Office of Chief Counsel
Internal Revenue Service
memorandum

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to: Associate Area Counsel, Large and Mid-Size Business CC:LMSB

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subject: Section 1341 and Retiree Medical Expenses

This Chief Counsel Advice responds to your memorandum dated April 2, 2002. In accordance with § 6110(k)(3) of the Internal Revenue Code this Chief Counsel Advice should not be cited as precedent.

LEGEND

Taxpayer =

ISSUE

Whether § 1341 applies to payments for retired employees' medical expenses.

CONCLUSION

Section 1341 does not apply to payments for retired employees' medical expenses.

FACTS

Taxpayer adopted a medical benefit plan that obligates it to pay medical expenses of certain retired employees. Taxpayer manufactures and sells durable consumer goods. The retired employees for whom Taxpayer pays medical expenses include some former Taxpayer production workers. These employees helped to produce goods that Taxpayer sold in taxable years ending before Taxpayer paid their medical expenses as retirees. For through , the taxable years at issue, Taxpayer paid more than $3,000 per year for retired production employees' medical expenses. Taxpayer asserts that it is entitled to deductions for those expenditures and that the deductions qualify for § 1341 tax treatment.

LAW AND ANALYSIS

Section 61 and Section 1341

Section 61(a) generally provides that gross income means all income from whatever source derived, including, but not limited to, under § 61(a)(2), gross income derived from business. Section 1.61-3(a) of the Income Tax Regulations provides that in a manufacturing, merchandising, or mining business, gross income from the sale of goods means total sales, less the cost of goods sold.

Section 1341 applies if:

(a)(1) the taxpayer included an item in gross income for a prior taxable year (or years) because it appeared that the taxpayer had an unrestricted right to the item,

(a)(2) a deduction is allowable to the taxpayer for the taxable year because it was established after the close of the taxable year (or years) of inclusion that the taxpayer did not have an unrestricted right to the item or portion thereof, and

(a)(3) the amount of the deduction exceeds $3,000.

If § 1341 applies the tax imposed by chapter 1 of the Code for the taxable year equals the lesser of:

(1) the chapter 1 tax for the taxable year taking into account the deduction referred to in the preceding paragraph, or

(2) the chapter 1 tax for the taxable year computed without the deduction, less the decrease in chapter 1 tax for the prior taxable year (or years) that would have occurred had the item or portion thereof been excluded from gross income.

Under tax computation method (2), except for the time value of money, § 1341 restores the taxpayer to the same tax position that the taxpayer would have been in if the taxpayer had never included the item or portion thereof in gross income.

Even if the general requirements of § 1341 are satisfied, § 1341 does not apply to any deduction that falls within the § 1341(b)(2) inventory rule. With an exception for certain sales made by regulated public utilities, the inventory rule applies 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 other property of a kind which would properly have been included in the inventory of the taxpayer if on hand at the close of the prior taxable year) or property held by the taxpayer primarily for sale to customers in the ordinary course of the taxpayer's trade or business.

Treas. Reg. 1.1341-1(a)(1) provides that § 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. Treas. Reg. 1.1341-1(a)(2) 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. The regulation goes on to provide that "restoration to another" means a restoration resulting because it was established after the close of such prior taxable year (or years) that the taxpayer did not have an unrestricted right to such item (or portion thereof).

Treas. Reg. 1.1341-1(f), in two sentences, interprets the inventory rule. The first sentence of the regulation largely parrots the rule's statutory definition. The regulation, however, interprets the statutory phrase "allowable with respect to an item" as meaning "attributable to an item". The second sentence of the regulation provides an example of the inventory rule's application. It provides that § 1341 is, therefore, not applicable to sales returns and allowances and similar items.

<u>Taxpayer Position</u>

Taxpayer asserts that the medical expenses it pays for retired production employees constitute additional manufacturing costs of goods produced and sold in prior taxable years. Taxpayer did not take these costs into account when it originally sold the goods. Therefore, Taxpayer contends that it had only an appearance of an unrestricted right to a portion of the gross income originally reported on the goods' sale, thereby satisfying the requirements of § 1341(a)(1).

