OFFICE OF
CHIEF COUNSEL

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR DISTRICT COUNSEL,

FROM: Deborah Butler
Assistant Chief Counsel (Field Service) CC:DOM:FS

SUBJECT:

This Field Service Advice responds to your memorandum, dated March 12, 1999. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

<u>LEGEND</u>:

Corp A =

Corp B =
Corp C =
Corp D =
Corp E =
Corp Q =
Corp R =
Corp S =
Corp T =
Corp U =
Corp X =
Date g =
Date h =
Date j =
Date k =

Date m	=
Date n	=
Date o	=
Date p	=
Country Y	=
Country Z	=
$a	=
$b	=
$c	=
Year 1	=
Year 2	=
Year 6	=
Year 8	=
Tax Year 1	=

ISSUE:

Whether Corp A may deduct certain environmental cleanup costs even though they are subject to indemnification under the agreement to sell Corp A's stock made in a previous year.

CONCLUSION:

Corp A may deduct certain environmental cleanup costs even though they are subject to indemnification under the agreement to sell Corp A's stock made in a previous year.

FACTS:

The issues presented herein pertain to Corp A, which is a wholly-owned subsidiary of Corp X, with whom it filed a consolidated income tax return for each of the years at issue. Corp A was previously a wholly-owned subsidiary of Corp B, which in turn was a wholly-owned subsidiary of Corp C.

For a number of years, Corp B, either directly or through its subsidiaries, owned and operated a wholesale and retail distribution and sales networks which involved various refineries, terminals, storage and distribution facilities, pipelines and other transportation facilities. In conducting its operations, Corp B caused pollution and contamination damage to the environment. The issues here involve claimed deductions for environmental cleanup costs incurred in the remediation of pollution and contamination associated with certain of Corp A's refining assets and operations.

Corp C acquired all of the issued and outstanding stock of Corp B during Year 1. In Year 2, Corp C and Corp B entered into negotiations with Corp X for the sale of Corp B's refining, marketing and transportation business (RMT business). To facilitate the sale of the RMT business to Corp X, Corp B formed a new wholly-owned subsidiary, Corp D (which was later renamed Corp A), and transferred to Corp D all of the refining, marketing and transportation assets earmarked for sale to Corp X. The nature and extent of the environmental damage liabilities which saddled those RMT assets were so vast and difficult to assess that the parties agreed to make the transfer free and clear of any and all such liabilities existing on the day of closing, together with any liabilities that might thereafter arise therefrom (collectively referred to as "Corp B's Retained Liabilities").

Corp C, Corp B and Corp X entered into a stock purchase agreement on Date g, in which Corp X acquired 100% of the stock of Corp A from Corp B on Date h. Under the agreement, Corp C and Corp B agreed, jointly and severally, to pay and indemnify Corp X and its affiliates for any of the above-referenced environmental damages which were part of Corp B's Retained Liabilities (the "Indemnity Agreement").

At some point during Year 2, Corp C formed Corp E as a wholly-owned subsidiary to succeed to the rights and obligations of Corp B. On Date j, Corp B transferred its remaining assets to Corp E and Corp E assumed all liabilities of Corp B. Corp E agreed to indemnify Corp B against all claims of third parties, including Corp A and Corp X. Thus, together with assuming Corp B's Retained Liabilities, Corp E assumed, jointly and severally with Corp C, Corp B's obligations and liabilities under the indemnity agreement.

Corp X held its 100% interest in Corp A for several years until Date k, when it sold 50% of its holdings in the Corp A stock to Corp Q, a Country Y company wholly-owned by Corp R. During Year 6, Corp Q transferred its 50% interest in Corp A to Corp S, a Country Z limited liability company wholly-owned by Corp T . Then, on Date m, Corp A redeemed the other 50% interest held by Corp X. As part of that redemption, Corp A acquired the existing indemnity rights against Corp C and Corp E. The redemption resulted in Corp S becoming the sole shareholder of Corp A. Lastly, on Date n, Corp S transferred total ownership of Corp A to Corp U, a wholly-owned subsidiary of Corp S. The stock ownership of Corp A remained unchanged throughout the tax years at issue here.

