Office of Chief Counsel
Internal Revenue Service

memorandum

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RARowley

date: MAR 1 6 2000

to: Chief, Examination Division, North-South Carolina District
Attn: CEP Case Manager Joe Orzechowski

from: District Counsel, North-South Carolina District, Greensboro

subject: I.R.C. § 172(f) Specified Liability Loss
Taxpayer: [redacted]
Taxable Years: [redacted] and [redacted]

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This is in response to the request of CEP Case Manager Joe Orzechowski, submitted by memorandum dated February 16, 2000, that we provide legal advice relative to the above matter.

ISSUE

UIL No. 172.07-00. Whether amounts paid in settlement of claims against the taxpayer based on overbilling for medical tests constitute specified liability losses under I.R.C. § 172(f).[1]

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[1] Citations to the Internal Revenue Code are to the Code as in effect for the taxable years [redacted] and [redacted].

CONCLUSION

The amounts in question do not qualify as specified liability losses under I.R.C. § 172(f).

FACTS

The taxpayer is in the business of performing diagnostic medical tests on bodily specimens submitted for analysis by physicians and other health care providers. In many instances, all or part of the taxpayer's charges for such tests is covered under federal health benefit programs such as Medicare, Medicaid, the Civilian Health and Medical Program of the Uniformed Services, and the Federal Employees Health Benefits Program.

After an investigation in the [redacted], the Federal Government asserted claims against the taxpayer under various federal statutes, based on alleged overbilling of the health benefit programs for such medical tests.[2] In [redacted], the taxpayer paid the Federal Government $[redacted] in settlement of those claims. In [redacted], the taxpayer paid $[redacted] in settlement of analogous claims for overbilling asserted by individual states and commercial insurance companies. We have been informed by the examining agent in this case, Larry Collier, that those sums constituted in their entirety restitution by taxpayer of over-billed amounts.

On its consolidated federal income tax returns for the taxable years [redacted] and [redacted], the taxpayer treated such settlement payments as specified liability losses under I.R.C. § 172(f) allowable as carrybacks to the [redacted] preceding taxable years pursuant to I.R.C. § 172(b)(1)(c).

DISCUSSION

I.R.C. § 172(f)(1)(B) provides, in pertinent part, that specified liability losses include

> [a]ny amount ... 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 -

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[2] The overbilling resulted from tests performed by the taxpayer that were neither ordered by the health care provider nor medically necessary. Depending on the particular statutory provision under which the claim was made, the alleged instances of overbilling began as early as [redacted], and continued as late as sometime in [redacted].

(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.

Although not explicit in the statutory language, the legislative history of the specified liability loss provision indicates that Congress intended that provision to apply only to net operating losses attributable to liabilities the deduction for which is deferred by the economic performance requirement of I.R.C. § 461(h). See, H.R. (Conf.) Rep. No. 861, 98th Cong., 2d Sess. 872 (1984); Sealy Corp., v. Commissioner, 107 T.C. 177, 185-186 (1996), aff'd 171 F.3d 655 (9th Cir. 1999). In the case of liabilities arising out of torts, violation of the law, or breach of contract, economic performance does not occur until the liability is satisfied by payment. Treas. Reg. § 1.461-4(g)(2). Accordingly, we believe the settlement payments here in question meet that threshold requirement for qualification as specified liability losses.

However, we do not believe that such amounts relate to liabilities described in I.R.C. § 172(f)(1)(B). Each individual test for which the taxpayer improperly billed and collected constituted a malfeasance giving rise to liability, and the claims asserted against the taxpayer reflected the aggregate of those discrete liabilities. To the extent those liabilities arose out of torts, they do not satisfy the requirement of I.R.C. § 172(f)(1)(B)(ii) that the liability arise out of a series of actions, or failures to act, over an extended period of time. Rather, each malfeasance giving rise to a liability occurred at one specific point in time - namely, when the taxpayer charged for the unauthorized and unnecessary medical test.

Similarly, even if those liabilities should be considered to have arisen, not out of "torts" of the taxpayer, but rather under a "Federal or State law," we do not believe that the liabilities qualify under I.R.C. § 172(f)(1)(B)(i). The only types of liabilities specifically referred to in I.R.C. § 172(f) are product liabilities, nuclear power plant decommissioning liabilities, and tort liabilities arising out of a series of actions or inactions over an extended period of time. In Sealy Corp., v. Commissioner, 107 T.C. 177, 186 (1996), aff'd 171 F.3d 655 (9th Cir. 1999), the Tax Court applied the statutory construction rule of ejusdem

generis[3] in concluding that Congress intended the 10-year carryback for liability losses under I.R.C. § 172(f)(1)(B) to apply to a relatively narrow class of liabilities similar to those specifically identified by the statute. The distinguishing characteristic shared by each of those identified liabilities is an inherent substantial delay between the acts or failures to act giving rise to the liability, and the time a deduction may be claimed for the liability because of the economic performance requirement.

There was no such inherent delay with respect to the instant taxpayer's liabilities resulting from the medical test overcharges. Such delay as occurred resulted solely from the taxpayer's concealment of the overcharges, and its initial contesting of the liabilities once they came to light. Accordingly, we do not believe that those liabilities constitute specified liability losses under I.R.C. § 172(f).

Because this memorandum provides significant legal advice in a large case, pursuant to CCDM (35)3(19)4(4) we are forwarding a copy to the National Office for post-review. The normal turn-around time for such post-review is 10 days. We will inform you of the National Office's response when it is received.

We are returning herewith a folder labeled "[redacted], [redacted], Planning File, Years: [redacted]" which was informally transmitted to us by Revenue Agent Larry Collier. If we may be of further assistance in this matter, please contact Mr. Ross Rowley of this office, telephone (336) 378-2123.

/s/ PGT
PAUL G. TOPOLKA
District Counsel

Attachment:
As stated

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[3] Under the rule of ejusdem generis, general words that follow the enumeration of specific classes in a statute are construed as applying only to things of the same general class as those enumerated. Id. at 186.