Host Marriott: Ten-Year Carryback Not Limited To Narrow Class of Liabilities

By Jeffrey A. Hyman

On August 10, 2000, the U.S. District Court for the District of Maryland held in *Host Marriott Corporation* v. *U.S.*, Case No. DKC 99-699 (8/11/2000), that federal tax deficiency interest and workers compensation liabilities qualify for the specified liability loss ("SLL") ten-year carryback under the pre-1998 version of Internal Revenue Code ("IRC") §172(f)(1)(B). The court so held because the liabilities satisfied the requirements set forth in the plain language of statute, and it rejected the IRS' attempt to limit SLL treatment to a narrow class of liabilities satisfying additional non-statutory requirements.

Factual Background

For 1991, the taxpayer in *Host Marriott* reported a net operating loss, comprised in part of deductions (treated by the taxpayer as SLLs) for interest on federal income tax deficiencies and for payment of workers compensation claims. The interest was on tax deficiencies for 1977, 1978 and 1979; the IRS commenced an audit of those years' returns in 1981, concluded the audit in 1985, and settled the controversy over the audit with the taxpayer in 1991. The workers compensation payments made and deducted by the taxpayer in 1991 stemmed from injuries sustained by its employees prior to 1988.

Statutory Requirements

IRC §172(f)(1)(B)(i) conditions treatment of a loss as a SLL on satisfaction of various requirements, two of which were at issue in *Host Marriott*. First, the loss must be with respect to a liability arising under a federal or state law. The *Host Marriott* court held that this requirement was satisfied in the case of both the tax deficiency interest liability, which is imposed by IRC §6601(a), and the workers compensation liability, which is imposed under the law of various states.

Second, the act (or failure to act) giving rise to the liability must occur at least three years before the beginning of the loss year. The taxpayer in *Host Marriott* argued, and the court agreed, that the act giving rise to the tax deficiency interest liability was the filing of tax returns for 1977, 1978 and 1979 which understated the taxpayer's tax liability. Since these returns were filed more than three years before the interest became deductible in 1991, the three-year requirement of IRC §172(f)(1)(B)(i) was satisfied. The IRS argued that the act giving rise to the tax deficiency interest liability was the settlement in 1991 of the controversy over the taxpayer's tax liability for 1977, 1978 and 1979. Since the interest became deductible at the time the settlement occurred, this IRS argument would result in failure to satisfy the three-year rule of IRC §172(f)(1)(B)(i). The IRS made an alternative argument that each day the taxpayer failed to pay the disputed amount constituted a separate act giving rise to the deficiency interest for that particular day. This IRS argument would result in the interest accruing during 1991 and the three year period prior thereto not satisfying the three-year requirement of IRC §172(f)(1)(B)(i). The court mentioned and rejected these IRS arguments in a footnote to the opinion, such footnote relegation indicating that the court found little or no merit in the arguments.

The court held that the injuries sustained by the taxpayer's employees prior to 1988 constituted the act giving rise to the workers compensation liabilities paid and deducted by the taxpayer in 1991; as a result, the liabilities satisfied the three-year requirement of IRC §172(f)(1)(B)(i). In *Host Marriott*, the IRS did not dispute that the injury of the employee is the act giving rise to the workers compensation liability. In other cases, however, the IRS has asserted that the relevant act is the continued disability of the employee or other event which would result in all or a portion of the liability not satisfying the three-year test of IRC §172(f)(1)(B)(i). Treating such an event as the act giving rise to the workers compensation liability is without merit and incompatible with the long line of cases, acquiesced in by the IRS, applying the all events test to the liability. Moreover, IRC §172(f)(1)(B) was amended in 1998 to restrict SLL treatment to a limited and exclusive list of liabilities, including the workers compensation liability. In light of the fact that the liability survived this legislative narrowing of the provision, the IRS' challenging qualification of the liability for pre-1998 periods is difficult to fathom.

Non-Statutory "Requirements"

Because the tax deficiency interest and workers compensation liabilities satisfied the requirements set forth in a plain language reading of IRC §172(f)(1)(B)(i), the *Host Marriott* court held that the liabilities qualified for SLL treatment. The IRS argued (but the court rejected the argument) that SLL treatment was unavailable because additional requirements not found in the language of the provision were not satisfied.

Ejusdem Generis/Inherent Delay

The pre-1998 version of IRC §172(f)(1) confers SLL treatment on three categories of liabilities, set forth in the following order in the provision: (i) product liabilities (IRC §172(f)(1)(A)), (ii) federal or state law liabilities arising out of an act or failure to act occurring at least three years earlier (IRC §172(f)(1)(B)(i)), and (iii) tort liabilities arising out of a series of actions or failures to act over an extended period of time a substantial portion of which occur at least three years earlier (IRC §172(f)(1)(B)(ii)). A special rule is set forth in IRC §172(f)(3) under which a SLL attributable to the nuclear power plant decommissioning liability is accorded a greater than ten-year carryback.

