Internal Revenue Service

Department of the Treasury

Washington, DC 20224

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Date: September 17, 2001

LEGEND:

X =
Y =
Z =
W =
Date 1 =
Location 1 =
Location 2 =
Year 1 =
Year 2 =
Year 3 =
d =

Dear :

This responds to your request for a ruling on behalf of X, a corporation engaged in business in the high-technology areas of systems integration, defense electronics, products, and avionics, as well as information technology for clients in the public and private sectors. You requested a ruling regarding the tax treatment of certain payments to be received by X from Z, a government agency, pursuant to an agreement to provide goods and services to Z. X will provide these goods and services through certain business operations, purchased from Y, a corporation engaged in businesses similar to that of X. The business operations that X is purchasing from Y include business assets and real property at Location 2. X and Y finalized the purchase agreement on Date 1.

FACTS:

In order to understand the relationship of X and Z under the proposed transaction, it is important first to set forth the background of the relationship between Y and Z. Y has been engaged in businesses that include providing goods and services to Z, at sites including Location 1 and Location 2.

In Year 1, environmental contamination caused by Y's work for Z was discovered at Location 1. It is estimated that completion of the necessary remediation may take as many as 40 years. In Year 2, Y began litigation against Z to recover the remediation costs (on the grounds that the remediation expenses were chargeable to Z as costs of providing goods and services). In Year 3, Y and Z entered into a settlement under which Z made certain cash payments to Y. Z also agreed to bear 65 percent of future remediation costs at Location 1. However, because of budgetary and appropriations concerns, Z determined that it would not pay its share of future remediation costs directly to Y. Instead, Z determined that its share of the future remediation costs incurred by Y would be treated as an allowable overhead cost of Y, which Y could include in its prices for goods and services sold to Z under their ongoing contractual relationship (which involves a cost-plus-profit payment arrangement). No additional profit would be included due to this additional "cost."

Contamination was subsequently discovered at Location 2, also caused by Y's work for Z. In Year 3, a "global settlement" was entered into by Y and Z, establishing a single environmental remediation overhead account covering 88 percent of costs incurred at both Location 1 and Location 2. The global settlement relates only to past contamination that occurred during the business operations of Y in performing contracts with Z, and does not consider the costs of any subsequent or future contamination.

The global settlement contemplates the effect of any transfer or sale of Y's business operations at either Location 1 or Location 2. Under the settlement, Y would continue to conduct remediation at Location 1 and Location 2, and the transferee would include as an allowable charge in its government contract pricing the allowable remediation costs related to the transferred business. Z would pay the allowable amount to the transferee, which would accept it on behalf of Y. The settlement agreement uses the mechanism of permitting a transferee to include the remediation costs as an allowable charge in its government pricing because of a concern that Z may not have the authority to make a retroactive price adjustment for products or services previously rendered by Y to Z. The settlement agreement also forbids Y from including in its allowable overhead for its remaining businesses any remediation cost related to a transferred business that it fails to collect from Z through the transferee of the transferred business.

Under the Date 1 purchase agreement, Y will transfer operations at Location 2 to X, selling both the business assets and the real property. Pursuant to an "environmental agreement" also entered into on Date 1, and incorporated into the purchase agreement, Y will agree to retain responsibility for pre-closing contamination and any remediation costs. X will not assume the environmental remediation liability covered by the global settlement; Y will continue cleanup operations and Y (or its parent corporation) will indemnify X for any liability relating to the remediation. X and Y have agreed that X will promptly remit to Y any amounts received from Z related to the environmental remediation. In addition, X intends to enter into an agreement with W, prior to acquiring the Location 2 business assets and taking title to the real property, that will provide X with a covenant not to sue by W and protection from claims of third parties, such as other potentially responsible parties, associated with the environmental remediation at Location 2. X will pay $d to W for this agreement.

