INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

October 20, 2000

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CASE MIS No.: TAM-103867-00/CC:ITA:B5

District Director,

Taxpayer's Name:
Taxpayer's Address:

Taxpayer's Identification No.:
Year Involved:
Date of Conference:

LEGEND:

Taxpayer	=
Purchaser A	=
Purchaser B	=
Company A	=
Company B	=
Escrow A	=
Escrow B	=
Bank A	=
Bank B	=
Date 1	=
Date 2	=
Date 3	=
Date 4	=
Date 5	=
Date 6	=
Date 7	=
Year 1	=
Year 2	=
Year 3	=
$c	=
$d	=
$e	=
$f	=
$g	=
$h	=

$i	=
$j	=
$k	=
$l	=
$m	=
$n	=
$o	=
$p	=
$q	=
$r	=
$s	=
$t	=
u	=

ISSUES:

(1) Whether Taxpayer is entitled to deduct a $c repayment made by Taxpayer of a portion of a tax sharing payment received by Taxpayer in connection with the "sale" of its losses.

(2) Whether Taxpayer is entitled to deduct a $d payment of interest made by Taxpayer in connection with the "sale" of its losses.

CONCLUSIONS:

(1) Taxpayer is not entitled to deduct the repayment of $c because the tax sharing payment was not previously included in income.

(2) Taxpayer is entitled to deduct the interest payment of $d under § 163 of the Internal Revenue Code.

FACTS:

Taxpayer is an Alaska Native Regional Corporation formed under the Alaska Native Claims Settlement Act of 1971 (ANCSA), P.L. 92-203, 85 Stat. 688 (1971). 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. The assigned 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 § 60(b) of the Tax Reform Act of 1984 (1984-3 (Vol. 1) C.B. 2, 87); § 1804(e)(4) of the Tax Reform Act of 1986 (1986-3 (Vol. 1) C.B. 1, 718); and § 5021 of the Technical and Miscellaneous Revenue Act of 1988 (1988-3 C.B. 1, 326).

The "Sale" of Taxpayer's Losses

Taxpayer entered into transactions with Purchaser A and Purchaser B for the sale of its losses. The terms of the loss sale to Purchaser A are contained in an agreement dated Date 3. The sale of Taxpayer's losses to Purchaser A was accomplished by means of a transitory subsidiary formed by Purchaser A called Company A. Company A was transferred to Taxpayer and filed a consolidated return with Taxpayer. Purchaser A assigned to Company A income equal to the amount of Taxpayer's losses being purchased ($e). The assigned income of $e was included in taxable income on the consolidated return. Thus, the use of the consolidated return allowed Taxpayer's tax loss to be used to offset what was Purchaser A's taxable gain.

Separate from the assigned income conveyed through Company A, Purchaser A paid Taxpayer a tax sharing payment of u cents for each one dollar of losses required to offset the amount of income assigned by Purchaser A to Company A. Based on the assigned income of $e, the tax sharing payment due Taxpayer from Purchaser A was $f. Taxpayer received $g at closing in Year 1 and the balance in Year 2 (payable $h cash and $i to Escrow A, maintained at Bank A.) Taxpayer included these tax sharing payments in book income for financial statement purposes, but did not include the tax sharing payments in income for federal income tax purposes.

The sale of Taxpayer's losses to Purchaser B was similar to the sale to Purchaser A. The sale of Taxpayer's losses to Purchaser B was accomplished by means of a transitory subsidiary formed by Purchaser B called Company B. Company B was transferred to Taxpayer and filed a consolidated return with Taxpayer. Purchaser B assigned to Company B income equal to the amount of Taxpayer's losses being purchased ($j). The assigned income of $j was included in taxable income on the consolidated return. Thus, the use of the consolidated return allowed Taxpayer's tax loss to be used to offset what was Purchaser B's taxable gain.

Separate from the assigned income conveyed through Company B, Purchaser B paid Taxpayer a tax sharing payment of u cents for each one dollar of losses required to offset the amount of income assigned by Purchaser B to Company B. Based on the assigned income of $j, the tax sharing payment due Taxpayer from Purchaser B was $k. Taxpayer received $l at closing in Year 1 and the balance in Year 2 (payable $m cash and $n to Escrow B, maintained at Bank B.) Taxpayer included these tax sharing payments in book income for financial statement purposes, but did not include the tax sharing payments in income for federal income tax purposes.

