Internal Revenue Service

Number: **200518014**
Release Date: 5/6/2005
Index Number: 61.00-00, 61.49-01, 162.00-00, 162.02-00

Department of the Treasury
Washington, DC 20224

Third Party Communication: None
Date of Communication: Not Applicable

Person To Contact:
, ID No.
Telephone Number:

Refer Reply To:
CC:ITA:4
PLR-129030-04

Date:
December 30, 2004

TY-

Legend

B =
C =
X =
Y =
DATE 1 =
YEAR 1 =
YEAR 2 =
YEAR 3 =
$X =
$Y =
$A =
YEAR 4 =
YEAR 5 =
DATE 2 =
$Z =
DATE 3 =

:

This responds to your request for a private letter ruling dated May 21, 2004, regarding the taxability of a payment received by B from C, and the deductibility of that payment by C.

On DATE 1, C and B entered into a Purchase and Sale Agreement (Agreement) for the sale of C's subsidiaries, X and Y to B. B included the two companies in its YEAR 1 U.S.

consolidated income tax return. B paid the entire purchase price for X and Y under the Agreement in YEAR 1 and YEAR 2. No amounts pertaining to any period prior to the closing date remain unpaid.

The Agreement contains a tax indemnity section concerning liabilities for taxes for the straddle periods in pre-closing and post-closing years. Under the Agreement, because C was liable for all pre-closing period taxes, C would be entitled to the benefit of any loss or deduction related to the pre-closing period. In the event that B received a refund of taxes related to pre-closing-period taxes paid by C, the Agreement required that B pay that refund over to C. The Agreement also generally required that B carry forward all of X's and Y's losses which otherwise would be carried back to C's tax year. Thus, C had no right to any net operating loss (NOL) carry back.

In YEAR 4, X and Y, now owned and operated by B, incurred net operating losses of $X and $Y, respectively. Although the Internal Revenue Code generally allows a two-year carryback period, Congress, in YEAR 4, amended § 172(b)(1) to allow certain taxpayers to carry NOLs generated in YEAR 3 or YEAR 4 back five years. Under the new law, B could cause the subsidiaries to carry the NOLs back five years so that C would benefit from X's and Y's NOL deductions in the carryback years. Conversely, B may waive the five-year carry back period under § 172(b)(3).

In YEAR 5, B contacted C and offered to carry back the YEAR 4 losses to a tax year in which C owned X and Y. Consequently, C and B entered into an oral agreement under which B would carry back the YEAR 4 NOLs in exchange for a fee equal to a percentage of C's anticipated refund. On DATE 2, B and C entered into a written agreement (NOL Carryback Agreement) memorializing the prior oral agreement under which the two companies agreed that B would not elect to relinquish the carryback period for the YEAR 4 losses, resulting in the YEAR 4 losses being carried back to C's consolidated return years. In consideration for B not making a § 172(b)(3) election, C agreed to pay B two-thirds of any refund C received as a result of the YEAR 4 losses, plus $A.

Pursuant to the NOL Carryback Agreement, B reported the YEAR 4 losses, but did not elect to relinquish the carryback period. C filed for a refund, claiming the YEAR 4 losses. In DATE 3, C received a refund. C transferred $Z to B in satisfaction of its obligation under the NOL Carryback Agreement. C intends to deduct $Z for its YEAR 5 tax year. B intends to report $Z received as income for its YEAR 5 tax year.

LAW AND ANALYSIS

Whether Payment is included in B's gross income

Section 61(a) provides that, except as otherwise provided by law, gross income means all income from whatever source derived.

Broad includibility of income was endorsed in *Commissioner v. Glenshaw Glass Co*., 348 U.S. 426 (1955), in which the Supreme Court of the United States held that the concept of gross income includes accessions to wealth, clearly realized, and over which the taxpayers have complete dominion.

Under § 64, ordinary income includes any gain from the sale or exchange of property which is neither a capital asset nor property described in § 1231(b).

On receipt of the payment under the NOL Carryback Agreement, B had an accession to wealth. Thus, C's payment to B under the NOL Carryback Agreement is included in B's gross income under § 61. Further, since the NOL Carryback Agreement did not involve the sale or exchange of a capital asset or property described in § 1231(b), the payment constitutes ordinary income to B under § 64.

