INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

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CASE MIS No.: TAM-111121-00/CC:ITA:B3

District Director

Taxpayer's Name:

Taxpayer's Address:

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

LEGEND

Taxpayer =

Inventory =

ISSUE

Whether in the years at issue Taxpayer may apply section 1341 of the Internal Revenue Code (Code) with respect to expenses for environmental remediation.

CONCLUSION

In the years at issue, Taxpayer may not apply section 1341 with respect to expenses for environmental remediation because (i) no item was included in gross income in a prior year as required under section 1341(a)(1); (ii) the basis for a current deduction of the expenses is not, as required under section 1341(a)(2), that an item included in gross income in a prior year was restored; and (iii) as provided under section 1341(b)(2), section 1341 does not apply with respect to inventory receipts.

FACTS

The District Director has agreed to assume the truth of certain factual claims that have been asserted but have not yet been proven by the taxpayer. This will enable us to reach the primary legal issue. The facts as represented for purposes of the TAM are as follows:

Taxpayer, an accrual method taxpayer, is a manufacturer of Inventory. During the course of the manufacturing process, Taxpayer produces waste byproducts, scrap, and unusable materials ("waste"). When Taxpayer disposes of waste related to the manufacturing process, the associated costs are treated as inventoriable in the year incurred. As such, the costs are accounted for in the computation of cost of goods sold (COGS) for the current period.

For each taxable year at issue, Taxpayer incurred additional costs ("environmental remediation costs") to capture and/or redispose of waste previously disposed of and to remediate damage caused by or alleged to be caused by waste from prior years. Taxpayer treats environmental remediation costs that are related to contamination from manufacturing in prior years as period costs, rather than inventoriable costs. Accordingly, environmental remediation costs are currently deductible as ordinary and necessary business expenses. As an alternative, however, to claiming a deduction on returns for the taxable years at issue, Taxpayer sought to apply section 1341 with respect to environmental remediation costs.

LAW

In <u>North American Oil v. Burnet</u>, 286 U.S. 417 (1932), the Supreme Court held that a taxpayer must include in gross income an item received with a claim of right and without restriction as to its disposition, even if it is determined in a subsequent year that the taxpayer must restore all or part of the item. In <u>United States v. Lewis</u>, 340 U.S. 590 (1951), the Court held that, if a taxpayer must restore all or part of an item previously received with a claim of right and included in gross income, the taxpayer may be entitled to a deduction in the year of the restoration but is not allowed to amend the prior year's return to exclude the item from gross income and obtain a refund of tax. In cases where income tax rates decrease between the year a claim of right item was included in gross income and the year the item is restored, Congress recognized that a deduction for the restoration would not reduce tax as much as the inclusion in income subjected the taxpayer to tax. The House Ways and Means Committee and the Senate Finance Committee explained:

> Under present law if a taxpayer is obliged to repay amounts which he had received in a prior year and included in income because it appeared that he had an unrestricted right to such amounts, he may take a deduction in the year of restitution. In many instances of this nature, the deduction allowable in the later year does not compensate the taxpayer adequately for the tax paid in the earlier year.

H. Rep. No. 83-1337, at 86 (1954) and S. Rep. No. 83-1622, at 118 (1954).

Consequently, Congress enacted section 1341 approximately three years after the Lewis decision. Under section 1341, the income tax for the year in which the claim of right item is restored is the lesser of (i) the tax for the year computed with a deduction for the restoration, or (ii) the tax for the year computed without a deduction for the restoration, minus the decrease in tax that would have resulted if the claim of right item had been excluded from gross income in the prior year. In effect, the taxpayer is permitted to obtain a refund of the tax paid in the prior year on the item included in gross income.