X and Z are currently finalizing the contract under which X will replace Y in providing goods and services at Location 2. As the drafted contract is currently written, Z specifically recognizes its obligation to defray Y's remediation costs under the "global settlement," and it agrees that amounts paid to X for these remediation costs are paid to X as a collection agent of Y. You have represented that the parties do not anticipate the final contract will differ materially from the drafted documents.

RULING REQUESTED:

You have requested a ruling that, following the proposed transaction described above, payments by Z for the remediation costs allocable to Location 2 will not be includible in X's gross income.

LAW AND ANALYSIS:

Section 61 of the Internal Revenue Code provides that "gross income" means all income from whatever source derived. In Commissioner v. Glenshaw Glass Co., 348 U.S. 429 (1955), 1955-1 C.B. 207, the Supreme Court defined income to include all accessions to wealth that are clearly realized and over which taxpayers have complete dominion.

As a general rule, income is taxed to the person who earns it. See Kenseth v. Commissioner, No. 00-3705 (7th Cir. 2001). A taxpayer who assigns or transfers compensation for services to another individual or entity fails to relieve himself of federal income tax liability under the "anticipatory assignment of income" doctrine, regardless of the motivation behind the transfer. Lucas v. Earl, 281 U.S. 111 (1930).

However, the courts and the Internal Revenue Service have recognized certain limited exceptions to this general rule. One of these exceptions is that amounts received by an agent on behalf of a principal, and later transferred to the principal, are not taxable to the agent. In Commissioner v. Bollinger, 485 U.S. 340, 346-347 (1988), the Supreme Court clarified the criteria established in National Carbide Corp. v. Commissioner, 336 U.S. 422 (1949), 1949-1 C.B. 165, for determining whether an agency relationship exists. The Court set out four indicia and two requirements ("the six National Carbide factors") for agency status:

> [1] Whether the [purported agent] operates in the name and for the account of the principal, [2] binds the principal by its actions, [3] transmits money received to the principal, and [4] whether receipt of income is attributable to the services of employees of the principal and to assets belonging to the principal are some of the relevant considerations in determining whether a true agency exists. [5] If the corporation is a true agent, its relations with its principal must not be dependent upon the fact that it is owned by the principal, if such is the case. [6] Its business purpose must be the carrying on of the normal duties of an agent.

The Court recognized that it is reasonable for the Commissioner to demand unequivocal evidence of the genuineness of the agency relationship, and that such genuineness is adequately assured when the fact that the corporation is acting as agent for its shareholders with respect to a particular item is set forth in a written agreement, the corporation functions as agent and not principal with respect to the item for all purposes, and the corporation is held out as the agent and not principal in all dealings with third parties relating to the item.

The Service has issued revenue rulings dealing with agency relationships. In Rev. Rul. 76-479, 1976-2 C.B. 20, physician members of a nonprofit research and educational foundation were required to remit fees received from clinical patients to the foundation. The physicians had no control over the fees charged or the collection and disbursement of such fees. The ruling holds that the physician members acted as agents of the foundation, and the fees were not includible in their gross income. Rev. Rul. 74-321, 1974-2 C.B. 16, holds that a farm production credit association, in administering group credit life insurance for its members, acted as an agent of the members in receiving premiums from the members and dividends from the insurance company. The credit association had only ministerial powers over the funds and could not divert the funds to its own purposes. Similarly, Rev. Rul. 75-370, 1975-2 C.B. 25, holds that a condominium management corporation was an agent of its shareholders with respect to certain special assessments, separately accounted for, as it received no benefit from the funds and was under a fiduciary duty to spend the amounts solely for the benefit of the shareholders.

Applying the relevant National Carbide factors, it appears that amounts received by X with respect to the environmental remediation will be received as an agent of Y, and will not be includible in X's gross income:

- [1] Whether X operates in the name and for the account of Y.