In each case, the purchaser required Taxpayer to establish an escrow account to hold a portion of the sales price as security against certain contingencies, including potential income tax liability. Taxpayer was to receive the interest income from the escrow accounts and Taxpayer reported the interest income annually for income tax purposes. The agreements provided that the net balances in each of the escrow accounts would be distributed between Taxpayer and the respective purchasers after there was a “final determination.” The “final determination” was defined as occurring after the date of a “Taxpayer return determination,” which was defined as the earlier of (1) the execution of a closing agreement (as defined in § 7121) by Taxpayer and the Service, or (2) the last to occur of (A) the expiration of the applicable statute of limitations or (B) if any administrative or judicial proceeding was commenced prior to the expiration of the applicable statute of limitations, the earlier of (i) the entry of a final and unappealable decision by any court of competent jurisdiction or (ii) the execution by Taxpayer and the IRS of a final and binding settlement agreement addressing each and all such matters. Both the agreement with Purchaser A and the agreement with Purchaser B contained this language.

During the process of selling some of its losses, Taxpayer requested private letter rulings from the Internal Revenue Service. The letter ruling regarding Purchaser A was dated Date 1. The letter ruling regarding Purchaser B was dated Date 2. The letter rulings dealt with various aspects of the consolidated structure to be used by Taxpayer to sell its losses. The letter rulings provide, in relevant part, that once Company A or Company B has included in its earnings and profits the assigned income from the purchasers, distributions from Company A or Company B to Taxpayer are not an additional item of income to Taxpayer because the distributions represent amounts previously included in Taxpayer group’s earnings and profits. The letter rulings do not address how Taxpayer’s group should treat the receipt of the tax sharing payments at issue in this technical advice memorandum.

<u>The Previous Examination and its Resolution</u>

The IRS examined Taxpayer’s returns for Year 1 and Year 2 and challenged the depletion deductions of various oil and gas producing properties claimed by Taxpayer. The adjustment of these claimed deductions resulted in a corresponding adjustment reducing the losses available for sale by Taxpayer to the purchasers. This, in turn, resulted in a reduction in the amount of income that the purchasers could assign to Company A and Company B, since the assigned income was limited to the available losses of Taxpayer. Under the agreements, the reduction in assigned income created a situation where the excess assigned income would "spring back" to the purchasers. The agreements also provided that if the IRS determined that Taxpayer's losses were less than originally filed, so that there was an excess of assigned income, then Taxpayer was required to reimburse the purchaser <u>u</u> cents for every one dollar of excess assigned income, plus interest at the overpayment rate for federal income tax under §§ 6611 and 6621.

The examination of Taxpayer's Year 1 tax return was resolved on Date 5, when Taxpayer and the IRS executed a closing agreement. Under the terms of the Closing Agreement, the amount of excess assigned income includible on the consolidated federal income tax returns covering Year 1 was $o for Purchaser A and $p for Purchaser B. The closing agreement required Taxpayer to reduce, by $q, the amount of assigned income reported on its consolidated federal income tax return for Year 1. The closing agreement also clarified the amount of net operating loss carryover available to Taxpayer. However, the closing agreement did not address if Taxpayer would have any additional income or deductions as a result of the closing agreement.

The Disbursements from the Trust Account

By a letter dated Date 6, Taxpayer requested the trustees of Escrow A to close and disburse the funds. Purchaser A received $r (including interest) from Escrow A and Taxpayer received the remainder. By a letter dated Date 7, Taxpayer requested the trustees of Escrow B to close and disburse the funds. Purchaser B received $s (including interest) from Escrow B and Taxpayer received the remainder.

On its original Year 1 income tax return, Taxpayer included in taxable income the assigned income from Company A and Company B. However, Taxpayer did not include the tax sharing payments of $f (from Purchaser A) and $k (from Purchaser B) in taxable income, although it did include the tax sharing payments in book income for financial statement purposes. Taxpayer also included in taxable income the interest income it earned on the portion of the tax sharing payments held in Escrow A and Escrow B.

The $r and $s paid to Purchaser A and Purchaser B, respectively, were deducted by Taxpayer on its Year 3 tax return. The deductions, totaling $t, were claimed as "IRC Section 162 Contract Payment" of $c and as "Interest Expense" of $d.

LAW AND ANALYSIS:

Section 162(a) allows a deduction for all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business.

Section 163(a) allows a deduction for all interest paid or accrued within the taxable year on indebtedness.

Section 165(a) allows a deduction for 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 § 162 or 165 upon the repayment of any amount which previously was not taxed. In Skelly Oil, the taxpayer was a natural gas producer that made refunds to customers who 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 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. Thus, for purposes of this technical advice request, we need not consider whether the tax sharing payments of $f (from Purchaser A) and $k (from Purchaser B) were properly not included in Taxpayer's income. Regardless of the reason, Taxpayer did not include the tax sharing 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." Skelly Oil, 394 U.S. at 680.