Section 1341 provides that a taxpayer is entitled to apply the statute if (1) an item was included in gross income for a prior taxable year (or years) because it appeared that the taxpayer had an unrestricted right to the item; (2) a deduction is allowable for a subsequent taxable year because it was established after the close of the prior taxable year (or years) that the taxpayer did not have an unrestricted right to the item or to a portion of the item; and (3) the amount of the deduction exceeds $3,000.

Section 1.1341-1(a)(1) of the Income Tax Regulations (Regulations) provides that section 1341 applies if the taxpayer is entitled to a deduction of more than $3,000 because of the restoration to another of an item that was included in the taxpayer’s gross income for a prior taxable year (or years) under a claim of right.

Section 1.1341-1(a)(2) of the Regulations provides that "income included under a claim of right" means an item included in gross income because it appeared from all the facts available in the year of inclusion that the taxpayer had an unrestricted right to such item, and "restoration to another" means a restoration resulting because it was established after the close of the prior taxable year (or years) that the taxpayer did not have an unrestricted right to all or a portion of the item included in gross income.

In Chernin v. United States, 149 F.3d 805 (8th Cir. 1998), the court held that, for purposes of applying section 1341, "restoration" means the taxpayer has to restore or repay something to the rightful owner. In support of its conclusion, the court cited Webster’s New World Dictionary for the definitions of “repay” and “restore.” The dictionary defines “repay” as “to pay back (a person)” and “restore” as “to give back (...); make restitution of.” In addition, the court cited Black’s Law Dictionary for the definition of “restitution”: the “[a]ct of making good or giving an equivalent for or restoring something to the rightful owner.”

A taxpayer may not apply section 1341 upon the payment of an item that was not included in the taxpayer's gross income for a prior taxable year. See Kraft v. United States, 991 F.2d 292 (6th Cir. 1993) (penalty was not an item previously included in gross income); Bailey v. Commissioner., 756 F.2d 44 (6th Cir. 1985) (penalty was not an item previously included in gross income); Maier Brewing Co. v. Commissioner, T.C. Memo. 1987-385, aff'd, 916 F.2d 716 (9th Cir. 1990) (compensation for use of assets was not an item previously included in gross income); Uhlenbrock v. Commissioner, 67

T.C. 818 (1977) (addition to tax was not an item previously included in gross income).

In Cal-Farm Insurance Co. v. United States, 647 F. Supp. 1083 (E.D. Calif. 1986), a taxpayer underpaid its share of common expenses for several years. The taxpayer did not claim deductions for its share of the unpaid expenses. In a subsequent year, the taxpayer made a payment to correct the expense allocation. The district court held that, for the year in which the taxpayer made the payment, the taxpayer was not entitled to apply section 1341 because its failure to claim deductions for unpaid expenses in prior years resulted, at best, in an indirect inclusion in gross income of an amount equal to the amount of the unclaimed deductions. Section 1341 does not apply where an amount was indirectly included in gross income; rather, the section applies where items were directly included in gross income.

TAXPAYER'S POSITION UNDER SECTION 1341(a)(1)

On returns for the taxable years at issue, Taxpayer sought to apply section 1341 to environmental remediation costs, i.e., costs that are related to environmental contamination from manufacturing in prior years. The costs are currently deductible but would have been included in COGS had they been paid or incurred in the years of the manufacturing activity to which the contamination relates. Because the costs were not paid or incurred and were not included in COGS in prior years, gross income for those years (as defined in Treas. Reg. §1.61-3(a) for manufacturing businesses as gross receipts less COGS) was not decreased by the amount of the costs. Thus, Taxpayer's position would suggest that gross income for the prior years was overstated in the amount of costs that were unpaid and unincurred in those years, and the overstatement of gross income constitutes an item included in gross income for purposes of section 1341.