The IRS asserts that the product, tort and nuclear decommissioning liabilities mentioned in IRC §172(f) are specifically enumerated liabilities sharing the common characteristic of a substantial inherent delay between the act giving rise to the liability and the deductibility of the liability. The IRS further asserts that the federal and state law liabilities mentioned in IRC §172(f)(1)(B)(i) are a general category of liabilities which, under the *ejusdem generis* cannon of statutory construction, must also possess this substantial inherent delay characteristic to qualify for SLL treatment.

The *Host Marriott* court noted that where a statutory provision contains specifically enumerated items followed by a general catch-all item, under the *ejusdem generis* principle, the general catch-all item is to be interpreted as referring to items similar to those specifically enumerated. The court gave as an example of an appropriate application of *ejusdem generis* the case of *Canton Police Benevolent Association* v. *U.S.*, 844 F.2d 1231, 1236 (6th Cir.

1988), where the Sixth Circuit Court of Appeals approved an IRS regulation which, in addressing the phrase "life, sick, accident, or other benefits" contained in IRC §501(c)(9), interpreted the term "other benefits" to mean benefits akin to a life, sick or accident benefit. The *Host Marriott* court held that *ejusdem generis* does not apply to IRC §172(f) because the provision sets forth three specific classes of SLLs in three separate subsections: product liability losses, federal and state law liability losses, and tort liability losses. The court indicated that if instead the provision were structured as and contained the language "tort liability, product liability, and other liability arising out of federal or state law," it may have merited application of *ejusdem generis*.

In holding that the product, federal and state law, and tort liabilities set forth in IRC §172(f) are specific classes of liabilities, and indicating that the federal and state law liabilities are not a general catch-all category required to possess characteristics common to the other enumerated liabilities, the *Host Marriott* court noted that IRC §172(f) imposes an actual three-year delay requirement on federal and state law liabilities and tort liabilities, but does not impose any delay requirement on product liabilities. In light of the actual delay requirement imposed by the language of IRC §172(f) on federal and state law and tort liabilities, the court rejected the IRS' inherent delay requirement saying that it saw "no basis for imposing an additional requirement of 'inherent delay' on top of those restrictions already specified by Congress." Accordingly, there is no inherent delay requirement for SLL treatment. The only delay required is that set forth in the language of IRC §172(f)(1)(B) which is a three-year actual delay, regardless of the reason for or the nature of the delay, between the act giving rise to and the time of deductibility of the liability.

Even though the *Host Marriott* court held that there is no inherent delay requirement for SLL treatment, the court noted in a footnote that workers compensation and tax deficiency interest liabilities may involve an inherent delay given the common delay in both resolution of workers compensation claims and the IRS audit process. This is borne out by the tax deficiency interest liabilities in *Host Marriott* which, although relating to 1977, 1978 and 1979, were not resolved until more than ten years later in 1991. Furthermore, the taxpayer cited in its briefs a 1994 General Accounting Office report indicating that there is an average delay of seven to nine years between the filing of a return and the completion of an audit for a Coordinated Examination Program taxpayer. The recognition by the *Host Marriott* court that an inherent delay includes the delay built into the system, including presumably the portion of the delay attributable to resolution of a contest over liability, is an implicit rejection of the IRS' position that an inherent delay is limited to a delay in deductibility of a liability attributable solely to the economic performance rules of IRC §461(h).

The genesis of the IRS' reliance on the *ejusdem generis* doctrine is the case of *Sealy* v. *CIR*, 107 T.C. 177 (1996), where the Tax Court indicated in *dicta* that the doctrine applied to limit SLL treatment to a narrow class of federal and state law liabilities possessing characteristics common to the other liabilities enumerated in IRC §172(f).[1] The *Host Marriott*

[1] In *Sealy*, the taxpayer claimed SLL treatment for professional fees paid in complying with various statutory regimes. The Tax Court disallowed such treatment, primarily because it believed that the liability for such fees did not satisfy the requirements set forth in IRC §172(f)(1)(B)(i) of arising under a federal or state law and being attributable to an act occurring three years earlier. The Ninth Circuit Court of Appeals affirmed the Tax Court

court explicitly rejected this portion of the Tax Court decision in *Sealy*, stating that "[t]hus, to the extent *Sealy* . . . goes beyond the plain language of §172(f)(1)(B), the court disagrees with the Tax Court." Interestingly, in applying the *ejusdem generis* doctrine, the Tax Court in *Sealy* indicated that the characteristic common to the other liabilities enumerated in IRC §172(f) was that they are non-routine. After the Tax Court decision in *Sealy*, the IRS expanded the list of common characteristics to include the inherent delay characteristic. Whatever characteristics may be common to the other liabilities enumerated in IRC §172(f), the *Host Marriott* decision makes clear that *ejusdem generis* does not apply and federal and state law liabilities need not possess those characteristics to qualify for SLL treatment.

