INTERNAL REVENUE SERVICE

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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR ASSOCIATE AREA COUNSEL CCLM:FSH:HAR
ATTN JOSEPH F. LONG

FROM: Associate Chief Counsel CC:ITA

SUBJECT: Income Relating to Tax Exempt Years

DISCLOSURE STATEMENT

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.

This Chief Counsel Advice responds to your memorandum dated April 13, 2001. In accordance with I.R.C. § 6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

<u>LEGEND</u>:

A =
State B =
Foundation A =
$A =
$B =
Date 1 =
Year 1 =
Year 2 =
Year 3 =
Year 4 =
Year 5 =
Year 6 =
Year 7 =
Year 8 =

Year 9	=
Year 10	=
Tax Year 1	=
Tax Year 2	=

ISSUE:

Whether the tax benefit rule entitles A to exclude from taxable income the portion of settlement proceeds relating to Year 1 through Year 9 when A was exempt from federal income tax.

CONCLUSION:

Under the tax benefit rule, A may exclude from taxable income the portion of settlement proceeds relating to Year 1 through Year 9 when A was exempt from federal income tax.

FACTS:

In Year 10, A and State B initiated a lawsuit against an industry alleging among other things, violation of consumer protection and antitrust laws. Plaintiffs presented their model of damages through the testimony of a major university biostatistician and a statistical consultant. On Date 1, A and State B settled their case against the industry. Several companies agreed to pay A $B over a five year period.

A states that the settlement amount is recovery of both losses incurred and litigation costs. The size of the settlement causes A to exceed the statutory maximum of surplus funds it can maintain under its enabling legislation. Negotiations ultimately resulted in a plan whereby A allocated the present value of the settlement proceeds to income taxes, Foundation A, and four service programs related to the underlying injuries alleged in the lawsuit. The plan for the ultimate disposition of the settlement proceeds remains in litigation.

The payments due from the companies to A have been paid on schedule. Tax Years 1 and 2 are at issue. A asserts that the portion of the settlement relating to past years 1 through 9, when it was tax exempt, are excluded from income by the tax benefit rule.

LAW:

Section 111 provides that a taxpayer excludes from gross income any recovery or refund of an amount deducted in a prior taxable year to the extent the deduction did not generate a tax benefit in the year of the deduction. The inclusionary component brings refunds, recoveries, etc., into income to the extent the prior treatment benefitted the taxpayer.

Under section 832(b), underwriting income, a component of gross income for a property and casualty insurance company is reduced by losses incurred. Losses incurred are further reduced by any recovered salvage and subrogation. Salvage consists of proceeds from the sale of damaged property for which companies have taken over title; subrogation is amounts recovered from third parties responsible for damage or injuries sustained by the insured. See also Treas. Reg. § 1.832-4(c).

In Home Savings and Loan Co. v. Commissioner, 39 T.C. 368 (1962), acq. in result, 1965-2 C.B. 5, taxpayer received a refund of state property taxes for several earlier years when it had been a tax exempt building and loan association. The court agreed with the taxpayer that because payment of the state taxes did not give rise to any tax benefit, their refund was not taxable income. If payment had resulted in a tax deduction, the later recovery would be taxable income. While the Service argued that taxpayer did not come within the exclusion provided in section 111, the court relied on the broader, more general tax benefit rule, first enunciated by the courts and only partially embodied in section 111.

California and Hawaiian Sugar Refining Corp. v. United States, 311 F.2d 235 (Ct. Cl. 1962) involved similar facts in that the taxpayer received a refund of taxes paid, which had been declared unconstitutional, and the taxes were paid while it was a tax exempt entity. The court held that a refund of taxes illegally collected in prior years is not taxable income in the refund year unless the taxpayer had previously obtained a tax benefit from the taxes.

The Tax Court in American Financial Corp. v. Commissioner, 72 T.C. 506 (1979), nonacq. A.O.D. CC-1980-5 (Nov. 20, 1979), agreed with the taxpayer that a certain portion of salvage and subrogation proceeds received were recoveries of claims paid in prior years in which deductions for losses incurred were taken without tax benefit. Thus, taxpayer was entitled to exclude the portion of salvage and subrogation proceeds corresponding to the amount of losses incurred, which were deducted without a tax benefit. The Service's view was that these recoveries reduce losses, and because section 111 acts to exclude items that would be income items, petitioner was not eligible for tax benefit treatment.