Taxpayer claims that it is entitled to a deduction under § 162(a) when it pays the retirees' medical expenses. Because Taxpayer paid more than $3,000 of such expenses for each of the taxable years at issue, Taxpayer maintains that it satisfies the requirement of § 1341(a)(3) for each of those years.

Taxpayer asserts that the payment of the medical expenses establishes, as required by § 1341(a)(2), that it did not have an unrestricted right to a portion of the gross income recognized on the sale of goods in prior taxable years. Finally, Taxpayer maintains that the inventory rule of § 1341(b)(2) only applies to sales returns, allowances, and similar items. Because the retiree medical expenses do not involve refunds to purchasers of the goods, Taxpayer contends that the inventory rule does not prevent § 1341 from applying to the medical expenses. Consequently, Taxpayer contends that deductions it claims for retired manufacturing employees' medical expenses qualify for § 1341 tax treatment.

The Retiree Medical Expenses Constitute Current Production Costs Rather Than Costs of Goods Manufactured and Sold in Prior Taxable Years

Taxpayer's fundamental premise that retiree medical expenses constitute part of the cost of goods produced and sold in prior taxable years is incorrect. The retiree medical expenses constitute part of the cost of goods produced during the taxable years the costs are incurred. Consequently, they cannot give rise to deductions that qualify for the tax treatment provided by § 1341.

For taxable years beginning after December 31, 1986, § 263A provides uniform rules for capitalizing or including in the cost of inventory certain expenses. Section 263A(b) provides, in part, that § 263A applies to real or tangible personal property produced by the taxpayer. Section 263A(g)(1) provides that the term "produce" includes construct, build, install, manufacture, develop, or improve. If § 263A applies, a taxpayer must include in inventory costs or capitalize the direct costs and the proper share of those indirect costs (including taxes) part or all of which are allocable to such property subject to § 263A.

Both the temporary § 263A regulations (which for property that is inventory in the hands of the taxpayer apply to taxable years beginning after December 31, 1986 but before January 1, 1994) and final § 263A regulations (which for property that is inventory in the hands of the taxpayer apply to taxable years beginning after December 31, 1993) require producers of tangible property held for resale to include certain indirect expenses as part of the property's cost. A taxpayer must capitalize all indirect costs properly allocable to property produced. Temp. Treas. Reg. § 1.263A-1T(b)(2)(ii); Treas. Reg. § 1.263A-1(e)(1). Indirect costs are properly allocable to property produced when the costs directly benefit or are incurred by reason of the performance of production activities. Temp. Treas. Reg. § 1.263A-1T(b)(2)(ii); Treas. Reg. § 1.263A-1(e)(3)(i).

For taxable years beginning after December 31, 1993, Treas. Reg. § 1.263A-1(a)(3)(ii) requires producers of tangible personal property to capitalize as part of the property's cost the property's allocable share of indirect costs regardless of whether the property is sold or used in the taxpayer's trade or business. Under both the temporary and final § 263A regulations, employee benefits, such as the provision of medical treatment, to the extent otherwise deductible may qualify as indirect costs that have to be included in the cost of inventory or other tangible property produced by the taxpayer. See Temp. Treas. Reg. § 1.263A-1T(b)(2)(iii)(P) and Treas. Reg. § 1.263A-1(e)(3)(ii)(D).

The expenses at issue are medical expenses of retired Taxpayer production employees. Taxpayer incurs these expenses after the employees leave its employ. Consequently, the expenses constitute costs for "past services" of the retired employees. There are two issues to be resolved. The first issue is whether employee benefit costs, other than pension plan costs, that are based on past services are subject to § 263A. The second issue is whether these past service costs should be treated as current production costs, that is, production costs of inventory produced during the taxable years the expenses are incurred, or should be treated as past production costs, that is, additional costs of goods produced when the employees actually worked for Taxpayer.

