

Office of Chief Counsel
Internal Revenue Service

memorandum

CC:LM:MCT:CLE:PIT:TL-N-6804-00

MAYost

date:

to: John Niederst, Team Manager - Group 1672

from: Associate Area Counsel, LM:MCT:CLE:PIT

subject: [REDACTED] Environmental Remediation Claim
[REDACTED] Audit
U.I.L. No. 1341.02-00

This is in response to your memorandum dated November 17, 2000, that requests advice on an informal claim filed by [REDACTED] [REDACTED] for the taxable years [REDACTED] through [REDACTED].

This memorandum is subject to 10-day post review by our National Office and, therefore, is subject to modification.

DISCLOSURE STATEMENT

This advice constitutes return information subject to I.R.C. § 6103. This advice contains confidential information subject to attorney-client and deliberative process privileges and if prepared in contemplation of litigation, subject to the attorney work product privilege. Accordingly, the Examination or Appeals recipient of this document may provide it only to those persons whose official tax administration duties with respect to this case require such disclosure. In no event may this document be provided to Examination, Appeals, or other persons beyond those specifically indicated in this statement. This advice may not be disclosed to taxpayers or their representatives.

This advice is not binding on Examination or Appeals and is not a final case determination. Such advice is advisory and does not resolve Service position on an issue or provide the basis for closing a case. The determination of the Service in the case is to be made through the exercise of the independent judgment of the office with jurisdiction over the case.

ISSUES

1. Whether [REDACTED] may apply I.R.C. § 1341 with respect to expenses incurred in the taxable years [REDACTED] through [REDACTED] to remediate or redispense of waste generated from manufacturing

operations in earlier tax years?

2. If I.R.C. § 1341 is applicable, whether [REDACTED] can in recomputing its tax liabilities pursuant to said section:

(i). Disregard or not fully account for insurance reimbursements relating to environmental remediation expenses associated with prior year operations;

(ii). Allocate the aforesaid expenses to prior years on a straight-line basis; and

(iii). Apply § 1341 on a fragmented basis by deducting the expenses at issue under I.R.C. § 1341(a)(4) for some years and claiming credits under I.R.C. § 1341(a)(5) for other years.

3. Whether [REDACTED] can substantiate its tax liabilities in prior years ([REDACTED] and earlier) for which transcripts of accounts are no longer available by providing only copies of the prior year tax returns?

CONCLUSIONS

1. The costs incurred by [REDACTED] in the tax years at issue to remediate or redispense of waste generated from manufacturing operations in prior tax years clearly is not subject to the relief provisions of I.R.C. § 1341.

2. In the unlikely event that I.R.C. § 1341 is found to be applicable:

(i) [REDACTED] must fully account for insurance reimbursements relating to the environmental remediation expenses associated with prior year operations. We agree with your position that the appropriate manner to allocate the insurance recovery to the costs allegedly eligible for § 1341 treatment should be based upon the ratio of the costs involved in the § 1341 claim (\$ [REDACTED]) over total claimed damages for insurance purposes (\$ [REDACTED]) times the insurance recovery (\$ [REDACTED]). This formula directly compares the § 1341 claim to [REDACTED]'s subsequent claims for reimbursement from its insurance carriers.

(ii). An allocation of remediation expenses to prior years on a straight-line basis does not reasonably attribute the expenses to the proper year to

which the expenses relate. Such an allocation does not specifically match the remediation expenses at issue to any overstatements of gross income caused by the alleged understatements of COGS. If [REDACTED]'s § 1341 claim were otherwise valid, the proper method of allocation would be based upon the level of manufacturing activity occurring in the prior years, which would directly mirror the degree of contamination and unincurred remediation expenses that arose in those years.

(iii). [REDACTED] should be allowed to apply § 1341 on a fragmented basis by deducting the expenses at issue under I.R.C. § 1341(a)(4) for some years and claiming credits under I.R.C. § 1341(a)(5) for other years.

3. [REDACTED] should be required to substantiate its tax liabilities in prior years ([REDACTED] and earlier) for which transcripts of accounts are no longer available. Providing only copies of the prior year tax returns is insufficient. [REDACTED]'s final tax liability, as adjusted, should be verified by adequate documentation. [REDACTED] may assert that it was not subject to any audit adjustments in these early years. As a result, the burden of going forward with evidence may shift to the Service to prove otherwise. Therefore, the Service should retrieve all records that may be available. In this regard, it should be noted that corporate returns with related documentation are stored at the Federal Records Center for 75 years. I.R.M. Handbook § 1.15.2, Records Disposition, Exhibit 22-1 (Records Control Schedule for Service Centers.)