In discussing and rejecting application of the *ejusdem generis* doctrine, the *Host Marriott* court stated that IRC §172(f) sets forth only three categories of liabilities: product liabilities, federal and state law liabilities, and tort liabilities. Most notably, the court did not treat the nuclear decommissioning liability as a separate class of liability. In its briefs, the taxpayer asserted that this was appropriate because the nuclear decommissioning liability is merely one type of federal or state law liability and is separately enumerated in IRC §172(f)(3) solely because it is accorded a carryback period longer than the ten-year carryback period accorded other federal and state law liabilities. By contrast, the IRS asserts that the nuclear decommissioning liability is a separate class of liability as this assertion is necessary to bolster the IRS' *ejusdem generis* argument because the inherent delay and non-routine characteristics are possessed by the nuclear decommissioning liability but not necessarily by product and tort liabilities. In any event, the fact that the *Host Marriott* court did not treat the nuclear decommissioning liability as a separate class of liability sends a clear message that SLL treatment is available for other types of federal and state law liabilities whether or not akin to the nuclear decommissioning liability, the IRS' poster child for SLL treatment.

Legislative History/Economic Performance

The IRS asserts that a liability qualifies as a SLL only if it satisfies another requirement not found in the language of IRC §172(f)(1)(B), namely that deductibility of the liability be deferred under the economic performance rules of IRC §461(h). The IRS bases this assertion on the legislative history underlying IRC §172(f)(1)(B) and on the fact that the provision was enacted at the same time as enactment of, and as part of the same section of the legislation enacting, the economic performance rules.

The *Host Marriott* court summarily rejected the IRS' economic performance requirement and the IRS' resort to legislative history to support it. The court held that the language of IRC §172(f)(1)(B) was plain, clear and unambiguous and that, as a result, resort to legislative history to interpret the provision was prohibited. The court cited and quoted from a number of cases enunciating this plain meaning rule of statutory construction, including *Connecticut National Bank* v. *Germain*, 503 U.S. 249, 253-54 (1992) ("We have stated time and again that courts must presume that a legislature says in a statute what it means and means in a statute what it says there."), and *Patten* v. *U.S.*, 116 F.3d 1029, 1035 (4th Cir. 1997) ("We do not even look at legislative history unless there is an ambiguity on the face of the statute.")

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decision in *Sealy* solely on this basis, and did not apply or even mention the *ejusdem generis* doctrine. 171 F.3d 655 (9th Cir. 1999).

The genesis of the IRS' economic performance requirement is the *Sealy* case, where the Tax Court in *dicta* stated that the legislative history "suggests" that Congress intended to limit SLL treatment to liabilities the deduction of which is deferred under the economic performance rules. The *Host Marriott* court rejected this portion of the Tax Court opinion in *Sealy*, saying that "[s]uch a diversion into the legislative history was unnecessary and inappropriate . . ." While the Ninth Circuit affirmed the Tax Court decision in *Sealy*, as noted above, it did so solely on the basis of the failure of the liability for the professional fees at issue in the case to satisfy the requirements set forth in the language of IRC §172(f)(1)(B)(i); the Ninth Circuit made no resort to nor any mention whatsoever of the underlying legislative history.

In a footnote to its opinion, the *Host Marriott* court indicated that, even if resort to the legislative history was proper, it does not support imposition of the IRS' economic performance requirement. In this footnote, the court noted that the IRS' briefs acknowledged that the legislative history was "somewhat sparse and itself not entirely clear." Quoting from *Toibb* v. *Radloff*, 501 U.S. 157, 162 (1991), the court also stated in this footnote that the scant legislative history does not suggest a "clearly expressed legislative intent contrary to the plain language" of IRC §172(f)(1)(B).

Conclusion

In its opinion, the *Host Marriott* court said "examining the plain language of the statute [IRC §172(f)(1)(B)(i)], it permits Plaintiff to avail itself of the provision's benefits." The IRS' inherent delay, economic performance and non-routine requirements, not found in the plain language of the provision, are not in fact requirements. All that is required for a liability to qualify as a SLL is that it satisfy the requirements set forth in the plain language of the provision.

In *dicta*, the Tax Court in *Sealy* applied the *ejusdem generis* doctrine to limit SLL treatment to a narrow class of liabilities, and it gleaned from the legislative history a Congressional intent to limit SLL treatment to liabilities subject to economic performance deduction deferral. The Ninth Circuit's affirmance of the Tax Court decision in *Sealy* on other grounds could only be interpreted as an implicit rejection of the *ejusdem generis*/narrow class analysis and the legislative history/economic performance analysis. However, the *Host Marriott* court explicitly rejected these analyses by the Tax Court in *Sealy*. The IRS' reliance upon and expansion of the Tax Court decision in *Sealy* has now run its course, and the IRS has gotten as much mileage out of the decision as it is going to get.

The *Host Marriott* decision has dealt a severe blow to the IRS' attempt to preclude taxpayers from obtaining the benefits provided by Congress in IRC §172(f)(1)(B). The court clearly held that IRC §172 (f)(1)(B) is an unambiguous statute to be interpreted under the plain meaning doctrine, and that principles such as *ejusdem generis* as well as forays into legislative history are unnecessary and inappropriate. By so holding that the federal tax deficiency interest and the workers compensation liabilities are SLL eligible, the *Host Marriott* case sets the stage for SLL eligibility for all other liabilities which properly arise under federal or state law.