Temp. Treas. Reg. § 1.263A-1T(b)(2)(iii)(P) provides that among the indirect costs required to be capitalized are contributions paid to or under a stock bonus, pension, profit-sharing or annuity plan, or other plan deferring the receipt of compensation whether or not the plan qualifies under § 401(a) (except for past service costs as described in paragraph (b)(2)(v)(H)) and other employee benefit expenses paid or accrued on behalf of labor, to the extent such contributions or expenses are otherwise allowable as deductions under chapter 1 of the Code. "Other employee benefit expenses" include (but are not limited to) payments pursuant to a wage continuation plan under §105(d) as it existed prior to its repeal in 1983, worker's compensation benefits, and employee medical benefits. Temp. Treas. Reg. § 1.263A-1T(b)(2)(v)(H)(1) provides that among the indirect costs not required to be capitalized are contributions paid to or under a pension or annuity plan allowable as a deduction under § 404 (and § 404A if applicable) to the extent such contributions represent past service costs as determined under the particular funding method established for the plan for the period in question under the provisions of § 412.[1]

The preamble to the temporary regulations explains the initial provision regarding past service costs for pensions as follows:

> Under the temporary regulations, contributions paid to or under a pension or annuity plan which are allowable under section 404 (and section 404A if applicable), are not subject to the capitalization requirements of section 263A to the extent that such contributions represent "past service costs." Until otherwise provided to the contrary, past service costs shall be determined, for purposes of section 263A, with reference to the allocation between "normal costs" and "past service costs" under the funding standards of section 412. With respect to an actuarial method which does not distinguish between normal costs and past service costs, none of the amount allowable as a deduction under section 404 shall be treated as past service costs.

T.D. 8131 (Preamble), reprinted in 1987-1 C.B. 98, 104.

The Joint Committee on Taxation, in its explanation of the pension costs and past service costs ("Blue Book"), stated:

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[1] The temporary § 263A regulations were patterned after the long-term contract rules in § 1.451-3. The exception for pension past service costs in the temporary regulations is also found in the long-term contract rules.

Pension costs

Under the uniform capitalization rules, contributions to a pension, profit-sharing, or stock bonus plan and other employee benefit expenses are considered indirect costs that must be capitalized to the same extent as other indirect costs, unless such contributions relate to past-service costs. It was intended that, in the case of a contribution to a qualified plan, the determination of whether the contribution relates to past or current services will be made independently of any allocation between "normal cost" and "past-service cost" required under the minimum funding standards (sec. 412) or under the plan's benefit formula. The Congress anticipated that the Treasury Department will publish guidelines for making this determination, and that such determination may be based, in whole or in part, on any actuarial funding methods that may be utilized by qualified defined benefit plans.

Staff of the Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986*, 100th Cong., 1st Sess. 512-13 (Comm. Print 1987).

Section 10204 of the Omnibus Budget Reconciliation Act of 1987 (the 1987 Act) eliminated the exception allowing an immediate deduction for past service costs for contributions to certain pension or annuity plans. Section 10204(a) of the 1987 Act provided that for purposes of § 263A, the allocable costs with respect to any property shall include contributions paid to or under a pension or annuity plan whether or not such contributions represent past service costs. For property that is inventory in the hands of the taxpayer the change in law is effective for taxable years beginning after December 31, 1987.

The Conference Report to the 1987 Act provides:

House bill

No provision.

Senate amendment

Under the Senate amendment, past service costs are subject to the uniform capitalization rules. Thus, an allocable portion of all otherwise allowable pension costs, whether relating to current or past services, must be included in the basis of the property produced by the taxpayer or held for resale by the taxpayer.

* * *

Conference agreement

> The conference agreement generally follows the Senate amendment with respect to costs allocable to property produced by the taxpayer or held for resale by the taxpayer.

H.R. Conf. Rep. No. 495, 100th Cong., 1st Sess. 923-24 (1987). In connection with the 1987 Act, Senator Bentsen observed that "[b]oth types of costs [past and current service costs] are costs that are necessarily recovered out of the proceeds from the sale of property produced or held in the year the costs are incurred." Statement of Sen. Bentsen, Thurs., Dec. 10, 1987, Cong. Rec. p. S-17600.

