INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

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District Director,

Taxpayer's Name:
Taxpayer's Address:

Taxpayer's Identification No.:
Year Involved:
Date of Pre-Submission Conference:
Date of Conference of Right:
Date of Additional Conference:

LEGEND:

Taxpayer	=
Purchasing Corporation	=
Company	=
Original Trustee	=
Property	=

Month/Day 1	=
Month/Day 2	=
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	=
Date 15	=
Date 16	=
Date 17	=
Date 18	=
Date 19	=
Date 20	=
A	=
B	=
C	=
D	=
E	=
F	=
G	=
H	=
J	=
K	=
L	=
M	=
N	=
P	=
Q	=
R	=
S	=
T	=
U	=
V	=
W	=
X	=
Y	=
Z	=
AA	=
BB	=
CC	=
DD	=
EE	=
FF	=
GG	=
HH	=
JJ	=
KK	=

LL =
MM =
NN =

ISSUE:

Whether Taxpayer is entitled to deduct all or any portion of the $A paid to Purchasing Corporation from a trust account that was established in connection with the "sale" of Taxpayer's losses to Purchasing Corporation?

CONCLUSION:

A deduction is not allowed for the repayment of an amount that was not previously included in income. Consequently, Taxpayer is not entitled to deduct $B, which is the portion of the payment that represents repayment of amounts not previously included in income. Taxpayer is entitled to deduct $C because that amount represents the portion of the payment that exceeds the amounts not previously included in income.

FACTS:

Background

Taxpayer is the common parent of a consolidated group that files federal income tax returns on the basis of a tax year ending Month/Day 1. Taxpayer uses an accrual method of accounting. Taxpayer is an Alaska Native Regional Corporation formed under 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 provisions of ANCSA, Property was conveyed to Taxpayer on Date 1.

Under the terms of various legislative acts, Taxpayer and other Alaska 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 those Native Corporations with 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, which was initially formed by the purchasing corporation. The subsidiary-member had been assigned income by the purchasing corporation. Such income could be offset by the losses and credits of the Native Corporation. Additionally, the Native Corporation would be paid for the losses and credits used based on the purchasing corporation's tax savings. See generally section 60(b) of the Tax Reform Act of 1984 (1984-3 (Vol. 1) C.B. 2, 87) and section 1804(e)(4) of the Tax Reform Act of 1986 (1986-3 (Vol. 1) C.B. 1, 718); section 5021 of the Technical and Miscellaneous Revenue Act of 1988 (1988-3 C.B. 1, 326).

The “Sale” of Taxpayer’s Losses

During the process of selling some of its’ losses, Taxpayer requested two letter rulings from the Internal Revenue Service. These letter rulings addressed various aspects of the consolidated structure to be used by Taxpayer to sell its losses. In the first letter ruling, Taxpayer elected to allocate its consolidated federal income tax liability according to the methods set forth in § 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 for all tax years beginning with the tax year ended Date 2. Permission to use this allocation method was granted in a letter ruling dated Date 3.

Purchasing Corporation is a member of a consolidated group that files federal income tax returns on the basis of a tax year ending Month/Day 2. On Date 4, Company was formed by Purchasing Corporation with an authorized capital stock consisting of D shares of $F par value common stock and E shares of $F par value convertible preferred stock. Each share of Company capital stock was entitled to one vote per share on all matters submitted to the vote of shareholders, and the charter provided for cumulative voting.

On Date 5, Taxpayer and Purchasing Corporation entered into several agreements with respect to the use of certain anticipated losses to be incurred by Taxpayer and its affiliates, mostly from the future sale of Property. On the same date, Company issued to Purchasing Corporation the E authorized shares of convertible preferred stock in exchange for the cancellation of the previously outstanding shares of Company capital stock and $G. Company also issued to Taxpayer H shares of common stock in exchange for $J cash. The convertible preferred stock represented E percent of the voting control of Company. It was convertible into a sufficient number of shares of common stock to permit Purchasing Corporation to acquire at least 80 percent of the voting control of Company. Company also received an assignment of rights to receive certain capital gains generated by Purchasing Corporation in the future. The gains subject to such assignment represented up to $K of capital gains expected to be generated by Purchasing Corporation.