Corp A began incurring environmental cleanup costs on some of its properties during Year 8. Because Corp A was the owner, operator and permit holder of those properties, it was legally responsible for all of the environmental cleanup costs, whether or not those costs were costs for which it could seek indemnification under the terms of the Year 2 Stock Purchase Agreement. Corp A then attempted to obtain reimbursement for certain of the cleanup costs from Corp E pursuant to the indemnity and assumption agreements. Corp E, for the most part, rejected Corp

A's claims and refused to recognize liability for the costs. Corp A filed suit against Corp E and Corp C on Date o seeking enforcement of the indemnity agreements. The parties entered into a settlement agreement on Date p, in which Corp E and Corp C agreed to pay Corp A an up front payment of $a for the indemnities set forth in the Year 2 Stock Purchase Agreement. Under the settlement, Corp A received $b of the $a in Tax Year 1 and $c in each of next three tax years. The parties further agreed that Corp A, Corp E and Corp C would share certain other future environmental cleanup costs which could not be determined or agreed upon at the time the settlement agreement was negotiated. The settlement agreement did not modify, revoke, or otherwise change the terms contained in the Year 2 Stock Purchase Agreement.

Corp A did not include in taxable income, any of the indemnity payments it received. Rather, Corp A treated all indemnity receipts as capital contributions, asserting that the payments "relate back" to the 1983 stock purchase transaction, and merely reduced the basis of the Corp A stock. On the other hand, Corp A currently deducted all environmental cleanup costs incurred during the years at issue, including those for which indemnity payments were received. Corp A argues that the environmental cleanup costs were paid out of capital contributions.

LAW AND ANALYSIS:

You have asked whether Corp A's environmental cleanup costs should be disallowed as current deductions under the principle of Arrowsmith v. Commissioner, 344 U.S. 6 (1952), because they relate back to the sale of its stock. You have also asked whether the costs should not be deductible because they are subject to reimbursement. We have assumed that the environmental cleanup costs involved in the present case would otherwise have been deductible and not capitalized under the principles set forth in Rev. Rul. 94-38, 1994-1 C.B. 35.[1]

In Arrowsmith, two former shareholders of a liquidated corporation were required as its transferees to pay a judgment against the corporation several years after its liquidation. The gain from the liquidation had been a capital gain to the shareholders. However, they deducted the judgment payment made in the subsequent year as an ordinary loss. The Supreme Court found the loss to be capital, rather than ordinary. The Court reasoned that had the judgment payment been required during the tax year of the liquidation there was no question that the

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[1] [redacted]

payment would have been capital. Arrowsmith, 344 U.S. at 8. The Court held that the payment would still be capital even though the payment was made in a subsequent year and that this classification did not offend the well-established principle that each taxable year is a separate unit for tax purposes. Id. at 8-9.

Following Arrowsmith, subsequent indemnity payments required to be made pursuant to a transfer of stock have been found to result in an adjustment to the sale price of the stock of the buyer. See Freedom Newspapers v. Commissioner, T.C. Memo. 1977-429; Rev. Rul. 83-73, 1983-1 C.B. 84. See also Federal Bulk Carriers, Inc. v. Commissioner, 66 T.C. 283 (1976), aff'd on other grounds, 558 F.2d 128 (2d Cir. 1977); Mitchell v. Commissioner, T.C. Memo. 1994-237, aff'd, 73 F.3d 628 (6th Cir. 1996); Rev. Rul. 58-374, 1958-2 C.B. 396. Thus, you agree that in the present case the indemnity payments will be adjustments to the basis of stock of Corp A and not income or capital gain to Corp A.

The issue involved here, i.e., whether an indemnified cost connected with a transfer of stock should be deductible to the corporation indemnified, was addressed in VCA Corporation v. United States, 566 F.2d 1192 (Ct. Cl. 1977), 40 AFTR 2d 77-5429, where the cost was allowed as a current deduction. In VCA, the taxpayer entered in an agreement with Aerosol Research Company (Aerosol) and its affiliate under which the two corporations were to be merged into the taxpayer. The taxpayer obtained the assets and assumed all the liabilities of Aerosol. Aerosol and its affiliate were owned by two shareholders who, as part of the merger agreement, received stock in the taxpayer and agreed to indemnify the taxpayer for certain expenses. The taxpayer subsequently incurred an expense which was at least in a part indemnified under the merger agreement, that is, a settlement payment to an officer of Aerosol, who had sued under an employment contract. The government disallowed the deduction to the extent it was indemnified by the two shareholders.