DISCUSSION

For the following reasons, we conclude that section 1341 does not apply with respect to the expenses for environmental remediation costs in this case. First, section 1341(a)(1) provides that the statute does not apply unless "an item was included in gross income for a prior taxable year (or years) because it appeared that the taxpayer had an unrestricted right to such item." Taxpayer's case involves a purported overstatement in prior years of the amount of gross income from the sale of inventory, caused by a failure to include unpaid, unincurred expenses in COGS. In other words, because COGS was understated, gross income was overstated and an item was included in gross income. We do not view COGS as a factor in determining whether an item was included in gross income under section 1341. Our view was applied in favor of the taxpayer in Rev. Rul. 72-28,1972-1 C.B. 269.

Rev. Rul. 72-28 held that only the gross receipts component is considered in determining whether an item was included in gross income under section 1341. In the ruling, a public utility company was subjected to a contingent rate increase on its gas purchases. The company passed on the rate increase by charging an equivalent rate increase to customers, then reported in gross receipts the additional amount collected from customers. In the same year, the company included in COGS the additional cost of gas paid to suppliers. With respect to these transactions, the company's gross receipts and COGS increased by the same amount, leaving gross income as defined under Treas. Reg. §1.61-3(a) unaffected.

In a subsequent year, the company received refunds from its suppliers of some of the cost increases paid in the prior year. As it was bound to do, the company made refunds in an equivalent amount to customers. The company included the supplier refunds in gross income for the year, and sought section 1341 treatment for the refunds to customers. The issue in the ruling was whether section 1341 applied where gross income was zero in the prior year because gross receipts and COGS had been increased by the same amount. Arguably, no item had been included in gross income for purposes of applying section 1341.

The ruling held that section 1341 was applicable, and the fact that the taxpayer had increased COGS in the prior year had "no relevancy in determining the application of section 1341." Clarifying the ruling, GCM 35403 stated that "included in gross income" under section 1341 means "included in the computation of gross income." This interpretation allowed for consideration of identifiable items included in gross receipts, which are included in the computation of gross income under Treas. Reg. §1.61-3(a). If "included in gross income" were not so interpreted, the utility company would have been precluded from applying section 1341 to items received in prior years (and restored in later years) to the extent COGS was equal to or greater than gross receipts.

Moreover, looking to gross receipts and ignoring COGS enables us to comply with the requirement of section 1341 that an "item" have been included in gross income under a claim of right. If we were instead to use the definition under Treas. Reg. §1.61-3(a), no "items" would remain after the calculation of gross income. On this issue, GCM 35403 stated: "all that would remain would be a net aggregate amount. In no case ... would it be possible to identify an item of gross income .... It must necessarily be possible to identify the various component items of gross income in order for Code §1341 to have any vitality."

In the context of section 6013(e), the former provision for innocent spouse relief, it was held that an *overstatement* of COGS constitutes *an item omitted* from gross income. See Lilly v. Internal Revenue Service, 76 F.3d 568 (4th Cir. 1996); Lawson v. Commissioner, T.C. Memo 1994-286; LaBelle v. Commissioner, T.C. Memo 1986-602.; but see Portillo v. Commissioner, T.C. Memo 1990-68. Based on this holding, one might conclude for purposes of section 1341 that an *understatement* of COGS constitutes *an item included* in gross income. However, the conclusion does not necessarily follow for Code sections other than section 6013(e).

In Colony, Inc. v. Commissioner (recognized in Lawson, T.C. Memo 1994-286, which considered gross income under section 6013(e)), the Supreme Court considered whether there was an omission from gross income when, upon the sale of realty, a taxpayer included an excessive item of cost in the calculation of profits and therefore understated gross income. 357 U.S. 28 (1958). The issue was raised in the context of section 275(c), a former provision for a special 5 year period of limitations. Section 275(c) provided that "[i]f a taxpayer omits from gross income an amount properly includible therein ... the tax may be assessed ... at any time within 5 years after the return was filed." Consistent with our view under section 1341, the Court was inclined to conclude based on the language in section 275(c) that "omits from gross income any amount properly includible therein" embraced only the omission of an item from gross receipts and did not include an understatement of gross income due to an overstatement of cost. Even so, the Court acknowledged that the statutory language was not entirely unambiguous and turned to the legislative history to arrive at the same conclusion. Thus, under the authority of Colony, Inc., each statute must be examined individually to determine which meaning of gross income was intended. As stated in footnote 4 of GCM 35403, "the term 'gross income' must be defined to carry out the purpose of the provision in which it appears." The history of a statute may be dispositive where the statutory language is ambiguous.