One of the agreements entered into on Date 5, was the Put Agreement. Purchasing Corporation and Taxpayer entered into an agreement granting Taxpayer a permanent option to sell all of its common stock in Company to Purchasing Corporation for $L upon the occurrence of certain specified events. The events were: (1) the failure of Taxpayer to receive payments under the Shareholders Agreement, (2) Company’s taxable income equals or exceeds $K, and (3) the close of business on Date 9. Simultaneously, the parties entered into the Call Agreement. Purchasing Corporation and Taxpayer entered into an agreement granting Purchasing Corporation the right to purchase the common stock of Company for $L upon the occurrence of either of the following events: (1) Company’s taxable income equals or exceeds $K and (2) the close of business on Date 9. To secure Taxpayer's obligations, Taxpayer granted Purchasing Corporation a security interest in the common stock.

Another agreement entered into on Date 5 was the Shareholders Agreement. Taxpayer, Purchasing Corporation, and Company entered into an agreement that provided the basis upon which Company would compute and remit payments to Taxpayer with respect to the federal income tax liability of Company. The parties expected Taxpayer's return for the year ended Date 10 to show available net losses of no less than $K and Company to generate sufficient net capital gains to absorb such losses by Date 9. Company agreed to make certain payments to Taxpayer based on the tax saved and projected to be saved by Company as a result of Company being a member of the Taxpayer group. Such payments were to be made on various dates and on the occurrence of certain contingencies as provided in the agreement. The agreement provided a formula for determining the amount of the payments subject to adjustment. Additionally, the above described payments were conditioned on the non-occurrence of an adverse legislative event, which might reduce materially the benefits contemplated by the parties.

The Shareholders Agreement also required Taxpayer to transfer certain payments received from Company into a grantor trust. The trust would provide security to Company and Purchasing Corporation by assuring a source of funds to make payment to the Internal Revenue Service of all or a portion of the federal tax liability due as a result of Company generating income in excess of the losses and credits of the Taxpayer group available to offset such income or tax in respect of which Company would make payment to Taxpayer, and for Taxpayer's contingent obligation to refund a portion of the payments Taxpayer would receive pursuant to the agreement. At the time the parties entered into the Shareholders Agreement, they expected any excess assigned income to cause a tax liability for the Taxpayer group instead of "springing back" to cause a tax liability for Purchasing Corporation. The trust would be terminated and Taxpayer would receive the funds in the trust after it was determined that all amounts that actually became due to Purchasing Corporation, or were reasonably expected to become due, were satisfied. This would occur no later than when the tax liabilities were finally determined. The Shareholders Agreement also included a provision that Purchasing Corporation guaranteed, primarily and as a principal and not as a guarantor or surety, payment to Taxpayer of all amounts required to be made by Company under the agreement. The parties intended that the consolidation of Company with the Taxpayer group would terminate and that Taxpayer would no longer be holder of Company common stock having 80 percent of the voting control no later than Date 10.

On Date 6, Taxpayer sold its interest in Property for $D.

On or about Date 7, Taxpayer, Company, and Original Trustee entered into the Grantor Trust Agreement. Taxpayer was identified as the grantor and Company was identified as the creditor. The Trust Agreement provided that the funds would be invested in certain types of liquid investments or any other investment requested by Taxpayer and consented to by Company. Under the terms of the Trust Agreement, the accrued interest income on the trust account was reported annually on Taxpayer's federal income tax return, but the interest income had to be retained in the trust account. Under the terms of the Shareholders Agreement, the trustee was required to transfer annually to Taxpayer an amount equal to the taxes owed on the trust account interest. Other amounts could not be paid out of the trust over the objection of Company.

On November 10, 1988, section 5021(b)(2) of the Technical and Miscellaneous Revenue Act of 1988 (1988-3 C.B. 1, 327) became effective and, under the facts of this technical advice memorandum, limited the amount of losses that could be "sold" to Purchasing Corporation to $40,000,000.

On or about Date 8, Purchasing Corporation made a payment of $M to Taxpayer.

On Date 11, the second letter ruling was issued jointly to Taxpayer and Purchasing Corporation. That ruling included the following holdings:

> All payments from Company to Taxpayer pursuant to the Shareholders Agreement in satisfaction of Company's allocable portion of the federal income tax liability of Taxpayer Group under the methods described in § 1.1552-1(a)(1) and § 1.1502-33(d)(2)(ii) shall not be treated, in whole or in part, as distributions with respect to Company's stock. Such payments are not income to Taxpayer, and Taxpayer shall not recognize any income, gain, or loss as a result of its receipt of such payments. Section 1.1552-1(b)(2).
>
> The amount of tax liability allocated to a member of Taxpayer Group, including Company, will decrease the member's earnings and profits and be treated as a liability of the member. The payment of this liability will not be treated as a distribution with respect to its stock or as a contribution to the capital of another member. If the full amount of this liability is not paid, the unpaid amount will be treated as a distribution with respect to the stock, a contribution to capital, or a combination thereof. If a member makes payments in excess of the amount of consolidated tax 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).