FACTS

An informal audit claim has been filed by [REDACTED] for \$ [REDACTED] relating to the tax years [REDACTED] through [REDACTED]. The claim is based on the application of I.R.C. § 1341 to environmental remediation expenses incurred in these years for past manufacturing wastes, which totaled \$ [REDACTED]. For purposes of its § 1341 claim, [REDACTED] reallocated \$ [REDACTED] of these costs back to its tax years [REDACTED] through [REDACTED].¹

¹ Among other items, the total remediation costs of \$ [REDACTED] were reduced by insurance recoveries of \$ [REDACTED] and \$ [REDACTED] of "tax only assets". Additionally, [REDACTED] did not consider costs for pre-[REDACTED] years (\$ [REDACTED]) or post-[REDACTED] years (\$ [REDACTED]). The § 1341 claim did not include pre-[REDACTED] and post-[REDACTED] tax years, because the tax rates were comparable to those prevailing in the claim

██████ contends that it utilized waste disposal practices in prior tax years in accord with applicable laws in effect at the time and acceptable industry standards. Nevertheless, ██████'s prior waste disposal practices were deficient at ██████ manufacturing sites and the company was required to incur additional clean-up costs during the tax years ██████ through ██████ to redispense of its prior manufacturing wastes. Under ██████'s present accounting policies, environmental-related expenditures are expensed or capitalized as appropriate, but expenditures relating to existing environmental problems caused by past operations, and which do not contribute to future revenues, are expensed for both book and tax purposes. ██████ alleges, however, that in the past it accounted for production waste disposal costs as inventoriable costs in cost of goods sold (COGS). ██████ claims that had the additional environmental costs for existing conditions been paid or incurred in the years of the manufacturing activity to which the contamination relates the costs would have been included in COGS.

██████ argues that since COGS is an element of the computation of gross income for manufacturers under Treas. Reg. §1.61-3(a), its gross income in the prior years was overstated in the amount of clean-up 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 I.R.C. § 1341. ██████ further argues that it had an apparent right to the gross income reported in earlier periods, but its reported income was overstated. According to ██████, I.R.C. § 1341 should apply to the understated waste disposal costs, to mitigate the effect of changes in tax rates between the years that gross income was originally reported and the current years in which deductions for these additional costs are allowed.

In computing its informal claim pursuant to I.R.C. § 1341(a)(5), ██████ identified the time period over which the contamination occurred, took "applicable" remediation expenses (incurred in ██████ through ██████), and allocated the expenses back to prior years on a straight-line basis over the time periods involved. Except for one manufacturing site in ██████ there was no specific matching of current expenses to specific production on a tonnage basis in prior years. Also, ██████ did not allocate the remediation expenses back to all prior years based upon its allocation method. For purposes of § 1341, only \$ ██████ in costs were allocated from ██████ to ██████ (no expenses incurred in years ██████ through ██████ were allocated to ██████), since a low capital gains tax rate applied. Also, no expenses

years ██████ through ██████. After all adjustments, net costs involved in ██████'s claim equaled \$ ██████.

were allocated to the tax years [redacted] through [redacted], because any expenses allocated to these years would increase the investment tax credit reduction resulting in a permanent loss; therefore, in order to obtain the greatest tax benefit, [redacted] deducted these expenses in the years of "repayment".

Additionally, [redacted] had submitted claims against insurance carriers for recovery of its past, present, and estimated future remediation expenses, amounting to \$ [redacted]. [redacted] eventually settled the claims in exchange for global releases of insurer liability for all past, present, and future environmental costs pertaining to any of [redacted]'s manufacturing sites. Various settlement payments from the insurance carriers, totaling \$ [redacted], were received in the tax years [redacted] through [redacted], as follows:

<u>TAXABLE YEARS</u>	<u>AMOUNTS</u>
[redacted]	\$ [redacted]
[redacted]	\$ [redacted]
[redacted]	\$ [redacted]
[redacted]	\$ [redacted]
[redacted]	\$ [redacted]
[redacted]	\$ [redacted]
[redacted]	\$ [redacted]

[redacted] is still prosecuting claims against the United States in regard to certain environmental remediation. [redacted] contends that the Government operated various sites during World War II and arranged for the disposal and treatment of hazardous waste. There was also one site partially owned and operated by the [redacted] [redacted] during the period [redacted] to [redacted]. [redacted]'s position is that the Government is liable for some or all of necessary environmental response costs.

