

## Part I

### Section 1341. Computation of Tax Where Taxpayer Restores Substantial Amount Held Under Claim of Right

26 CFR 1.1341-1: Restoration of amounts received or accrued under claim of right. (Also ' 263A.)

Rev. Rul. 2004-17

#### ISSUES

Do amounts paid or incurred in the current taxable year to remediate environmental contamination that occurred in prior taxable years qualify for treatment under ' 1341 of the Internal Revenue Code?

#### FACTS

##### *Situation 1*

*N* manufactures products that it sells to wholesalers and retailers. *N*'s manufacturing process creates hazardous waste. *N* uses an accrual method of accounting and the calendar taxable year. From the inception of its business in 1950 until 1979, *N* buried the hazardous waste on land that it owned in accordance with then applicable state, federal, and local environmental laws. *N* accounted for waste disposal costs as a deductible expense under § 162.

Significantly stricter state, federal, and local hazardous waste disposal laws were enacted in later years. In 2004, in order to comply with current environmental laws, *N* incurs expenses for all necessary services to eliminate soil and water contamination caused by the buried waste, transport the waste to a waste disposal facility that complies with current environmental laws, and restore the land.

##### *Situation 2*

The facts are the same as in *Situation 1* except that *N* accounted for waste disposal costs as a production cost in calculating its inventory costs for all years.

#### LAW AND ANALYSIS

Section 1341 applies if: (1) the taxpayer included an item in gross income for a

prior taxable year (or years) because it appeared that the taxpayer had an unrestricted right to the item, (2) a deduction is allowable to the taxpayer for the taxable year because it was established after the close of the taxable year (or years) of inclusion that the taxpayer did not have an unrestricted right to the item or to a portion of the item, and (3) the amount of the deduction exceeds \$3,000. Section 1341(a)(1) - (3).

If ' 1341 applies, the chapter 1 tax for the taxable year equals the lesser of: (1) the tax for the taxable year computed with the current deduction, or (2) the tax for the taxable year computed without the deduction, less the decrease in tax for the prior taxable year (or years) that would have occurred if the item or portion thereof had been excluded from gross income in the prior taxable year (or years). Section 1341(a)(4) and (5). Section 1341 ensures that the taxpayer=s position is not worse than the position the taxpayer would have been in if the taxpayer had not included the item or portion thereof in gross income in the earlier year (except for the time value of money).

Section 1.1341-1(a)(1) of the Income Tax Regulations 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 a claim of right.

Under the claim of right doctrine, a taxpayer that receives an amount under a claim of right without restriction on disposition must include the amount in gross income in the taxable year received, notwithstanding that the taxpayer=s right to retain the amount received may be uncertain and the taxpayer subsequently may be required to restore the amount to the rightful owner. *North American Oil Consol. v. Burnet*, 286 U.S. 417, 424 (1932).

In *United States v. Lewis*, 340 U.S. 590 (1951), the Supreme Court concluded that a taxpayer who was required under the claim of right doctrine to include a bonus in income in the taxable year received, and who had to repay part of the bonus in a later year, could not amend his tax return for the earlier year. The taxpayer=s only remedy was to deduct the amount repaid in the taxable year in which the taxpayer restored it to the payor. The Court followed the principle that income is properly reported under the claim of right doctrine in the year received, consistent with a tax system based on annual rather than transactional accounting. See *Burnet v. Sanford & Brooks Co.*, 282 U.S. 359, 364, 365 (1931).

The application of the claim of right doctrine may result in an inequity when, because of changes in tax rates or other circumstances, the tax increase resulting from the income inclusion in the earlier year exceeds the tax decrease that results from the deduction in the later year. Congress enacted ' 1341 to ameliorate this inequity in cases such as *Lewis*, in which a taxpayer receives an amount that it is required in a later taxable year to restore or repay to another claimant. See S. Rep. No. 1622, 83d Cong. 2d Sess. 118 (1954)

(AUnder present law if a taxpayer is obligated to *repay* amounts which he had *received* in a prior year and included in income because it appeared that he had an unrestricted right to such amounts, he may take a deduction in the year of restitution@) (emphasis added); H.R. Rep. No. 1337, 83d Cong. 2d Sess. 86 (1954) (same).

Section 1341(a)(2) requires that it be established after the close of the taxable year or years that the taxpayer did not have an unrestricted right to the item of gross income or portion thereof. To satisfy this test the taxpayer must repay or restore the item or portion of the item to another claimant. Section 1.1341-1(a)(1); see also *Chernin v. United States*, 149 F.3d 805 (8<sup>th</sup> Cir. 1998) (relying on a legislative history [that] is replete with references to repayment, restoration, and restitution@); S. Rep. No. 1622, 83d Cong. 2d Sess. at 118; H.R. Rep. No. 1337, 83d Cong. 2d Sess. at 86.