  With respect to the remediation payments, it is clear from the agreements among X, Y, and Z that X is acting in the name of and for the account of Y. In the documents concerning the transaction, Z recognizes its pre-existing liability to Y regarding environmental remediation costs, and it has acknowledged that its payments to X for this item are intended to satisfy that liability and that X receives the payments as collection agent for Y. Y will perform the environmental remediation and pass along receipts and invoices to X for submission to Z, and X is obligated to pay any amounts it receives for this item to Y. In addition, because of its agreement with W, the payments X receives and passes along to Y do not discharge any liability of X with respect to environmental remediation.

- [2] Whether X binds Y by its actions.

  It is clear that under the contracts involved, if X bills Z to recoup Y's remediation costs and receives the payment, Y will not then be able to seek the payment for these costs from Z.

- [3] Whether X transmits money received to Y.

  The agreement between X and Y requires X to pay over all amounts received from Z with respect to the environmental remediation.

- [4] Whether receipt of income is attributable to the services of employees of Y and to assets belonging to Y.

  The environmental remediation is performed by employees or assigns of Y. None of the remediation is performed by X or its assigns.

- [5] If X is a true agent, its relations with Y must not be dependent upon the fact that it is owned by Y, if such is the case.

  X is unrelated to Y, so this factor is irrelevant.

- [6] X's business purpose must be the carrying on of the normal duties of an agent.

  Although X is not in the business of being a collection agent, with respect to the payments for environmental remediation it accounts for the payments and remits them to Y in the same manner as an agent.

In addition, X's position with respect to the remediation payments is similar to that of the physicians with respect to fees from teaching cases in Rev. Rul. 76-479. Specifically, X was required as a condition of purchasing Location 2 to enter into the reimbursement arrangement with respect to the remediation payments, X has no control over the amount of those payments, and X must remit all such payments to Y. X is required to collect the payments solely due to a pre-existing settlement that is designed to implement Y's goal of recovering a portion of its remediation costs from Z. Also, like the farm production credit association that received insurance premiums and dividends in Rev. Rul. 74-321, and the condominium association that received the special assessments in Rev. Rul. 75-370, X has only ministerial powers over the remediation payments it receives from Z and cannot use those payments for its own benefit.

Although the anticipated contract between X and Z will treat these payments as payments for the provision of goods and services by X (which would ordinarily be includible in X's income), this treatment is, in substance, a way of ensuring that Z will be able to fund its environmental remediation liability to Y. The totality of the agreements among X, Y, and Z explicitly contemplate that X exercises no dominion or control over the environmental remediation payments, and is merely a conduit for these payments from Z to Y. In fact, the payments are not related to X's provision of goods and services to Z, but rather relate to the pre-existing liability between Y and Z, and X does not earn a profit related to this additional "cost" under the proposed cost-plus-profit contract with Z.

The facts of this case are clearly distinguishable from a situation involving a taxpayer whose earnings are subject to payment to a third party under a separate agreement or obligation. For example, in Bennett v. Commissioner, 23 T.C. 1073 (1955), the taxpayer, a film director, could not exclude certain payments he received from a movie studio for a temporary directing job that he was obligated to pay over to another studio that had him under exclusive contract. In that case, there was no contractual arrangement or pre-existing liability between the two studios, and it was clear the payment was specifically for services rendered by the taxpayer.

CONCLUSION

Based strictly on the information submitted and the representations made as set forth above, and assuming the final contract between X and Z is materially unchanged from the draft agreements regarding the treatment of remediation payments, amounts received by X from Z with respect to the environmental remediation costs incurred by Y will not be includible in X's gross income under § 61.

CAVEATS:

Except as expressly provided in the preceding paragraph, no opinion is expressed or implied concerning the tax consequences of any aspect of any item discussed or referenced in this letter. A copy of this letter must be attached to any income tax return to which it is relevant. We enclose a copy of the letter for this purpose.

This ruling is directed only to the taxpayer(s) requesting it. Section 6110(k)(3) provides that it may not be used or cited as precedent.

Sincerely,
Michael J. Montemurro
Senior Technician Reviewer, Branch 4
Office of Associate Chief Counsel
(Income Tax & Accounting)

cc: