INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

August 17, 2000

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CASE MIS No.: TAM-118298-99/CC:ITA:B2

District Director

Taxpayer's Name:
Taxpayer's Address:

Taxpayer's Identification No:
Years Involved:
Date of Conference:

LEGEND:

X =
W =
Y =
Z =
Property =

Month/Day =
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 =
x =
v =
Year =

ISSUE:

Whether X is entitled to deduct a $49,775.41x repayment made by X of a portion of a tax sharing payment received in connection with a transaction involving the sale of losses by X?

CONCLUSION:

X is not entitled to deduct any portion of the $49,775.41x repayment because the repayment represented an amount not previously included in X's gross income.

FACTS:

Background

X, an Alaska Native Regional Corporation, is the common parent of an affiliated group of corporations ("Consolidated Group") that files federal income tax returns on the basis of a tax year ending Month/Day. X was formed in accordance with the Alaska Native Claims Settlement Act of 1971 (ANCSA), 1972-1 C.B. 490, as amended, 43 U.S.C. § 1601 et seq.

Under the terms of various legislative acts, X and other native corporations were effectively able to "sell" their losses and unused tax credits to purchasing corporations. The purpose of these provisions was to financially benefit native corporations that had losses and credits. The sale of these losses and credits could be accomplished by allowing a native corporation to file a consolidated return with a subsidiary-member in which the native corporation held stock with 80 percent or more of the voting power and in which the purchasing corporation held 80 percent or more of the equity. The purchasing corporation would then assign income to the subsidiary-member corporation. The income would be offset by the native corporation's losses and credits, and the native corporation would be paid for the losses and credits based on the purchasing corporation's tax savings. See generally § 60(b) of the Tax Reform Act of 1984, 1984-3 (Vol. 1) C.B. 87; § 1804(e)(4) of the Tax Reform Act of 1986, 1986-3 (Vol. 1) C.B. 718; and § 5021 of the Technical and Miscellaneous Revenue Act of 1988, 1988-3 C.B. 326.

The "Sale" of X's Losses

On Date 1, the purchasing corporation, W, formed Y. On Date 2, X, W, and Y entered into a Master Agreement ("MA") under which approximately $990,000x of losses of the Consolidated Group could be used to offset W's net taxable income. Also, on Date 2, X, W, and Y entered into a Tax Sharing Agreement ("TSA") in which Y agreed to make tax sharing payments to X for the availability of the losses of X or any wholly-owned direct subsidiaries of X for the taxable year of the Consolidated Group ending Date 6.

Y agreed to pay X v for each dollar of available losses. In satisfaction of that obligation, Y paid X $269,280x on Date 4. This amount was subject to adjustment to reflect circumstances such as changes in the amount of income, gains, losses, deductions, or credits of the Consolidated Group (other than Y) resulting from amended returns, claims for refund, or examinations by the Internal Revenue Service. If adjustments were required, additional payments were to be made by Y to X or repayments were to be made by X to Y, as appropriate.

To secure X's potential obligation to make repayments to Y, the MA required X to deposit a portion of the $269,280x received from Y into a trust account established pursuant to a Grantor Trust Agreement ("GTA"). The amount deposited into the trust account was $149,280x. The trustee, Z, was to hold the trust account in trust for the benefit of X as beneficiary, subject to the interests of W and Y. In the GTA, X was identified as the grantor, and W and Y were identified as the creditors.

The MA provides for the distribution of the trust funds after a final determination has occurred. The TSA defined final determination to mean the earlier of certain specified events, one of which was the execution of a Closing Agreement (as that term is defined in § 7121 of the Internal Revenue Code and the regulations promulgated thereunder) by X and the IRS with respect to the total federal tax liability of the Consolidated Group for its taxable year ending Date 6. Under the terms of a Security and Pledge Agreement X also granted a security interest and pledged certain stock to W, acting for itself and as agent for Y, in order to provide additional security to W and Y with respect to X's obligations under the MA and related agreements.

As part of the overall transaction, W and Y entered into additional related agreements. In an Assignment Agreement W assigned to Y all gross receipts, not to exceed $990,000x, that would otherwise be realized by W from its retail sales of products (except for those in excluded stores) during the period from Date 3 to the close of business on Date 5. The intended effect of this assignment of income was that up to $990,000x of ordinary income that would otherwise be realized and reported as gross income by W would then be realized as gross income by Y; the $990,000x of ordinary income would be offset by the $990,000x of X's losses and made available to the Consolidated Group. In summary, X sold $990,000x of losses for a payment of $269,280x.

X has obtained two letter rulings from the IRS addressing various aspects of the transaction relating to the sales of the losses and the consolidated structure used by it to sell the losses. The Consolidated Group elected to allocate its consolidated federal income tax liability among its members in accordance with §§ 1.1552-1(a)(1) and 1.1502-33(d)(2)(ii) of the Income Tax Regulations, with the percentage specified in

§ 1.1502-33(d)(2)(ii)(b) being 100 percent.[1] A private letter ruling was issued prior to the transaction granting the Consolidated Group permission to use this allocation method.

On Date 7, the second ruling letter was issued by the IRS jointly to X and W and included the following holdings:

> Payments from [Y] to [X] pursuant to the Tax Sharing Agreement in satisfaction of [Y's] allocable portion of the federal income tax liability of the [Consolidated] Group, under the methods described in sections 1.1552-1(a)(1) and 1.1502-33(d)(2)(ii) of the regulations, will not be treated, in whole or in part, as distributions with respect to [Y's] stock, as a contribution to the capital of another member, or as taxable income of [X] or any other member of the [Consolidated] Group. Section 1.1552-1(b)(2) of the regulations. No deduction shall be allowed to [W] or to [Y] in computing its taxable income as a result of any such payment.
>
> If the full amount of tax liability allocated to a member of the [Consolidated] Group is not paid, the unpaid amount will be treated as a distribution with respect to stock, a contribution to capital, or a combination thereof. If a member makes payments in excess of the amount of consolidated tax liability allocated to the member, the amount of the excess payment will be considered an intercompany distribution. Sections 1.1552-1(b)(2) and 1.1502-33(d)(2)(ii)(c) of the regulations.
>
> The earnings and profits of [X] will be increased, and the earnings and profits of [Y] will be reduced, by the amounts allocated to [Y] pursuant to § 1.1502-33(d)(2)(ii)(b) of the regulations. Sections 1.1502-33(d)(2)(ii)(c) and 1.1551-1(b)(2) of the regulations.

On the consolidated income tax return for the year ending Date 6, X reported $990,000x of assigned income, which offset $990,000x of losses. X did not separately include the $269,280x payment on its return, but did include it in financial book income.

The Previous Examination and its Resolution

The IRS examined the income tax returns of the Consolidated Group for certain years,

[1]These citations are to the regulations in effect at the time.

including the year ending Date 6. In the year ending Date 6 X had disposed of a portion of the Property and claimed a loss. The IRS contended that the basis of the Property was overstated and therefore that the loss claimed on the disposition was overstated. The IRS further contended that a portion of the income assigned by W to Y should revert to W and be taxed to W.

To resolve issues raised in the examination, X, W, and the IRS executed a Closing Agreement ("CA") in Year. The specific determinations agreed upon in the CA that effect the issues considered In this technical advice memorandum are as follows:

(1) The proper basis for that portion of the Property that X disposed of during the taxable year ending Date 6 was $700,000x.[2]

(2) The amount of taxable income attributable to Y that is properly included in the X consolidated federal income tax return for the taxable year ending Date 6 is $807,002.16x, all of which was derived from W and assigned to Y, and all of which has been properly offset on X's return by losses, credits, net operating loss carryforwards, or credit carryforwards allowed to X. For federal tax purposes, such income is not taxable to W or any affiliates of W in the consolidated federal income tax return filed by W and its affiliates for the taxable year ending Date 5, or for any other taxable year. Income of Y in excess of $807,002.16x, whether earned during the period in which such company was affiliated with X or otherwise, is not taxable in the X consolidated federal income tax return for the taxable year ending Date 6 or for any other year.

(3) Of the $990,000x of taxable income Y originally reported on the X consolidated federal income tax return for the year ending Date 6, $182,997.84x (the excess of $990,000x over $807,002.16x) is taxable to W and is includible in the consolidated income tax return filed by W for the taxable year ending Date 5. X shall reduce its reported income in its taxable year ending Date 6, by $182,997.84x.

(4) The tax sharing payments payable to X under the MA are excludable from the taxable income of X and are not deductible by W.

(5) X is entitled to a deduction under §162 for the amount in excess of $49,775.41x it is obligated under the MA to pay W (as successor in interest to Y) when payable. W shall not be required to include in income the first $49,775.41x received by it as an indemnity payment under the MA, but shall include in income all payments received in excess of $49,775.41x in the tax year received.