In Home Mutual Insurance Co. v. Commissioner, 639 F.2d 333 (7th Cir. 1980), cert. denied, 451 U.S. 1017 (1983), the court held that the tax benefit rule only applied to amounts that otherwise would be includible in income (and not to a decrease in the balance of unpaid losses). The court noted that the exclusionary aspect of the tax benefit rule becomes relevant only after the Commissioner has employed the inclusionary aspect of the rule to include in gross income recoveries that, according to the strict terms of the statute, are not income.

At issue in Allstate Insurance Co. v. United States, 936 F.2d 1271 (Fed. Cir. 1991) was whether the tax benefit rule permitted Allstate to exclude certain subrogation recoveries from offsets to losses paid, and thus, from gross income.

> Subrogation is, by definition, a recovery from a previously deducted loss. Thus, a taxpayer–under the inclusionary aspect of the tax benefit rule–must include subrogation within income. The taxpayer may then exclude that share of subrogation from income to the extent the previous deduction generated no tax benefit. Subrogation, by its nature, demands application of the tax benefit rule. Section 832 does not bar that application.

936 F.2d at 1274.

ANALYSIS:

Where subrogation recoveries relate to insurance losses deducted under section 832(b)(5), albeit without a tax benefit, Service position has been that such recoveries do not come under the tax benefit rule of section 111 and are not excludible from the calculation of losses incurred under section 832(b)(5). The Service's technical argument was that section 111 does not apply to recoveries which are offsets to otherwise deductible amounts, rather than items of gross income. This view was approved by the 7th Circuit in Home Mutual, supra.

On the other hand, the Service unsuccessfully litigated against application of the tax benefit rule when a recovery related to a deduction item in a prior tax exempt year. Home Savings, supra and California and Hawaiian Sugar, supra. The Service did acquiese in the result in Home Savings. We believe that the exclusionary aspect of the tax benefit rule applies even though the taxpayer was exempt from income tax in the prior years.

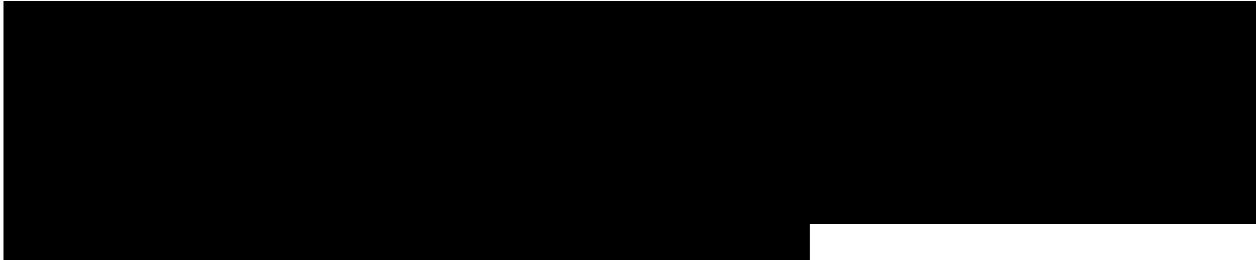
There is relatively recent and unequivocal support for A's exclusion of the settlement proceeds in Allstate Insurance, supra and American Financial, supra. In Allstate, the company was permitted to exclude from income under the tax benefit rule recovered subrogation that was traceable to claims and losses incurred in an amount which provided no tax benefit.

In American Financial, the Service argued that salvage and subrogation were offsets applied to compute the incurred loss deduction. The court determined that the recovered amounts related to earlier claims and losses, and such recoveries were a gross income inclusion under section 832(b). Therefore, the proceeds relating to losses incurred that were deducted without tax benefit were excluded under the tax benefit rule.

In summary, we recognize that previous Service position has been that the language of sections 111 and 832 operates to preclude the use of tax benefit principles in factual circumstances such as those at issue here, relying on the theory that a salvage or subrogation recovery solely constitute an offset to a deduction and not a gross income inclusion under section 832(b). However, we recommend against continuing to advance this somewhat technical argument. Arguably neither the fact that Congress chose to treat subrogation recoveries as a deduction offset, rather than an

income item, nor the fact that in section 832(b)(5) Congress has, in effect, codified the inclusionary aspect of the tax benefit rule, necessarily precludes the application of the rule's exclusionary aspect.

We find persuasive the rationale in such taxpayer favorable cases as American Financial Corp., supra and Allstate Insurance, supra and would not litigate the issue in these cases again.



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