Although we are inclined to conclude based on the language in section 1341 that "an item ... included in gross income" embraces only the inclusion of an item in gross receipts and does not include an overstatement of gross income due to an understatement of COGS, we will consider the history and purpose of the statute. As stated above, section 1341 was enacted in response to the Supreme Court's decision in United States v. Lewis. The taxpayer in Lewis was disadvantaged by the Court's decision that disallowed the amendment of a prior year's return to exclude from gross income an item received with a claim of right. In legislative history, Congress cited this case as exemplary of the common law rule: "Under the rule of the Lewis case ..., the taxpayer is entitled to a deduction only in the year of repayment." H. Rep. No. 83-1337, at A294 and S. Rep. No. 83-1622, at 451.

The Lewis case involved an identifiable item of income (as do the many cases that have applied section 1341). Because Congress was responding to situations similar to the situation in Lewis, it is reasonable to conclude that section 1341 was intended to apply where the items of income are identifiable, as opposed to situations where a taxpayer understated COGS. "The notion that only a payee of funds under a claim of right, who subsequently is required to refund the funds to his original payor is eligible for a recovery under §1341, is suggested by the choice [in legislative history] of the Lewis case." First Nat'l Bank v. United States, 330 F. Supp. 975, 977 (N.D. Ind. 1971). There is no evidence that Congress intended "item included in gross income" to apply to taxpayers who missed an opportunity in a prior year to account for an expense. Cal-Farm Insurance Co. v. United States, 647 F. Supp. 1083, 1092 (E.D. Cal. 1986). Therefore, the history of section 1341 supports our conclusion that "an item ... included in gross income" embraces only the inclusion of an identifiable item in gross receipts and does not include an overstatement of gross income due to an understatement of COGS.

The second reason we do not believe section 1341 applies with respect to Taxpayer's environmental remediation costs is that the basis for the current deduction of the costs is not that an item, included in gross income in a prior year, was restored. Section 1341(a)(2) provides that the statute applies if "a deduction is allowable for the taxable year because it was established after the close of the [taxable year in which an item was included in gross income] that the taxpayer did not have an unrestricted right to such item or to a portion of such item." Treas. Reg. §1.1341-1(a)(2) clarifies that a deduction must be allowable because an item received and included in gross income in a prior year has been restored to another. "[T]he legislative history is replete with references to repayment, restoration, and restitution," and the title to section 1341, "Computation of Tax Where Taxpayer Restores Substantial Amount Held Under Claim of Right," indicates that a taxpayer must restore funds to qualify for treatment under the statute. Chernin, 149 F.3d at 815-16. The Eighth Circuit in Chernin sustained the view that restoration means to restore an item to the original payor. Taxpayer's payment of environmental remediation costs will not restore to an original payor an item previously included in gross income. In order to remediate environmental contamination, Taxpayer will likely make payments to third parties who will physically clean up the contamination; a payment to a third party is not a restoration to an original payor of an item previously included in gross income. Cf. Maier Brewing Co., T.C. Memo. 1987-385, aff'd, 916 F.2d 716 (taxpayer not entitled to apply section 1341 because payment of interest and rent expense did not restore an item previously included in gross income).