The final § 263A regulations reflect the 1987 Act's change in the law regarding the capitalization of past service costs for pension plans. For pension and other related costs, contributions to employee plans for past services must be capitalized in the same manner as amounts contributed for current services. § 1.263A-1(e)(3)(ii)(C). Other employee benefit expenses, including but not limited to wage continuation plan payments under former § 105(d) as it existed prior to its repeal in 1983, worker's compensation benefits, and employee medical expenses, must also be capitalized. § 1.263A-1(e)(3)(ii)(D).

The costs under consideration here do not involve pensions or annuities. Rather, the costs involve retiree medical benefits, that is, other benefit costs. The question is what effect the "past service costs" language associated with the pension costs in the temporary regulations has on payments for benefits for prior service involving other types of benefit costs. The original temporary regulations indicated past service costs for pensions were not subject to capitalization. Congress in 1987 specifically changed the Service's position on past service costs for pensions, mandating the capitalization of such costs.

One possible position is that all past service costs are currently deductible under § 263A even though the temporary regulations only specifically mention that rule in the context of pension past service costs. If so, the change made by the 1987 Act would simply prevent the immediate deduction of pension past service costs. Past service costs for other types of employee benefits would still be immediately deductible after the 1987 Act. This would include past service costs for current employees and costs incurred for retired employees.

Our view is that as originally promulgated, the temporary § 263A regulations required all past service costs for production employee benefits to be capitalized except for pension costs. The exclusion for past service pension costs followed from the long-term contract regulations, upon which the uniform capitalization rules were modeled. When the past service pension costs exception was specifically overruled by Congress in 1987, then all past service costs were treated alike: all were capitalizable.

Our view that when the pension past service costs exception was specifically overruled by Congress in 1987, then all the past service costs were treated alike--all were capitalizable–is buttressed by legislative history. The Conference Report to § 10204 of the 1987 Act, under "Senate amendment," states that "past service costs are subject to the uniform capitalization rules." H.R. Conf. Rep. No. 495, *supra* at 924. The conference agreement followed the Senate amendment. The change under § 10204 of the 1987 Act to require capitalization of past service pension costs arguably reflects congressional intent that the law requires capitalization of all past service pension and employee benefits costs. Hence, the language used in the legislative history: "past service costs are subject to the uniform capitalization rules." That is, now that past service costs for pensions are to be capitalized, all past service costs are treated alike--all are subject to the uniform capitalization rules.

Furthermore, we note that both the temporary and final regulations give examples of employee benefits that must be capitalized as indirect production costs which involve or potentially involve past service costs. Temp. Treas. Reg. § 1.263A-1T(b)(2)(iii)(P) and Treas. Reg. § 1.263A-1(e)(3)(ii)(D) include among the indirect costs required to be capitalized payments pursuant to a wage continuation plan under § 105(d) as it existed prior to its repeal in 1983. Section 105(d) wage continuation plans involve payments to former employees who retired on disability totally and permanently disabled. Like the retiree medical benefits at issue in this advice, § 105(d) wage continuation plans involve payments for the benefit of former employees. Similarly, Temp. Treas. Reg. § 1.263A-1T(b)(2)(iii)(P) and Treas. Reg. § 1.263A-1(e)(3)(ii)(D) include worker's compensation benefits among the indirect costs required to be capitalized. Worker's compensation benefits, such as periodic disability or survivor benefits, often involve payments of benefits years after the end of the period of employment. Accordingly, within the definition of "other employee benefit expenses" found in the temporary and final regulations there are situations involving costs incurred in the current taxable year for services performed in prior taxable years.

Finally, we interpret the regulations as requiring inclusion of past service pension costs in the cost of goods produced during the taxable year in which the past service pension costs are incurred. Likewise, the payments for the retiree medical expenses at issue in this case constitute current production costs, rather than part of the cost of goods manufactured in prior taxable years. This interpretation is consistent with the legislative history and the contemporaneous statements of Senator Bentsen.

