CCH
a Wolters Kluwer business

THE M&A Tax Report

VOLUME 17, NUMBER 1
AUGUST 2008

THE MONTHLY REVIEW OF TAXES, TRENDS & TECHNIQUES

More Claim of Right Authority

By Robert W. Wood • Wood & Porter • San Francisco

Here at the M&A TAX REPORT, we recently covered what we *thought* was an isolated incident: an important claim of right case that seemed to impact tax practitioners generally as well as M&A TAX REPORT readers. The case was *Alcoa, Inc.*, CA-3, 2007-2 USTC ¶50,824, 509 F3d 173 (2007), decided by the Third Circuit. It involved the tax treatment of environmental cleanup expenses and implicitly impacts other deduct-versus-capitalize dichotomies. [*See* Robert W. Wood, *Cleaning up Environmental (and Other) Cleanup Expenses via Claim of Right?* M&A TAX REP., Feb. 2008, at 4.]

It appears, however, that this judicial *tour de force* through the claim of right doctrine was *not* an isolated incident. Indeed, the latest claim of right offering may be more important. It certainly is to Texaco!

Alcoa, Meet Texaco

In *Texaco*, 2008 TNT 116-47 (9th Cir. 2008), the Ninth Circuit Court of Appeals reversed a district court award in favor of Texaco with a jaw-dropping figure. Texaco had achieved a favorable district court decision granting it more than a $100 million refund. The Ninth Circuit put the kibosh on the deduction, and our old friend the claim of right doctrine now may be cocktail party conversation among tax practitioners once again.

Tortured History

The very short version of Texaco's history pertinent to this tax refund case is hardly short. Between 1973 and 1981, Texaco sold crude petroleum and refined petroleum products at prices that exceeded federal price ceilings. Oops! Texaco included the overcharges as gross income in its 1973 though 1981 tax returns. However, the Department of Energy dogged Texaco in various administrative proceedings.

Eventually Texaco entered into a consent decree with the Department of Energy that required Texaco to pay $1.25 billion plus interest.

ALSO IN THIS ISSUE

Texaco made the payments and deducted the settlement amount for the years in question as ordinary and necessary business expenses.

In 2001, Texaco filed refund claims for its 1988, 1990, 1991 and 1992 tax years. The theory of the refund claims was that the tax benefit of the ordinary and necessary business expense deductions should have been calculated under Code Sec. 1341. The government denied the refund claims, so in 2004, Texaco filed suit in district court.

On cross motions for summary judgment, the district court concluded that Code Sec. 1341(b)(2) did not preclude Texaco from reaping the benefits of Code Sec. 1341(a). The Code Sec. 1341(b)(2) subsection in question says that Code Sec. 1341 does *not* apply with respect to an item included in gross income by reason of a sale of inventory. The district court said this provision did not apply (to preclude Code Sec. 1341 benefits) because the statute was ambiguous. Plus, other sources (including the legislative history) suggested that Texaco was right that Code Sec. 1341(b)(2) only prohibited using Code Sec. 1341 for "sales returns, allowances and similar items."

Back to Basics

The Ninth Circuit started its romp through the history of the claim of right doctrine with U.S. Supreme Court cases from the 1930s. Then, in 1951, the U.S. Supreme Court observed that a taxpayer who is required in a later year to restore to a third-party income it previously received is entitled to a deduction if the payment is deductible under some other provision of the Internal Revenue Code. [*See E.R. Lewis*, SCt, 51-2 USTC ¶9211, 340 US 590 (1951).] The understandable goal is to provide fairness to a taxpayer who is whipsawed between multiple years, and who may not get the full measure of an appropriate deduction in the later year.

Code Sec. 1341 essentially bridges that divide. After all, absent this statutory provision, a deduction in the year of repayment may result in a savings that is less—perhaps enormously less—than the amount of increased tax as a result of the taxpayer's original inclusion of the amount. With Code Sec. 1341, the taxpayer is able to recover the taxes he paid in the initial year.

Whether this is good tax policy or not is not relevant. Arguably, there is some degree of manipulation permissible because taxpayers usually can choose to apply or not to apply the provision. Yet, as the Third Circuit recently noted in *Alcoa*, allowing the taxpayer a choice between a simple deduction and a recalculation of the prior year's tax liability ensures that any change in rates (or in the taxpayer's tax bracket) is tax neutral. [*See Alcoa, supra*, 509 F3d 173, 177.]