In summary, the CA provides that of the $990,000x of taxable income originally

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[2] X had claimed a basis of $2,017,087.67x.

reported on X's consolidated federal income tax return for the year ending Date 6, the amount of $182,997.84x is taxable to W and is includible in W's consolidated income tax return for the year ending Date 5. That is, excess assigned income of $182,997.84x "sprang back" to W and was not taxable to X. Consequently, the CA required X to reduce by $182,997.84x, the amount of assigned income reported on its consolidated federal income tax return for the tax year ending Date 6. After that adjustment, the assigned income X reported on the consolidated return was $807,002.16x, all of which was offset by X's losses or credits..

The CA also recognizes that X was obligated to repay W the amount of $49,775.41x. This amount represented v for each dollar of the $182,997.84x "spring back" to W. This repayment arose out of the TSA, which provided that if the IRS determined that X's losses were less than originally reported on its tax return, so that excess assigned income would spring back to W, X was to repay W v for every dollar of excess assigned income, plus pay W interest at the overpayment rate. The CA states that X is entitled to a deduction under §162 for the amount in excess of the $49,775.41x it is obligated to pay W, and that W shall not be required to include in income the first $49,775.41x received by it, but shall include in income all payments received in excess of $49,775.41x. The CA does not include an express statement concerning the deductibility of the first $49,775.41x.

After the parties executed the CA, X requested Z to disburse the trust funds. On Date 11, Z wired W the amount of $79,661.61x, which represented $49,775.41x plus interest of $29,886.2x. On the same day Z also wired to X the remainder of the trust funds, $16,542.91x. X claimed an "Internal Revenue Code Section 162 Contract Payment" deduction of $79,661.61x on its federal income tax return for the year ending Date 12, which is the same amount that Z disbursed to W.

The agent asserts that X never included the tax sharing payment ($269,280x) in income and that to allow a deduction for the $49,775.41x repayment of a portion of the tax sharing payment would be inconsistent with the prior treatment. X disagrees and asserts that the tax sharing payment was conveyed by W as part of the earnings assigned by it to Y and thus was included in the Consolidated Group's return for the year ending Date 6. The agent does not dispute X's right to deduct $29,886.2x, the amount paid by X to W that exceeded $49,775.41x.

LAW AND ANALYSIS:

Section 162(a) allows a deduction for ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. Section 165(a) allows a deduction for losses sustained during the taxable year and not compensated for by insurance or otherwise.

In United States v. Skelly Oil Co., 394 U.S. 678 (1969), 1969-1 C.B. 204, the Supreme Court of the United States, held that a taxpayer is not entitled to a deduction under either § 162 or § 165 upon the repayment of any amount that previously was not taxed. In Skelly Oil, the taxpayer was a natural gas producer who made refunds to customers that had been overcharged in earlier years. The taxpayer sought to deduct the full amount of the refunds. During the earlier years, the taxpayer included the full amount of the overcharges in gross income, but in accordance with applicable provisions of the Code, properly deducted 27.5 percent of the receipts to compensate for the depletion of the natural resources from which the income was derived.

The Court stated that as a result of the depletion allowance, the taxpayer in essence had been taxed on only 72.5 percent of its gross receipts. The remaining 27.5 percent of the income in reality had been tax exempt. Permitting a deduction only for the 72.5 percent of the refunded payments that had been previously taxed, the Court stated that it "cannot believe that Congress intended to give taxpayers a deduction for refunding money that was not taxed when received." 394 U.S. at 685. Permitting a deduction for the return of previously untaxed amounts, the Court noted, would confer upon the taxpayer the practical equivalent of a double deduction, a result that would be both "inequitable" and contrary to "sound principles of tax law." 394 U.S. at 680. See also Hintz v. Commissioner, 712 F.2d 281 (7th Cir. 1983) (no deduction allowed for repayment of sick pay and unemployment benefits because the amounts were not subject to taxation when received); Dynamics Corp. of America v. United States, 449 F.2d 402 (Ct. Cl. 1971) (deduction allowed for only 15 percent of the repayment amount because the 85 percent dividends received deduction applied in the year the funds were originally received); Buras v. Commisioner, T.C.M. 1977-325 (no deduction allowed for repayment of item improperly excluded from income in the year received).

Skelly Oil controls the tax determination at issue and unequivocally precludes X's ability to claim a deduction for the return of amounts not previously taxed, regardless of the reason for, or the correctness of, not reporting the amounts in income.