In responding to the Service's position, Taxpayer has asserted that the tax sharing payments of $f (from Purchaser A) and $k (from Purchaser B) were conveyed by the purchasers as part of the income assigned by them to Company A and B, respectively, and thus were included in the Taxpayer group's consolidated return for each transaction. As a result, Taxpayer argues, the $f and $k payments were in fact reported as income and, therefore, 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, nor in fact provided, anything other than the payment of consideration of $f in the case of Purchaser A, and $k in the case of Purchaser B, in exchange for Taxpayer's agreement to sell a separately stated amount of tax losses (using income assigned to Company A and Company B and eliminated on the Taxpayer group's consolidated return for each transaction as the mechanism for "selling" the losses). On the facts provided, we believe $f was the purchase price for the sale to Purchaser A, and $k was the purchase price for the sale to Purchaser B. In each case, these purchase price payments were wholly distinct from the asset being sold (Taxpayer's losses). Because neither purchase price was ever included in Taxpayer's taxable income, Taxpayer's return of a portion of the purchase price to each purchaser may not be deducted.

Taxpayer contends, however, that the private letter rulings it received supports its argument that the tax sharing payments received from the purchasers were included in its gross income as part of the income assigned by Purchaser A to Company A and by Purchaser B to Company B. Taxpayer reads the private letter rulings as stating that the tax sharing payments were not income to Taxpayer because the tax sharing payments were part of the income assigned to Company A and Company B. As a result, Taxpayer argues, a deduction is appropriate for the portion of the tax sharing payments it repaid to the purchasers.

Taxpayer, however, misreads the private letter rulings. The letter rulings merely provide that once Company A or Company B has included in its earnings and profits the assigned income from the purchasers, distributions from Company A or Company B to Taxpayer are not an additional item of income to Taxpayer because the distributions represent amounts previously included in Taxpayer group's earnings and profits. The only scenario in which Taxpayer would be entitled to a deduction for the returned portion of the tax sharing payments is if Taxpayer's group had reported the tax sharing payments themselves as a separate item of income. This issue was not addressed in the private letter rulings and, in fact, Taxpayer's group did not report the tax sharing payments as income.

Taxpayer also argues that the recent decision in Doyon v. United States, Nos. 97-5049, 99-5010, and 99-5154, 2000 U.S. App. LEXIS 12107 (Fed. Cir. 2000), rev'g 37 Fed. Cl. 10 (1996) and 42 Fed. Cl. 175 (1998), reh'g req'd, No. 94-1074T (June 13, 2000), supports its position. In Doyon, the Court of Appeals held that § 1804(e)(4) of the Tax Reform Act of 1984, which provides that no provision of the Internal Revenue Code or principle of law shall apply to deny the "benefit or use of losses" of native corporations, was violated by requiring tax sharing payments generated by loss sales transactions to be included in book income for alternative minimum tax purposes. First, the holding in Doyon is not applicable to the facts in the instant case because Doyon addresses only the propriety of reporting tax sharing payments in alternative minimum taxable income. Even assuming this holding would apply to regular taxable income, the issue in the instant case is not whether the tax sharing payments are includible in income, but instead whether Taxpayer can deduct a portion of the tax sharing payments that it never reported in income. Thus, our conclusion does not conflict in any way with the holding in Doyon. Further, our conclusion does not in any sense deprive Taxpayer of the use or benefit of any portion of its losses. To the contrary, Taxpayer received full compensation for the sale of its tax losses and was not required to pay any federal tax on the sales proceeds.

Finally, however, we note that the payments from the escrow accounts to Purchaser A and Purchaser B included interest in addition to returning a portion of the tax sharing payments. Purchaser A received $r (including interest) from Escrow A and Purchaser B received $s (including interest) from Escrow B. Of the total $t deduction taken by Taxpayer, $c was a return of a portion of the tax sharing payments to the purchasers, while $d represented interest on those amounts. Under the agreements with the purchasers, in the case of a spring back of assigned income to the purchasers, Taxpayer was required to reimburse the purchasers a portion of the tax sharing payments (u cents for every one dollar of the spring back amount), plus interest at the overpayment rate for federal income tax under §§ 6611 and 6621. The interest that was paid from the escrow accounts to the purchasers constitutes an expenditure by Taxpayer for interest on the returned portion of the tax sharing payments. This interest was a “true” expenditure for Taxpayer. It was in addition to, and based on, the portion of the tax sharing payment that was returned to the purchasers. In contrast to the return of the tax sharing payments, the payment by Taxpayer of interest on those payments constitutes an expense, which is deductible interest under § 163.

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