Even if the Retired Employees' Medical Expenses Constitute Costs of Goods Manufactured and Sold in Prior Taxable Years, § 1341 Would Not Apply

Under the claim of right doctrine, a taxpayer that receives an amount under a claim of right without restriction on disposition must include the amount in gross income in the taxable year received, notwithstanding that the taxpayer's right to retain the amount received may be uncertain and the taxpayer subsequently may be required to restore the amount to the rightful owner. *North American Oil Consol. v. Burnet*, 286 U.S. 417, 424 (1932).

In *United States v. Lewis*, 340 U.S. 590 (1951), the Supreme Court concluded that a taxpayer who was required under the claim of right doctrine to include a bonus in income in the taxable year received, and who had to repay part of the bonus in a later year, could not amend his tax return for the earlier year. The taxpayer's only remedy was to deduct the amount repaid in the taxable year in which the taxpayer restored it to the payor. The Court followed the principle that income is properly reported under the claim of right doctrine in the year received, consistent with a tax system based on annual rather than transactional accounting. See *Burnet v. Sanford & Brooks Co.*, 282 U.S. 359, 364-65 (1931).

The application of the claim of right doctrine may result in an inequity when, because of changes in tax rates or other circumstances, the tax increase resulting from the income inclusion in the earlier year exceeds the tax decrease that results from the deduction in the later year. Congress enacted § 1341 to ameliorate this inequity in cases such as *Lewis,* in which a taxpayer receives an amount that it is required in a later taxable year to restore or repay to another claimant. *See* S. Rep. No. 1622, 83d Cong. 2d Sess. 118 (1954) ("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." (emphasis added); H.R. Rep. No. 1337, 83d Cong. 2d Sess. 86 (1954) (same).

Section 1341(a)(2) requires that it be established after the close of the taxable year or years of income inclusion that the taxpayer did not have an unrestricted right to the item of gross income or portion thereof. To satisfy this test the taxpayer must repay or restore the item or portion of the item to another claimant. Section 1.1341-1(a)(1); see also *Chernin v. United States*, 149 F.3d 805 (8th Cir. 1998) (relying on a "legislative history [that] is replete with references to repayment, restoration, and restitution"); S. Rep. No. 1622, *supra* at 118; H.R. Rep. No. 1337, *supra* at 86.

For purposes of § 1341, to restore an item included in gross income, the repayment "must arise out of the circumstances, terms, and conditions of the original payment of such item to the taxpayer." *Blanton v. Commissioner*, 46 T.C. 527, 530 (1966), *aff'd per curiam*, 379 F.2d 558 (5th Cir. 1967). The fact that the amount of the repayment bears no relationship to the amount included in gross income indicates that the repayment does not arise from the same circumstances, terms, and conditions as the original transaction. *Bailey v. Commissioner*, 756 F.2d 44, 47 (6th Cir. 1985); *See Uhlenbrock v. Commissioner*, 67 T.C. 818, 823 (1977).

In appropriate circumstances the term "gross income" may mean gross receipts rather than gross income as defined in § 1.61-3(a). See *Colony, Inc. v. Commissioner*, 357 U.S. 28 (1958). Rev. Rul. 72-28, 1972-1 C.B. 269 concludes that cost of goods sold is ignored in determining whether an item has been included in gross income within the meaning of § 1341. In essence the revenue ruling holds that for § 1341 purposes an item of gross income means an item of gross receipts.

In the present case the item of gross income for § 1341(a) purposes is the proceeds received from the sale of Taxpayer's products in certain taxable years ending prior to payment of the retiree medical expenses. During those years Taxpayer had an unrestricted right to the sale proceeds. In through , Taxpayer's right to the sales proceeds remained unrestricted.

Taxpayer's payment of the retiree medical expenses does not restore in later taxable years any portion of the proceeds received from the sale of Taxpayer's products in earlier taxable years. Moreover, Taxpayer's obligation to pay the retiree medical expenses does not arise from the same circumstances, terms or conditions and bears no relationship to the original sale of Taxpayer's products. Accordingly, Taxpayer's payment of these expenses is not a repayment or restoration of the item included in gross income. Payment of Taxpayer's retiree medical expenses does not satisfy the repayment or restoration requirement of § 1341(a)(2).