X contends, however, that the $269,280x tax sharing payment received from W, although not included in X's gross income as a separate item, was included in its gross income as part of the $990,000x of income assigned by W to Y. X contends that in the written submission for technical advice the IRS field office has so agreed. As a result, X argues that a deduction is appropriate for the amount it repaid.

The agent was present at the taxpayer conference held on April 17, 2000, and disputed that the $269,280x payment was ever considered by the IRS to be part of the assigned income. For support of this view, the agent notes that the "Facts:" portion of the submission states that "None of the Tax Sharing Payments received by [X] was ever included in its federal taxable income." Additionally, the agent says that the language in the submission X refers to is not in the "Facts:" portion of the submission, but was instead included in the "Discussion:" portion as an alternative position.[3]

The CA, which X agreed to, states that the tax sharing payments made to X are excludable from X's taxable income. X has not offered any explanation of the discrepancy between its present argument and the statement in the CA. The clear import of the CA is that the parties agreed that X was entitled to a deduction only for the interest paid on the repayment, but not for the repayment itself: "[X] is entitled to a deduction under Section 162 of the Code for the amount in excess of [$49,775.41x] it is obligated under the ... Agreement to pay [W] and [W] shall not be required to include in income the first [$49,775.41x] received by it as an indemnity payment under the ... Agreement but shall include in income all payments received in excess of [$49,775.41x] in the tax year received." X has not established that the $269,280x payment was ever included in its gross income.

For purposes of this technical advice memorandum, we need not consider whether the $269,280x tax sharing payment was properly not included in X's income. Regardless of the reason, X did not include the $269,280x payment in an income tax return as income. As the courts consistently have held, permitting a deduction for the repayment of an amount that was not previously taxed would effectively provide a taxpayer with a double deduction, regardless of the reason for, or the propriety of, not reporting the

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[3] In summary, the alternative position is that no deduction is allowable to X for the repayment even if the tax sharing payment was included in X's gross income in Year 6 as part of the income assigned by W. When $182,997.84x sprang back to W, the CA provides that X shall reduce its taxable income by that amount for the year ending Date 6. If the income assigned when received included the tax sharing payment, then the spring back would have included a pro rata amount, $49,775.41x, of the tax sharing payment. Thus, under this approach X's gross income would already have been reduced by the $49,775.41x it seeks to deduct, and a deduction for the repayment of an amount not included in income will not be allowed. Skelly Oil, 394 U.S. 678. X cites a field service advice issued in 1992 as authority for the proposition that no portion of the tax sharing payment sprang back to W. However, X fails to recognize that the tax sharing payments in the field service advice did not spring back with the assigned income because the advice is based upon a conclusion that the tax sharing payments were a separate additional item included in the native corporation's income and not part of the assigned income. If the tax sharing payments were separately included in income, it was appropriate to treat them separately from the spring back. It is noted that X does not agree that the tax sharing payment it received was a separate item of income. The facts addressed in the field service advice are distinguishable from the facts presented in this technical advice memorandum.

amount in income. Doing so would be both "inappropriate" and contrary to "sound principles of tax law." Skelly Oil, 394 U.S. at 680. Thus, regardless of whether X acted properly or improperly[4] in not reporting the $269,280x payment as income, it did not do so, and therefore is not entitled to deduct any portion of its repayment of the amount of $49,775.41x.

The recent decision in Doyon v. United States, Nos. 97-5049, 99-5010, and 99-5154, 2000 U.S. App. LEXIS 12107 (Fed. Cir. 2000), rev'g 37 Fed. Cl. 10 (1996) and 42 Fed. Cl. 175 (1998), does not avail X on the issue presented. In Doyon the Court of Appeals held that § 1804(e)(4) of the Tax Reform Act of 1984, which provides that no provision of the Internal Revenue Code or principle of law shall apply to deny the "benefit or use of losses" of native corporations, was violated by requiring tax sharing payments generated by loss sales transactions to be included in book income for alternative minimum tax purposes. Our conclusion herein does not in any sense deprive X of the use or benefit of any portion of its losses. To the contrary, for the year in which the sale of the losses was effective (the year ending Date 6), all of X's losses were offset by the income assigned by W. X received full compensation for the losses so used and was not required to pay any federal tax on the sales proceeds.[5]

CAVEAT:

A copy of this technical advice memorandum is to be given to the taxpayer(s). Section 6110(k)(3) provides that it may not be used or cited as precedent.

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[4]We note that the period of limitations for making assessments has expired with respect to the tax year ending Date 6.

[5]X did not include the tax sharing payment in income for alternative minimum tax purposes.