On or before the extended due date of Date 12, Taxpayer timely filed a consolidated federal income tax return for the tax year ended Date 10.

Based on $N of income assigned by Purchasing Corporation, the payment due to Taxpayer was $B. Previously, Purchasing Corporation made a payment of $M to Taxpayer on or about Date 8. On or about Date 13, Purchasing Corporation made a wire transfer of $P to the trustee, who then transferred the funds into the trust account on behalf of Taxpayer. The Shareholders Agreement provided that Company would make a payment to Taxpayer, and Taxpayer would immediately pay the amount to the trustee of the trust account.

The Previous Examination and its Resolution

As a result of the sale of Property, Taxpayer claimed a capital loss of $Q on Form 4797 (Sales of Business Property) when it filed a consolidated federal income tax return for the tax year ended Date 10. During the examination of that return, the Service challenged the basis used for Property and, therefore, the loss claimed by Taxpayer from the sale of Property. The adjustment of this claimed loss could result in a corresponding reduction to the amount of assigned income reported on Taxpayer's consolidated return (which was $N) and a corresponding increase in the amount of income reported on Purchasing Corporation's return due to the "spring back" of excess assigned income.

On or about Date 15, while Taxpayer and Purchasing Corporation were negotiating a settlement with the Service regarding the tax year ended Date 10, Taxpayer and Purchasing Corporation entered into the Letter Agreement to modify the terms of the Shareholders Agreement because they did not originally anticipate at the time they entered into the Shareholders Agreement that any excess assigned income would "spring back" to Purchasing Corporation. The Letter Agreement included a schedule showing how the trust account funds should be divided between Purchasing Corporation and Taxpayer when there was a final disbursement from the trust account. Also, because there was a delay in making the original payment to be placed in the trust account, the Letter Agreement included a requirement for Purchasing Corporation to make a payment of $R plus an interest factor into the trust account immediately prior to the final disbursement from the trust account.

Taxpayer and the Service agreed as to the allowable basis of Property ($S) and the correct loss on the sale of Property ($T). This agreement was evidenced in a settlement document. Additionally, Taxpayer, Purchasing Corporation, and the Service executed a closing agreement dated Date 17. The closing agreement addressed matters not covered by the settlement document. The closing agreement provided that of the $N of short-term capital gain originally reported on Taxpayer's consolidated federal income tax return for the tax year ended Date 10, $U is taxable to Purchasing Corporation and is includable in the consolidated federal income tax return for Purchasing Corporation for the tax year ended Date 9 (i.e., the excess assigned income "sprang back" to Purchasing Corporation). Consequently, the closing agreement required Taxpayer to reduce, by $U, the amount of assigned income reported on its consolidated federal income tax return for the tax year ended Date 10. After that adjustment, the assigned income reported was $V. The closing agreement also clarified that there were no net operating loss carryovers to be utilized in Taxpayer's tax years after Date 14. However, the closing agreement did not address whether Taxpayer would have any additional income or deductions as a result of the settlement.

The Disbursements from the Trust Account

By a letter dated Date 19, Taxpayer notified the trustee of the trust account (a successor to Original Trustee) that the purpose for establishing the trust had been resolved and that calculation of the amounts to be disbursed had been completed. The trustee was instructed to disburse all of the available funds, which amounted to $W. Based on the terms of the Shareholders Agreement and the Letter Agreement, Taxpayer received $X and Purchasing Corporation received $A. The amount disbursed to Purchasing Corporation was determined by first computing the federal income tax Purchasing Corporation would pay on the $U of excess assigned income at the rate of Y percent plus interest on the additional tax. This total tax liability was then allocated Z percent to Purchasing Corporation and AA percent to Taxpayer in accordance with the parties' agreement. Based on the terms of the Letter Agreement, the amount due Purchasing Corporation was reduced by $BB, thereby increasing the payment to Taxpayer. This adjustment was made instead of having Purchasing Corporation make a payment into the trust account immediately prior to the final disbursement. Taxpayer did not report the receipt of $X on its federal income tax return. It has not been confirmed by the examining agent how Purchasing Corporation treated the receipt of the $A for federal income tax purposes.