Whether payment made by C is deductible under § 162

Section 162 permits a taxpayer to deduct "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business." Deductions, however, are a matter of legislative grace, and the taxpayer must point to specific provisions of the Internal Revenue Code that purport to allow the claimed deduction. *INDOPCO, Inc. v. Commissioner*, 503 U.S. 79, 84 (1992). In addition, the taxpayer is not entitled to a "double deduction," i.e., two deductions under two provisions of the Code for the same item. Section 1.162-1 of the Income Tax Regulations.

An expense is deductible under § 162 if it is "ordinary" and "necessary." An expense is "ordinary" if it is normal, usual, or customary in the trade or business, even if it happens only once in a taxpayer's lifetime. *Welch v. Helvering*, 290 U.S. 111, 113-14 (1933). A "necessary" expense is appropriate and helpful for the development of the taxpayer's business. *Welch*, 290 U.S. at 113. In asserting that the payment is an ordinary and necessary business expense, C contends that the payment does not relate back to the Agreement, which was a capital transaction. Under the *Arrowsmith* doctrine, when a later transaction is sufficiently related to an earlier transaction, the later transaction will be treated as having the same character as the earlier transaction. *Arrowsmith v. Commissioner*, 344 U.S. 6, 8-9 (1952).

In *Arrowsmith*, two individual shareholders liquidated their corporation and divided the proceeds equally. The shareholders reported the resulting gain as capital gain. Four years later, a judgment was rendered against the liquidated corporation and one of the shareholders. The shareholders each paid one-half of the judgment as transferees of the assets of the old corporation and deducted their payments as ordinary losses. The Commissioner determined that the loss claimed by the stockholders was part of the corporate liquidation and classified the loss as capital. The Supreme Court agreed with the Commissioner, stating that "their liability as transferees was not based on any ordinary business transaction of theirs apart from the liquidation proceeding." *Id.* at 8. The Court considered the judgment as simply the last event in the liquidation begun four years later. The stockholders, in effect, were required to return a portion of the assets received in the liquidation. The Court held that because the original distribution of assets was a capital transaction, the return of assets resulted in a capital loss.

The Supreme Court applied *Arrowsmith* in *United States v. Skelly Oil Co.*, 394 U.S. 678 (1969). In that case, the taxpayer had overcharged customers for natural gas over a period of several years. During this same period, the taxpayer was allowed a 27½% depletion allowance as a direct offset to income from those same receipts. When the taxpayer refunded the overcharges, it deducted the full amounts. The Court determined that the taxpayer was not entitled to deduct the full amounts of the overcharges refunded. An offset was required by the same percentage as was allowed for depletion in prior years. In explaining its decision, the Court stated:

> The rationale for the *Arrowsmith* rule is easy to see; if money was taxed at a special lower rate when received, the taxpayer would be accorded an unfair tax windfall if the repayments were generally deductible from receipts taxable at the higher rate applicable to ordinary income. The Court in *Arrowsmith* was unwilling to infer that Congress intended such a result. . . . We cannot believe that Congress intended to give taxpayers a deduction for refunding money that was not taxed when received.

Skelly Oil, 294 U.S. at 685.

Courts generally cite *Arrowsmith* for the principle that two transactions, one occurring subsequent to the other, and each integrally related, should be treated as parts of the same transaction, so that the subsequent event should relate back and be given the same effect and treatment as the prior. This relation-back doctrine is premised on the idea that the tax consequences should be the same as if the prior and the subsequent transactions had occurred at the same time. *Seagate Technology, Inc. v. Commissioner*, 80 T.C.M. (CCH) 759, 763 (2000). The *Arrowsmith* doctrine is commonly employed to distinguish between capital and ordinary treatment.