Because Killeen v. United States, 63-1 USTC 9351 (US District Court, S.D. Cal.), has on occasion been incorrectly cited as an authority for the proposition that a restoration can be made to a party other than the original payor, we mention the case here. In Killeen, an agreement between a manufacturer and a designer provided for the division of profits realized from the sale of inventory. In a subsequent year, the designer obtained a judgment that the manufacturer had wrongfully withheld a portion of the profits. The manufacturer satisfied the judgment through a payment to the designer, and the manufacturer applied section 1341 to the payment.

In the year the total profits were received, the manufacturer included in gross income not only his share of the profits, but also the share that should have been paid to the designer. As to the manufacturer, the share of profits belonging to the designer was considered income held in contravention of a profit sharing agreement, rather than profits from the sale of inventory.[1] In the year the designer's share was withheld, it was as if the manufacturer had taken the designer's share from him. Thus, it is appropriate to view the manufacturer's subsequent payment to the designer as a restoration of funds to the payor, and Killeen does not support the proposition that, under section 1341(a)(2), a restoration can be made to a party other than the payor.

Even if we were to accept the view that the requirements of sections 1341(a)(1) and (2) are satisfied, Taxpayer would be precluded from obtaining the benefits of the statute. An exception in the statute, referred to as "the inventory exception" and found in section 1341(b)(2), provides that the statute does not apply "to any deduction allowable with respect to an item which was included in gross income by reason of the sale or other disposition of stock in trade of the taxpayer ... or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business." Taxpayer's case is premised on the view that gross income from the sale of inventory was overstated in prior years because unpaid, unincurred expenses were not included in COGS. Taxpayer would conclude that the overstatement of gross income from the sale of inventory is an item included in gross income, and that the payment of environmental remediation costs is a restoration of overstated gross income from the sale of inventory. This position, therefore, involves the restoration of inventory receipts, and the taxpayer is precluded from obtaining the benefits of section 1341 because, as provided under section 1341(b)(2), the statute does not apply in cases where inventory receipts are restored.

It has previously been suggested that the inventory exception applies only to matters involving sales returns and allowances. The argument is not supported by the language of the statute. The first sentence of section 1341(b)(2) provides that section 1341 does not apply where a deduction is allowable with respect to an item that was included in gross income by reason of the sale or other disposition of inventory. However, the second sentence in section 1341(b)(2) provides that "this paragraph shall not apply if the deduction arises out of refunds or repayments with respect to rates made by a regulated public utility … if such refunds are required to be made by the Government." Refunds with respect to public utility rates do not involve sales returns or allowances. In addition, section 1341(b)(2) previously contained an exception to the inventory exception for refunds made pursuant to price redetermination provisions in subcontracts. See Portland Copper & Tank Works, Inc. v. Commissioner, 43 T.C. 182 (1964), aff'd 351 F.2d 460 (1st Cir. 1965). Refunds due to price redeterminations do not

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1 For the same reason, Killeen does not support the proposition that the inventory exception (discussed below) applies only to sales returns and allowances. Although the court declined to apply the inventory exception, application of the exception would not have been warranted. The manufacturer in Killeen was entitled to the benefits of section 1341 because the item restored was not profits from the sale of inventory, but rather income held in contravention of a profit sharing agreement.

involve sales returns and allowances. Therefore, it cannot be said that the inventory exception applies only to sales returns and allowances because, if it were so, the current and former exceptions to the inventory exception would have been unnecessary.

In conclusion, no court has addressed the issues in this TAM with respect to environmental remediation costs or in other factual contexts. The issues were briefed in Elbo Coals, Inc. v. Commissioner, T.C. Memo 1987-2, but the court did not address them. Instead, the court held for other reasons that the taxpayer was not entitled to apply section 1341. The fact that the court did not address the issues that were briefed (particularly the significant issue of whether gross receipts or gross income as defined under Treas. Reg. §1.61-3(a) is relevant under section 1341) does not imply disagreement with the Service on these issues. If the taxpayer had prevailed in the case, a stronger argument could be made that the court's failure to address these issues implied disagreement with the Service on all issues in the case.

CAVEAT

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