As a result of the settlement on or about Date 18, Taxpayer claimed two deductions totaling $A on its federal income tax return for the year ended Date 20. This is the same amount as the trust account disbursement to Purchasing Corporation. The deductions were claimed as "IRC Section 162 Contract Payment" of $CC on line 26 (Other Deductions) and as "Interest Expense" of $DD on line 18 (Interest). The $A was allocated between the contract payment and interest expense based on the ratio of federal income tax ($EE) and interest ($FF) to the total approximate federal income tax payment ($GG) due by Purchasing Corporation on the $U excess assigned income. The ratio was rounded off to HH percent tax and JJ percent interest for computational purposes. Taxpayer's return for the year ending Date 20 contains two Schedule M-1 (Reconciliation of Income (Loss) per Books With Income per Return) adjustments for deductions on return not charged against book income totaling $A. Taxpayer's current position is that the entire $A is deductible under § 162.

Other Reporting Information

Taxpayer included the $M payment received on or about Date 8 in financial book income, but not on its income tax return as taxable income. Also, Taxpayer did not report the transfer of $P into the trust account on or about Date 13 in financial book income or as taxable income on its return. Additionally, Taxpayer included the $X paid from the trust account around Date 19 in financial book income, but not on its return as taxable income. The $X was included in financial book income for the year ending Date 16. As a result, the $X was shown as a Schedule M-1 adjustment on Taxpayer's return for the year ending Date 16. The $N of income initially assigned to Company was included on Taxpayer's consolidated tax return because Company was part of Taxpayer's consolidated group, but Company was not included in the separate financial statements issued by Taxpayer. No separate financial statements were issued for Company. Also, none of the specific funds used to make the $A payment from the trust account to Purchasing Corporation were included in Taxpayer's financial book income, except to the extent they included some of the $KK in trust account net earnings reported by Taxpayer.

Taxpayer was subject to the alternative minimum tax (AMT) in the tax year ended Date 10. In computing the AMT for that year, the $N of assigned income was included in adjusted net book income (ANBI). As a result of the settlement, ANBI was reduced by the $U "spring back" to Purchasing Corporation. None of the $A payment to Purchasing Corporation has ever been included in Taxpayer's ANBI, except to the extent it included earnings from the trust account.

The only items of income from the sale of losses reported on Taxpayer's federal income tax returns were the $N (later reduced by $U) of assigned income and the earnings accrued from the trust account. Taxpayer had reported annually for its tax years ending Date 14 through Date 20 all of the accrued interest income of the trust account (totaling $LL). In computing the final disbursement out of the trust account, the parties used a cumulative net earnings amount of $KK. The $MM difference between interest income and the net earnings is assumed to result from net capital losses in the trust account. The trustee's administration fees were approximately $NN per year and were paid directly by Taxpayer (and not from funds in the trust).

LAW AND ANALYSIS:

Section 162(a) provides the general rule that there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business.

Section 165(a) provides the general rule that there shall be allowed as a deduction any loss 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), the United States Supreme Court held that a taxpayer is not entitled to a deduction under either section 162 or section 165 upon the repayment of any amount which 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% 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% of its gross receipts. The remaining 27.5% of the income in reality had been tax exempt. Permitting a deduction only for the 72.5% 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 Supreme 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. Commissioner, T.C. Memo. 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 the Taxpayer'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.

During its tax year ended Date 10, Taxpayer received a payment of $M from Purchasing Corporation in partial satisfaction of the total purchase price due from the sale of a specified amount of tax losses. Although it did include the amount in its financial book income, Taxpayer did not include the $M payment in its income tax return as income. During its tax year ended Date 14, Taxpayer filed a consolidated return with Company, reflecting the $N of income assigned to Company by Purchasing Corporation (thereby effectuating the "sale" of the losses), and received the $P balance of the purchase price from Purchasing Corporation in the form of a wire transfer to the trustee. As with the earlier $M partial payment, Taxpayer did not report the $P as income.

For purposes of this technical advice, we need not consider whether the $M and $P payments were properly not included in Taxpayer's income. Regardless of the reason, Taxpayer did not include the $M and $P payments 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 Taxpayer with a double deduction, regardless of the reason for, or the propriety of, not reporting the amount in income. Doing so would be both “inappropriate” and contrary to “sound principles of tax law.” 394 U.S. at 680. Thus, regardless of whether Taxpayer acted properly or improperly[1] in not reporting the $M and $P payments as income, it did not do so, and therefore unequivocally is not entitled to a deduction for its repayment of these amounts.