The United States Tax Court applied the *Arrowsmith* doctrine to a renegotiation of a prior sale in *Wener v. Commissioner*, 24 T.C. 529 (1955), *aff'd*, 242 F.2d 938 (9th Cir. 1957). In *Wener*, the taxpayers were partners in a partnership and conveyed their partnership interests to other partners, receiving a cash downpayment and an agreement to receive the remainder of the purchase price over three installments. In the year following the sale, due to a pressing need for funds, the taxpayers negotiated a settlement of the remaining installment obligations. The taxpayers settled for an immediate cash payment that was less than the amount remaining under the installment agreement, and treated the difference as an ordinary loss. The court rejected the taxpayer's argument that the sale and the settlement were two separate transactions.

> [P]rior to the dates the remainder of the purchase price was to become due, there was a renegotiation, adjustment, or revamping of the sale itself

> both as to price and the terms of payment. . . . [T]here was . . . a renegotiation and revision of the unexecuted provisions of the sales contract itself and the substitution of new provisions therefor.

Id. at 532-33.

Courts also use *Arrowsmith* to determine the capital or ordinary character of damages paid by a party to a sale transaction in settlement of a claim relating to the sale. For example, in *Kimbell v. United States*, 490 F.2d 203 (5th Cir. 1974), the taxpayer sold his interest in two oil and gas leases and reported a long-term capital gain. It was later discovered that the wells were illegally slanted and production was stopped. A bank that held a security interest in the leases from the buyer threatened to sue the taxpayer. Subsequently, the taxpayer settled the claim based upon fraud and deducted the payment as a § 162 expense. The court concluded that *Arrowsmith* was controlling and characterized the settlement proceeds as an adjustment to the purchase price of the oil and gas leases.

The present case, however, is distinguishable from the *Arrowsmith* line of cases. The payment from C to B is not so integrally related to the Agreement in YEAR 1. The payment was made pursuant to a separate agreement of the parties in YEAR 5 and as a result of an amendment to § 172 in YEAR 4. Although the NOL Carryback Agreement essentially waives B's YEAR 1 covenant to carry forward all NOLs from the two subsidiaries, there otherwise was no adjustment, renegotiation, or revision to the original contract. C simply agreed to pay B not to exercise its right to waive the five-year carryback period. Because the parties could not possibly have contemplated that C would be able to utilize the YEAR 4 losses at the time they entered into the original YEAR 1 contract, the refund payment does not relate back to the YEAR 1 purchase.

The instant case also is distinguishable from *Skelly Oil*, which often is cited for the broad proposition that a taxpayer should not get a deduction for items not included in the taxpayer's income. Under that reasoning, C would not be entitled to a deduction because it did not include the tax refund in income. Such a reading of *Skelly Oil* is too broad. The specific holding of the case is that a taxpayer may not receive a deduction for a *refund or repayment* of an item that was not included in income. *Skelly Oil*, 394 U.S. at 684-85. To allow a deduction on the original 27½% depletion allowance in that case would have resulted in a "double deduction"—the 27½% depletion allowance exclusion from gross income and a 27½% extra deduction upon refunds to customers. *Id.* at 685.

Unlike *Skelly Oil*, no refunds or repayments are present in this transaction. The facts do not indicate that C is refunding a portion of the YEAR 1 sales price paid by B. Instead, the two companies reached an agreement whereby C would receive the benefit of the NOLs generated by X and Y in exchange for a payment of . The payment from C to B represents consideration for B's forbearance—its agreement not to waive the five-year carryback period for the YEAR 4 losses. Such payments for a forbearance, when in the interest of C's trade or business, clearly are deductible under § 162. *T.J. Enterprises, Inc. v. Commissioner*, 101 T.C. 581, 589 (1993) (holding that "expenses incurred to protect, maintain, or preserve a taxpayer's business," such as a payment to induce a majority shareholder not to sell her shares, "even though not in the normal course of such business, may be deductible as ordinary and necessary business expenses").

CONCLUSIONS

1. C's payment to B under the NOL Carryback Agreement is included in B's gross income as ordinary income under §§ 61 and 64.

2. The payment from C to B under the NOL Carryback Agreement is an ordinary and necessary business expense deductible under § 162.

CAVEATS

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

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representative.

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

Sincerely,

Robert A. Berkovsky
Branch Chief
(Income Tax & Accounting)

Enclosures (2)