In allowing a current deduction to the taxpayer for the full amount of the settlement payment, the court in VCA relied extensively upon the specific provisions of section 381 and the regulations thereunder. Section 381 allows an acquiring corporation to succeed to and take into account certain items of the transferor. Section 381 applies to certain types of transactions including statutory mergers, but does not apply to the transaction in the present case.

However, VCA also addressed arguments that are relevant to the present case. Specifically, the government had argued that the settlement payment should not be deductible because there was an unconditional right to reimbursement. See Canelo v. Commissioner, 447 F.2d 484 (9th Cir. 1971); Burnett v. Commissioner, 356 F.2d 755 (2d Cir. 1966), cert. denied, 385 U.S. 832 (1966). The court rejected this argument for a number of reasons. The first two reasons involved the court's view that the government's argument was inconsistent with section 381 and the regulations thereunder.

The third reason was that the indemnity should be considered an adjustment to the stock transferred under the rationale of Arrowsmith. The court in VCA relied primarily upon Estate of McGlothin v. Commissioner, 370 F.2d 729 (5th Cir. 1967), which had applied the principle of Arrowsmith to a transferor's indemnity payment. The court also noted that Rev. Rul. 58-374 had treated a similar indemnity payment as relating back to the sale of stock and as an adjustment to the sale price of the stock of the seller.

Fourth, the court in VCA rejected the government's position regarding reimbursement because it was -

> not well-founded in the kind of transaction at issue.... Not all money received from another and used to pay an expense is nondeductible. If the receipt is from a stockholder or transferring stockholder it may more properly be deemed an addition or contribution to capital, whether or not designated as for a particular purpose.

40 AFTR 2d at 77-5437. The court noted that the capital contributions would provide basis for the deduction. Id. citing I.R.C. § 362; Brown Shoe Co. v. Commissioner, 339 U.S. 583, 589 (1950); United States v. Chicago, B. & Q.R. Co., 412 U.S. 401, 405-06 (1973).

The Service followed VCA in Rev. Rul. 83-73, 1983-1 C.B. 84, which holds that the indemnified expenses arising out of a merger are deductible by the corporation indemnified. Rev. Rul 83-73 is the culmination of much consideration by the Service of the issues involved in VCA.[2] The facts of Rev. Rul. 83-73 are essentially the same as VCA and again involve extensive analysis of section 381. The revenue ruling, however, also relies upon Arrowsmith to find that "the indemnity payments should be treated as if they had been contributions to the capital of the transferor corporation, made by its shareholders immediately before the merger." 1983-1 C.B. at 85.[3]

We recognize that the present case can be distinguishable from VCA and Rev. Rul. 83-73 in that the present case does not involve the application of section 381. VCA and the revenue ruling do rely upon the specific provisions of section 381 and the regulations thereunder to allow the deductions. Nevertheless, the holdings of VCA

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[2] See [redacted] VCA, AOD CC-1980-132 (May 16, 1980); VCA, AOD CC-1981-115 (April 27, 1981); GCM 38,977(April 8, 1982).

[3] See also Rev. Rul. 95-74, 1995-2 C.B. 36, holding that environmental cleanup costs assumed by a transferee in a section 351 exchange may be deductible under section 162, even though they are arguably part of the cost of acquiring the predecessor's property.

and underlying assumptions of Rev. Rul. 83-73 would be totally inconsistent with disallowance of the costs incurred in the present case.

First, it is clear that the principle of Arrowsmith does not compel disallowance of the cleanup costs as current deductions because they relate back to the sale of the stock. If that were true, the expenses described in the Rev. Rul. 83-73 would not have been given current deduction treatment.

Second, the cleanup costs here should not be disallowed because they are subject to reimbursement. Again, if that were the case, the expenses would not be allowable in Rev. Rul. 83-73. Instead, under Rev. Rul. 83-73, the indemnity payments are to be treated as a contribution of capital to Corp A just before the sale of the stock. The rejection of the reimbursement argument is made explicit in GCM 38,977, which accompanies Rev. Rul. 83-73 and follows the reasoning of VCA on this issue.

Lastly, the tax benefit rule should not be applied to the indemnity payment and the corresponding deduction of the expense by Corp A. Compare [redacted] AOD CC-1980-132 with AOD CC-1981-115, modifying the earlier AOD.

Accordingly, we conclude that the environmental cleanup costs could be currently deductible by Corp A under section 162 even though they are subject to indemnification under the stock purchase agreement.

DEBORAH A. BUTLER

By: ______________________

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