For purposes of § 1341, to restore an item included in income, the repayment must arise out of the same circumstances, terms, and conditions as the original payment of the item to the taxpayer. *Griffiths v. United States*, 54 Fed. Cl. 198 (2002). The fact that the amount of the repayment bears no relationship to the amount included in income indicates that the repayment does not arise from the same or specific circumstances, terms, and conditions as the original transaction. *Bailey v. Commissioner*, 756 F.2d 44 (6<sup>th</sup> Cir. 1985); *Uhlenbrock v. Commissioner*, 67 T.C. 818 (1977).

In both *Situation 1* and *Situation 2*, the environmental remediation costs *N* incurs in 2004 do not qualify for treatment under § 1341(a). *N* did not include an item in gross income that *N* is repaying or restoring in a later year. In these situations, the item of gross income for purposes of § 1341(a) is the proceeds received from the sale of *N*'s products from 1950 to 1979. See Rev. Rul. 72-28, 1972-1 C.B. 269. During 1950 to 1979, *N* had an unrestricted right to the proceeds received from the sale of *N*'s products during those years. In 2004, *N*'s right to the sales proceeds received during 1950 to 1979 remains unrestricted. *N*'s payment of the environmental remediation costs does not restore in a later taxable year any portion of the proceeds received from the original sale of *N*'s products in 1950 through 1979. Moreover, *N*'s obligation to incur the environmental remediation costs does not arise from the same or specific circumstances, terms, or conditions as the original sale of *N*'s products in 1950 to 1979. The amount of *N*'s environmental remediation costs bears no relation to the amount of proceeds received from the sale of *N*'s products in 1950 to 1979. Accordingly, *N*'s payment of environmental remediation costs in 2004 is not a repayment or restoration of an item included in gross income. *N*'s environmental remediation costs do not satisfy the repayment or restoration requirement of § 1341(a)(2).

Section 1341(a)(2) also requires, as a prerequisite to § 1341 treatment, that a

deduction must be allowable to the taxpayer for the repayment or restoration of the item included in income. Section 1341 itself provides no right to a deduction. Instead, the deduction must be allowable under another provision of the Code. Section 1.1341-1(a)(1); *Wood v. United States*, 863 F.2d 417, 420 (5<sup>th</sup> Cir. 1989); *MidAmerican Energy Co. v. Commissioner*, 114 T.C. 570, 583( 2000), *aff=d*, 271 F.3d 740 (8<sup>th</sup> Cir. 2001).

Inventory costs under ' 263A are recovered through cost of goods sold when the inventory is sold. Section 1.263A-1(c)(4). Costs of goods sold, or inventory costs, are not deductions but are properly treated as adjustments to gross income. Section 1.61-3(a). Environmental remediation costs incurred by reason of a production activity must be included in inventory costs. See Rev. Rul. 2004-18, 2004-8 I.R.B. (clarifying Rev. Rul. 94-38, 1994-1 C.B. 35); ' 1.263A-1(e)(3). Thus, under ' 263A, N=s environmental remediation costs are inventory costs, not deductions. Furthermore, in *Situation 2*, because the environmental remediation costs N incurs in 2004 would have been accounted for under N=s method of accounting as inventory costs in 1950 through 1979 if incurred in those earlier years, the costs are properly treated as inventory costs under N=s method of accounting when incurred in 2004. Therefore, N=s environmental remediation costs do not qualify for treatment under ' 1341 because the costs are inventory costs and do not satisfy the deduction requirement of § 1341(a)(2).

Section 1341(b)(2) provides that ' 1341(a) does not apply to any deduction allowable with respect to an item included in gross income by reason of the sale or other disposition of the taxpayer=s stock in trade (or other property of a kind that would have been included in the taxpayer=s inventory if on hand at the close of the prior taxable year) or property held by the taxpayer primarily for sale to customers in the ordinary course of its trade or business. Thus, even if N=s environmental remediation costs constituted deductible expenses rather than inventory costs recovered through cost of goods sold, ' 1341(a) would not apply. N=s environmental remediation costs are a consequence of the manufacture and sale of N=s products and, if not an inventory cost, would be deductible as an ordinary and necessary business expense of selling N=s products. Accordingly, in both *Situations 1* and *2*, the environmental remediation costs would be allowable with respect to an item that is included in gross income by reason of the sale of N=s products and would not be eligible for ' 1341(a) treatment by reason of ' 1341(b)(2).

## HOLDING

Amounts paid or incurred in the current taxable year to remediate environmental contamination that occurred in prior taxable years do not qualify for treatment under ' 1341.

**DRAFTING INFORMATION**

The principal author of this revenue ruling is Forest Boone of the Office of Associate Chief Counsel (Income Tax & Accounting). For further information regarding this revenue ruling, contact Mr. Boone at 202-622-4960 (not a toll-free call).