In its informal claim, [redacted] reduced the remediation expenses allocated back to prior years for purposes of I.R.C. § 1341 by a total of \$ [redacted] for the insurance reimbursements. The method employed by [redacted] to allocate the insurance proceeds was based upon the ratio of remediation costs incurred in each of the open tax years to the total damages sought from insurance carriers. The percentage derived in this manner was then applied to the proceeds received in each tax year and the product was used to reduce the amount of environmental remediation expenditures eligible for § 1341 treatment. [redacted] contends that this is a reasonable and conservative approach, since it believes that it could deduct the expenses in full without netting them against the insurance reimbursements, which were reported in gross income when received.

Finally, for years prior to [REDACTED], no transcripts of account were available to verify whether [REDACTED] was audited and whether the reported tax liability was adjusted.

LAW AND ANALYSIS

The claim of right doctrine requires that a taxpayer currently include items in gross income when he has received or taken such items under a claim of right without substantial restrictions upon disposition. North American Oil Consolidated v. Burnet, 286 U.S. 417 (1932). In United States v. Lewis, 340 U.S. 590 (1951), the application of the claim of right doctrine resulted in the taxpayer reporting certain amounts in income in a prior year although information discovered in a later year required him under compulsion of a court judgment to refund some of the amounts previously received. The Lewis court held that the subsequent refunding of these items did not permit a recomputation of the tax liability for the year of inclusion. Rather, the Court held that the taxpayer should deduct the amount of the returned items as a loss in the later year of repayment. Due to a reduction in the effective tax rates from the year of inclusion to the year of deduction, the taxpayer suffered a net tax loss.

To mitigate the sometime harsh result of the Lewis decision and of a tax system based on annual accounting rather than transactional accounting, Congress enacted I.R.C. § 1341 which provides that the tax liability for the taxable year of repayment of an income item is the lesser of the amounts computed under the following two methods:

1. Deduct the repayment in arriving at taxable income, and then compute the resulting tax liability, §1341(a)(4); or
2. Compute the tax for the year of repayment without deduction for the income item, but reduce the resulting tax liability by the reduction in tax that would have occurred in the year of receipt had the amount of the repayment been excluded from income, § 1341(a)(5).

Under I.R.C. § 1341(a), there are three requirements for taxpayers who wish to avail themselves of the above tax relief. First, an item must have been included in gross income for a prior taxable year(s), because it "appeared that the taxpayer had an unrestricted right to such item." I.R.C. § 1341(a)(1). Second, a deduction is allowable for the taxable year, because it was established after the close of such prior taxable year(s)

that "the taxpayer did not have an unrestricted right to such item or to a portion of such item." I.R.C. § 1341(a)(2). And third, the amount of such deduction exceeds \$ 3,000. I.R.C. § 1341(a)(3).

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 the claim of right.

For several reasons, we do not believe that [REDACTED] is entitled to the § 1341 relief sought.

First, I.R.C. § 1341(a)(1) provides that the statute does not apply unless an item was included in gross income under a claim of right. [REDACTED]'s argument is that it had overstated its gross income from the sale of inventory in prior years, caused by a failure to include unincurred expenses in COGS, and consequently an item was included in gross income. It is the Service's view, however, that COGS is not a factor in determining whether an item was included in gross income under § 1341. See, Rev. Rul. Recently, 72-28, 1972-1 C.B. 269, which holds that only the gross receipts component in the computation of COGS is considered in determining whether an item was included in gross income under § 1341. TAM 200050005 (Sept. 5, 2000) indicates that "an item included in gross income" requirement under § 1341 looks to identifiable items included in gross receipts that are included in the computation of gross income under Treas. Reg. § 1.61-3(a). Looking to gross receipts rather than COGS comports with the concept under § 1341 that an "item" be included in gross income under a claim of right. If the taxpayer's definition of an item of gross income is used, which factors in COGS, then no "items" would remain after the calculation of gross income. All that would remain would be a net aggregate amount. It would not be possible to identify an item of gross income and application of § 1341 would be questionable.

