary duties to the partners. On Date 5, a second set of letters was sent to the partners. In Date 6, Taxpayer settled the litigation with Sublessee by agreeing to acquire Property A from Lessor.

On Date 7, Taxpayer sent Partner 1 a third letter giving him the same choices as before. Partner 1 advised Taxpayer that he was unable to make an educated decision concerning his options and requested additional information. On Date 8, Taxpayer sent Partner 1 a letter indicating that Partnership was dissolved.

On Date 9, Partnership acquired Property A from Lessor for $o.

On Date 10, Taxpayer, purportedly acting on behalf of Partnership (which it had earlier claimed had been dissolved), agreed to sell Property A to an unrelated party for $p.

On Date 11, Taxpayer sent Partner 1 a Schedule K-1 for Year 2 indicating that Partnership ceased doing business as of Date 12 and that Partner 1's interest in Partnership was sold to Taxpayer on or about Date 12.

On Date 13, the partners filed a complaint in state court against Taxpayer, Shareholder, and Law Firm. An amended complaint was filed in Year 6 alleging offenses including breach of fiduciary duty; constructive fraud; fraud; breach of contract; negligence; negligent misrepresentation; conversion; RICO; professional negligence; and conspiracy.

Partner 1 settled his claims with the defendants, including Taxpayer, in Date 14. Taxpayer, Shareholder, and the Law Firm agreed to pay Partner 1 $q. The other partners settled their claims in Year 8. The defendants agreed to pay them $r.

On its income tax for Year 7,[1] Taxpayer claimed deductions for legal expenses of $s and the settlement with Partner 1 of $t. For Year 8, it claimed a deduction for legal expenses of $u. For Year 9, it claimed a "Tort Claim Expense" deduction of $v.

Taxpayer filed amended returns for Year 3 and Year 4, claiming carrybacks from Year 7 to Year 3 of $w, from Year 8 to Year 4 of $x, and from Year 8 to Year 3 of $y and to Year 4 of $z.

LAW AND ANALYSIS

This memorandum assumes for the purposes of analysis of the section 172(f) issue that the amounts have been substantiated and that they are, in fact deductible in the years claimed.

For the years in question, section 172(b)(1)(A) provided that taxpayers were able to carry net operating losses back three years and forward 15 years.[2] An exception to this rule, section 172(b)(1)(C), provided that in the case of a taxpayer that has a "specified liability loss," the specified liability loss shall be a net operating loss carryback to each of the 10 taxable years preceding the taxable year of the loss.

Before its amendment by the Tax and Trade Relief Extension Act of 1998, Pub. L. No. 105-277, section 3004, section 172(f)(1) defined "specified liability loss" as the sum of the following amounts to the extent taken into account in computing the NOL for the taxable year:

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[1] Taxpayer was on a fiscal year ending FY. All references to tax year are for years ending FY.

[2] Section 172(b) was amended in 1997 to provide for a 2-year carryback and a 20-year carryforward.

> (A) Any amount allowable as a deduction under section 162 or 165 which is attributable to –
>
> > (i) product liability, or
> >
> > (ii) expenses incurred in the investigation or settlement of, or opposition to, claims against the taxpayer on account of product liability.
>
> (B) Any amount (not described in subparagraph (A)) allowable as a deduction under this chapter with respect to a liability which arises under a Federal or State law or out of any tort of the taxpayer if –
>
> > (i) in the case of a liability arising out of a Federal or State 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.

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.

Settlement

We do not believe that the settlement payments are subject to section 172(f). The legislative history suggests that section 172(f) should be read narrowly. Sealy Corp. v. Commissioner, 107 T.C. 177, 185-86 (1996), aff'd 171 F.3d 655 (9th Cir. 1999), citing Conf. Rep. No. 861, 98th Cong. 2d Sess 871-73 (1984), 1984-3 C.B. (Vol. 2) 125-27. While Sealy did not concern a tort payment covered by section 172(b)(2)(ii), we think the principle of narrow construction enunciated in that case applies to the analysis of that subsection as well.

We believe that the liability settled by the taxpayer is not part of the narrow class of liabilities intended to be covered by the statute. First, the liability does not arise out of a series of actions or failures to act. It is our position that "single act" torts are not covered by section 172(f)(1)(B)(ii). The tort alleged against Taxpayer amounts to one act, namely misrepresentations made by Taxpayer when it offered to purchase the Partners' limited partnership interests. Specifically, Taxpayer misrepresented the value of the ground lease and failed to divulge any information relating to Partnership's purchase of Property A. While the one act of defrauding the partners included several steps, we think the statutory requirement for a series of actions precludes the use of the longer carryback period.

Second, it seems clear to us, as it did to you, that the liability did not arise out of a series of actions taken over an extended period of time. Assuming that each step identified in the Partners' complaint was essential to the commission of the tort, the tort was committed over a period of less than two years. The statute, on the other hand, specifically requires that the liability must arise out of a series of actions (or failures to act) over an "extended period of time." All the actions relating to the Partners' claim occurred in Year 1 and Year 2.

The portion of section 172 providing the special ten-year carryback was initially added by the Deficit Reduction Act of 1984. Section 91 of that Act was the same section that added the economic performance rules of section 461(h) of the Code. Thus, section 172(f) should be interpreted in the context of its enactment as part of the overall changes to the Code resulting from adopting the economic performance rules. In enacting the economic performance rules, Congress recognized that this resulted in pushing deductions substantially further into the future than had been the rule under the "all events" test. Section 172(f) represents an effort to ameliorate the possible harshness created by that rule.

Given a plain reading of the statute, as well as the interrelationship between the economic performance rules and section 172(f), we do not think that Congress intended the period of time involved here to be considered an extended period of time and would be willing to defend such a position. We do not believe that a tort--even one involving a series of actions, which we do not think this one does--committed in such a short period could be covered by section 172(f)(1)(B).

Legal Expenses

Irrespective of whether settlement of the underlying liability is covered by section 172(f)(1)(B)(ii), any attendant legal or professional fees with respect to that liability are not. Those fees arise from a contract, not a tort. Sealy is directly on point, 107 T.C. at 184.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS: [redacted]

[redacted]

If you have any further questions, please call the branch telephone number.

By: ______________________________
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