Inventory Sale

The sole (but very large) legal question present in *Texaco* was whether Code Sec. 1341(b)(2) took away the applicability of Code Sec. 1341 on Texaco's facts. Interestingly, Texaco conceded that during 1973 through 1981, all of Texaco's sales of crude oil and petroleum products were sales of inventory. Because the income in question arose out of inventory sales, the IRS asserted that Texaco was barred from using Code Sec. 1341(a).

THE M&A Tax Report
THE MONTHLY REVIEW OF TAXES, TRENDS & TECHNIQUES

EDITOR-IN-CHIEF
Robert W. Wood

MANAGING EDITOR
Kurt Diefenbach

COORDINATING EDITOR
Tara Fenske

PRODUCTION EDITOR
Don Torres

THE M&A TAX REPORT (ISSN 1085-3693) is published monthly by CCH, 4025 W. Peterson Ave., Chicago, Illinois 60646.
Subscription inquiries should be directed to 4025 W. Peterson Ave., Chicago, IL 60646.
Telephone: (800) 449-8114. Fax: (773) 866-3895. Email: cust_serv@cch.com.

Thus, the question was what Congress meant by the inventory exclusion in Code Sec. 1341(b)(2).

Statutory meaning involves language, and the Ninth Circuit's *Texaco* opinion contains enough mention of grammar, construction and syntax to make an English major proud. A good bit of the opinion talks about plain meaning, which words and phrases modify others, and stylistic discussion of similar ilk. There is also discussion of the regulations under Code Sec. 1341, with a similar sentence structure and syntax bent.

Quoting from another oil company case, *Pennzoil-Quaker State, Co.*, FedCl, 2008-1 USTC ¶50,131, 511 F3d 1365 (2008), the court even included citations to a stylebook on the meaning and use of the word "therefore." [*See* Bryan A. Garner, THE ELEMENTS OF LEGAL STYLE 141 (1941), quoted in *Pennzoil-Quaker State, Co., supra*, 511 F3d 1365, 1372.]

Ultimately, the Ninth Circuit (rightly or wrongly) concluded that the language and meaning of Code Sec. 1341(b)(2) was clear, and did not suffer from ambiguity. To the court, the conclusion that Code Sec. 1341(b)(2) is plain and unambiguous meant that several Texaco arguments would be discarded. Predictably, Texaco argued about Congress's intent in enacting Code Sec. 1341, and there was (in my view anyway) at least some support for this notion.

Still, the Ninth Circuit was not persuaded, finding that such arguments could not overcome what it found to be the plain meaning of Code Sec. 1341(b)(2). That plain meaning nixed Texaco's outsized $100 million–plus claim.

IRS Too

Toward the end of the Ninth Circuit's opinion, the court also notes (more than apocryphally) that the IRS had issued Rev. Rul. 2004-17, 2004-1 CB 516. Although Texaco suggested that the ruling was "an unreasoned afterthought," the Ninth Circuit found this clear enunciation of this IRS policy was significant. The IRS is, after all, the agency charged with interpreting these laws and enforcing them.

This revenue ruling says plainly that the prohibition in Code Sec. 1341(b)(2) makes Code Sec. 1341(a) inapplicable:

> 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. [*Id.*]

Texaco noted with more than a little irony that Rev. Rul. 2004-17 was issued on February 6, 2004, shortly *after* Texaco had filed its complaint in federal district court. Good timing! Texaco argued that a revenue ruling issued during the pendency of litigation has no power to persuade. The Ninth Circuit gave a somewhat muddled answer to this, but seemed to view this primarily as a question of degree. The Ninth Circuit said it could and would consider the conclusion of the revenue ruling notwithstanding timing, especially since the Ninth Circuit found that the ruling was not based on the facts in Texaco's case.

To the court, the conclusion that Code Sec. 1341(b)(2) is plain and unambiguous meant that several Texaco arguments would be discarded.

Continued Viability

As we noted recently in connection with the *Alcoa* case, the claim of right doctrine (and the relief that Code Sec. 1341 affords) is not for everyone. It is tough and tricky. In fact, complying with Code Sec. 1341 to achieve the equalization Congress intended can be a steeplechase. That was clear in *Alcoa*, and it is doubly clear in *Texaco*.

The Assistant Attorney General of the Justice Department's Tax Division, Nathan Hochman, even issued a press release about this important government victory. Hochman stated that the Ninth Circuit respected plain statutory language, and had deferred to the IRS, which after all, is entrusted with enforcing the Code.

Boy, whoever said the Ninth Circuit was the "Taxpayer's Circuit"?