Furthermore, the legislative history of § 1341 supports the Service's view that an item included in gross income encompasses only the inclusion of an item in gross receipts and does not include an overstatement of gross income due to an understatement of COGS. Id. As indicated above, § 1341 was enacted in response to the Lewis case, which involved an identifiable item of income. It is therefore reasonable to conclude that § 1341 was intended to apply only where items of gross income are identifiable. See, Cal-Farm Insurance Co. v. United States, 647 F. Supp. 1083, 1092 (E.D. Cal. 1986) (No evidence that Congress intended the phrase "item included in gross income" to be read so broadly so as to

include the understatement of or failure to take a deduction in a prior year which indirectly results in excessive gross income being reported.)

Accordingly, waste disposal costs may have been a past element of [REDACTED]'s COGS, and under Treas. Reg. § 1.61-3, "gross income" for a taxpayer which is engaged in manufacturing, such as [REDACTED], means total sales or gross receipts, less COGS. However, it does not follow that unclaimed, unpaid and unincurred expenses, even if treated as a component of COGS, represent reported items of gross income within the ambit of I.R.C. § 1341. We believe the correct interpretation of § 1341 and Treas. Reg. § 1.61-3 is that an item of gross income means an item of total sales or gross receipts, which is clearly includible in the computation of gross income.

A second reason for denying the I.R.C. § 1341 relief to [REDACTED] is that no item of gross income included in a prior year was restored in one of [REDACTED]'s open tax years. Treas. Reg. § 1.1341-1(a)(2) provides that "restoration to another" is a prerequisite for eligibility under § 1341. Restoration means to repay the original payor of the item previously included in gross income. Chernin v. United States, 149 F.3d 805, 815-16 (8th Cir. 1998). Here, [REDACTED]'s payment of environmental remediation costs will not restore to an original payor an item previously included in gross income (i.e., a customer of its various aluminum products). Rather, [REDACTED] has made and will make payments to third parties to remediate environmental contamination. A payment to a third party is not a restoration or repayment to an original payor. Moreover, I.R.C. § 1341 requires a direct relationship between the item included in gross income and the deductible repaid item. The Tax Court has held that for I.R.C. § 1341 to apply, the deductible restored item must be directly connected to the item that was previously included in gross income. Uhlenbrock v. Commissioner, 67 T.C. 818 (1977). The obligation to repay an item of income must arise out of the specific circumstances or transaction in which the amount was originally required to be included in income. See, Kraft v. United States, 991 F.2d 292, 295 (6th Cir. 1993); Pahl v. Commissioner, 67 T.C. 286 (1976); Blanton v. Commissioner, 46 T.C. 527 (1966), aff'd per curiam 379 F.2d 558 (5th Cir. 1967). In [REDACTED]'s case, the sale of goods in prior years and the payment of additional environmental cleanup costs in latter years are two separate and distinct transactions involving different parties. [REDACTED] incurred its liability for environmental remediation independent from the circumstances, terms and conditions of its sale transactions.

Third, [REDACTED] is not entitled to a recomputation under

§ 1341, because its claim is subject to the "inventory exception" found in § 1341(b)(2), which 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 property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business. [REDACTED] argues that its gross income was overstated in prior years due to an understatement of COGS, but its gross income was derived from the sale of inventory. Thus, [REDACTED]'s claim necessarily involves the restoration of inventory receipts, and the § 1341 relief sought by [REDACTED] is precluded by § 1341(b)(2).

And fourth, I.R.C. § 1341 may not apply, because the "income" was not included under a claim of right. Treas. Reg. § 1.1341-1(a)(1) 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. In this case, [REDACTED] reported income from product sales, not because it "appeared" to have an unrestricted right to such income, but rather because it had an absolute right to such income. The fact that subsequent litigation or government regulation created a liability for environmental clean-up may not make § 1341 available to the taxpayer. A later accruing liability does not vitiate [REDACTED]'s right to the sales income at the close of the taxable years in which earned. See, Rev. Rul. 67-437, 1967-2 C.B. 296; Rev. Rul. 58-226, 1958-1 C.B. 318. But see, Dominion Resources, Inc. v. United States, 2000-2 USTC ¶50,633 (4th Cir. 2000); Van Cleave v. United States, 718 F.2d 193, 197 (6th Cir. 1983); and Prince v. United States, 610 F.2d 350, 352 (5th Cir. 1967).

In the unlikely event that any part of [REDACTED]'s claim under § 1341 would be allowed, several alternative issues, as addressed in your memorandum, should be raised.

[REDACTED]'s handling of the insurance reimbursements in regard to its § 1341 claim does not appear to be accurate. The total damages or environmental remediation costs for which [REDACTED] filed claims against its insurance carriers amounted to \$ [REDACTED]. [REDACTED]'s insurance claims allegedly encompassed its actual past, present and estimated future remediation costs. [REDACTED] settled the claims for a total recovery of \$ [REDACTED]. [REDACTED] netted the insurance recovery against the amounts involved in its claim, based upon the ratio of costs incurred each year over the total damages claimed times the insurance recovery per year, purportedly under the origin of claim doctrine. [REDACTED]'s allocation method results in only \$ [REDACTED] of the insurance recovery being netted against [REDACTED]'s § 1341 claim, whereas the

claim itself involved \$ [REDACTED]² of [REDACTED]'s total estimated remediation costs of \$ [REDACTED]. We agree with your position that the appropriate manner to allocate the insurance recovery to the costs allegedly eligible for § 1341 treatment should be based upon the ratio of the costs involved in the § 1341 claim (\$ [REDACTED]) over total claimed damages for insurance purposes (\$ [REDACTED]) times the insurance recovery (\$ [REDACTED]). This formula, which directly compares the § 1341 claim to the taxpayer's insurance claim, results in \$ [REDACTED] or [REDACTED]% of the insurance recovery being allocable to the claimed § 1341 costs covering over [REDACTED] years of past contamination, rather than an unrealistically low [REDACTED]% under the taxpayer's method.

[REDACTED] argues that it did not have to net the insurance reimbursements against the costs purportedly eligible for § 1341 relief because of the tax benefit rule, but did so for the sake of being conservative. [REDACTED]'s reliance on the tax benefit rule, however, is inappropriate. The tax benefit rule applies to a recovery of an amount that was deducted in a prior taxable year. Treas. Reg. § 1.111-1(a)(1). The rule is inapplicable when the amount is deductible in the same year as the recovery. In such case, the recovery is usually netted against the deduction. An accrual basis taxpayer, such as [REDACTED], is not allowed a deduction for an expense for which it has a fixed right to reimbursement through insurance or otherwise, or for which it has already been reimbursed. Charles Baloian Co., Inc. v. Commissioner, 68 T.C. 620, 626 (1977), aff'd in unpublished opinion (9th Cir. 1982); Wolfers v. Commissioner, 69 T.C. 975, 984 (1978).

Another alternative issue that can be raised concerns whether [REDACTED]'s straight-line allocation of expenses to prior years for purposes of its § 1341 claim is appropriate. Such an allocation does not specifically match the remediation expenses at issue to any overstatements of gross income caused by the alleged understatements of COGS. If [REDACTED]'s § 1341 claim were otherwise valid, the proper method of allocation would be based upon the levels of manufacturing activity occurring in prior years, which would directly mirror the degree of contamination and unincurred remediation expenses that arose in those years.

We do not recommend, however, that you challenge [REDACTED]'s elections to deduct the additional remediation expenses under I.R.C. § 1341(a)(4) for certain years and to claim credits under I.R.C. § 1341(a)(5) for other years, depending on whichever is most advantageous for tax purposes. This "fragmentized" application was fully approved in Missouri Pacific R.R. Co. v.

² This figure represents the net costs allegedly subject to § 1341 prior to any netting of insurance reimbursements.

United States, 427 F.2d 727 (Ct. Cl. 1970). Although the Service expressed disagreement with the opinion in an action on decision, A.O.D. (March 27, 1971), the issue, as far as we can determine, has not been relitigated. Also, in a recent letter ruling, LTR 199921001 (Dec. 28, 1998), the Missouri Pacific outcome was cited in a footnote without adverse comment. It, thus, appears that the Service has decided not to pursue the issue further.

On the other hand, ██████ should be required to substantiate its tax liabilities in prior years (█████ and earlier), for which transcripts of accounts are no longer available, by providing more than just the copies of the prior year tax returns. The returns do not establish the final tax liability, as adjusted, and it cannot be assumed that ██████ escaped audit in these old tax years, or if audited, did not have any tax adjustments. ██████, however, may assert that it has no records indicating that it was audited in these years and the burden of going forward with evidence may shift to the Service to prove otherwise. At the very least, the Service should make every attempt to retrieve all available records. In this regard, it should be noted that corporate income tax returns with related documents are stored at the Federal Records Center for 75 years. I.R.M. Handbook § 1.15.2, Records Disposition, Exhibit 22-1 (Records Control Schedule for Service Centers).

If you have any questions, please feel free to call Michael A. Yost, Jr. at (412) 644-3441.

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By : _____
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