In responding to the Service’s position, Taxpayer has asserted that the $M and $P payments were conveyed by Purchasing Corporation as part of the earnings assigned by it to Company and thus were included in the Taxpayer group’s consolidated return. As a result, Taxpayer argues, the $M and $P payments were in fact reported as income and a deduction is appropriate under Skelly Oil. We disagree. Taxpayer has not demonstrated either in its written submissions or during its conferences with the National Office that the parties intended anything other than the payment of a total consideration of $M and $P in exchange for Taxpayer’s agreement to sell a separately stated amount of tax losses (using earnings assigned to Company and eliminated on the Taxpayer group’s consolidated return as the mechanism for “selling” the losses). On the facts provided, we believe the parties intended the $M and $P payments to constitute the purchase price, a wholly distinct payment from the commodity being sold, notwithstanding that both the commodity and its purchase price were denominated in U.S. currency. For the reasons set forth above, because the purchase price was never included in Taxpayer’s income, Taxpayer’s return of a portion of the purchase price to the buyer may not be deducted.

Taxpayer, in its post-conference submission, attempts to distinguish the case law cited in support of limiting Taxpayer’s deduction in this instance to $C. In this effort, Taxpayer, in our judgment, misconstrues the central theme for which the cases are cited. Namely, that although the nature of a payment may indeed be a legitimate deduction in most circumstances, the amount deducted, whether as a business expense or a loss, must first have been recognized and reported as income. Taxpayer makes much of the statement in the majority opinion in Skelly, “... the approach here adopted will affect only a few cases.” Taxpayer argues that this serves to limit the applicability of the opinion and render it inapplicable to Taxpayer’s facts. In so doing, Taxpayer fails to take into account the full context of the next sentence of the Court’s opinion, “... unlike most other deductions provided by the Code, it [depletion allowance] allows a fixed portion of gross income to go untaxed.” Therein lies the core of the Court’s concern and it is that thread that can be found in the weave of all of the other cited cases.

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[1]We note that the period of limitations for making assessments has expired with respect to the tax years ending on Date 10 and Date 14.

It is that same concern, stemming from the facts established in this case, that compels us to the conclusion that Taxpayer may not deduct the $A payment to Purchasing Corporation. Taxpayer asserts that the Service's finding that the $M payment to Taxpayer and the $P payment to the trust were not included in Taxpayer's income for tax purposes constitutes a "narrow interpretation of the facts" and "... is, if not erroneous, clearly misleading". However, Taxpayer does not offer any facts to the contrary. Instead it makes an unpersuasive attempt to recast the tax effect of these payments when viewed in the context of the larger complex transaction. Taxpayer also takes exception to the characterization of the repayment to Purchasing Corporation as a tax sharing payment. The focus on labeling the repayment, however, is misplaced. It is the fact that the amount being repaid was never included in Taxpayer's income that determines the outcome of the issue in this case.

Finally, however, we note that the payment from the trust to Purchasing Corporation actually exceeded the sum of $M and $P, leaving for consideration the proper tax treatment of this excess amount. We note preliminarily that although the payment to Purchasing Corporation was made by the trust rather than by Taxpayer directly, we believe Taxpayer was the owner of the funds in the trust and is entitled to a deduction for any portion of the payment to Purchasing Corporation which does not represent previously untaxed receipts. Taxpayer's ownership of the funds in the trust and any earnings thereon is supported by a number of factors. First, the Shareholders Agreement provided that Company would make a payment to Taxpayer, and Taxpayer would immediately pay the amount to the trustee of the trust account. Second, the primary purpose of the trust was to ensure a source of funds to pay any additional tax liability that might result from the transaction, and it was expected that any such additional tax liability would be that of Taxpayer, not that of Purchasing Corporation. This indicates that Taxpayer itself merely was setting aside its own funds (including the $P) as a security device for payment of its own potential tax liability. Third, Taxpayer would have been entitled to retain the amount in the trust if the Service had not adjusted the loss claimed as a result of the sale of Property. Of primary importance for purposes of this technical advice, Taxpayer treated the trust as a grantor trust and reported as income on its federal income tax returns all of the trust's accrued interest income during the years at issue.

Thus, because the total payment made to Purchasing Corporation by the trust was $A, an amount exceeding the total of the amounts not included in income by $C, Taxpayer is entitled to a deduction in the amount of $C.

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