Section 1341(a)(2) also requires, as a prerequisite to § 1341 treatment, that a deduction must be allowable to the taxpayer for the repayment or restoration of the item included in income. Section 1341 itself provides no right to a deduction. Instead, the deduction must be allowable under another provision of the Code. § 1.1341-1(a)(1); *Wood v. United States*, 863 F.2d 417, 420 (5th Cir. 1989); *MidAmerican Energy Co. v. Commissioner*, 114 T.C. 570, 583(2000), *aff'd*, 271 F.3d 740 (8th Cir. 2001). Costs constituting "cost of goods sold" are properly treated as adjustments to gross income rather than as "deductions." § 1.61-3(a).

Costs that are properly accounted for as inventory costs or cost of goods sold must be treated as such even though incurred in a taxable year after the taxable year in which the goods to which the costs relate are sold. For example, Rev. Rul. 2001-8, 2001-1 C. B. 726, holds that floor stock tax increases allocable to goods physically on hand but deemed sold in prior taxable years are properly included in cost of goods sold in the taxable year the costs are incurred.

If the retiree medical expenses that Taxpayer incurred in the taxable years at issue really constitute part of the cost of inventory manufactured and perhaps sold in earlier taxable years, the medical expenses are properly treated as an inventory cost or a cost of goods sold in the taxable years incurred. The intervening period of time does not change the costs' character from inventory costs or cost of goods sold to a deductible expense. Therefore, whether the retiree medical expenses are treated as a current manufacturing cost or a cost of previously manufactured and sold goods the expenses cannot qualify for treatment under § 1341 because they are not allowable deductions.

Even if all of § 1341(a)(1)-(3)'s elements were satisfied the medical expenses still would not qualify for § 1341 treatment because of the § 1341(b)(2) inventory rule. Section 1341(b)(2) provides that § 1341(a) does not apply to any deduction allowable with respect to an item included in gross income by reason of the sale or other disposition of the taxpayer's stock in trade (or other property of a kind that would have been included in the taxpayer's inventory if on hand at the close of the prior taxable year) or property held by the taxpayer primarily for sale to customers in the ordinary course of its trade or business. Taxpayer's retiree medical expenses are a consequence of the manufacture and sale of Taxpayer's products and if deductible would be deductible as an ordinary and necessary business expense of selling Taxpayer's products.

If, as asserted by Taxpayer, the retiree medical expenses are properly treated as part of the cost of products manufactured and sold in prior taxable years, it is clear that had the products not been sold these expenses would have been treated as an additional cost of inventory still on hand rather than as deductions. If for § 1341 purposes the item of gross income is comprised of two elements, that is, gross receipts less cost of goods sold, both of those elements are essential in determining the amount of the item. Therefore, it follows that any deduction that directly corresponds to either of those elements should be treated as allowable "with respect to an item which was included in gross income" within the meaning of § 1341(b)(2). Accordingly, any deduction for the retiree medical expenses would be allowable with respect to an item that is included in gross income by reason of the sale of Taxpayer's products and would not be eligible for § 1341 treatment by reason of § 1341(b)(2).

The contrary argument is that the inventory rule only applies to sales returns and allowances or similar items and the retiree medical expenses do not qualify as such. The argument is based on the last sentence of § 1.1341-(1)(f). After stating the general inventory rule § 1.1341-1(f) provides that "[t]his section is, therefore, not applicable to sales returns and allowances and similar items." However, the statutory language does not limit its application to sales returns and allowances or similar items. Moreover, if the last sentence of § 1.1341-1(f) constitutes the entire inventory rule it makes the first sentence of that section, which states the general inventory rule, superfluous. The last sentence of section 1.1341-1(f) merely provides examples of the application of the inventory rule. It does not constitute the entire rule.

For the reasons stated above we conclude that § 1341 does not apply to Taxpayer's retiree medical expenses for the taxable years at issue. This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

Please call (202) 622-4960 if you have any questions.

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