Office of Chief Counsel
Internal Revenue Service
Memorandum

Number: **AM2008-012**
Release Date: 12/19/2008

CC:ITA:B04:
POSTF-144864-08

UILC: 172.07-00, 263A.03-02

date: December 09, 2008

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subject: Application of § 172(f) to Costs Included in Inventory Under § 263A

This memorandum responds to your October 24, 2008, request for Generic Legal Advice.

ISSUE

Whether environmental remediation costs and workers compensation costs constitute specified liability losses within the meaning of § 172(f) where those costs are allocated to inventory under § 263A of the Internal Revenue Code (Code) and recovered through cost of goods sold.

CONCLUSION

Environmental remediation costs and workers compensation costs that are allocated to inventory under § 263A and recovered through cost of goods sold constitute specified liability losses to the extent they are taken into account in computing a net operating loss for the taxable year.

FACTS

The Large and Mid-Size Business Operating Division (LMSB) has identified many taxpayers engaged in manufacturing trades or businesses who pay workers compensation or incur costs to remediate environmental contamination. If not for the fact that these costs are indirectly related to the production of inventory, these costs would constitute § 162(a) deductions in the year incurred by these accrual method taxpayers.

These taxpayers properly include the remediation costs and workers compensation payments in inventory costs under § 263A. A portion of these amounts is included in cost of goods sold and therefore is taken into account in computing gross income for the taxable year. The remainder is included in ending inventory and will be taken into account in computing gross income when that inventory is sold or, more precisely, when the cost of the inventory is included in cost of goods sold under the taxpayer's method of accounting.

For purposes of this memorandum, we assume that the act or failure to act giving rise to the liabilities for environmental remediation or workers compensation occurred at least 3 years before the beginning of the taxable year. We also assume that the taxpayer used an accrual method of accounting for all relevant taxable years, that the remediation and workers compensation costs are incurred in satisfaction of a liability under a Federal or a State law, and that the taxpayer had a net operating loss as defined in § 172(c) in the taxable year.

LAW

Section 172(a) allows as a deduction for a taxable year an amount equal to the aggregate of (1) the net operating loss carryovers to such year, plus (2) the net operating loss carrybacks to such year.

Section 172(c) defines a net operating loss as the excess of the deductions allowed by Chapter 1 of the Internal Revenue Code over the gross income.

Section 172(b)(1)(A) provides that, generally, a net operating loss for any taxable year is carried back to each of the 2 taxable years preceding the taxable year of the loss and carried forward to each of the 20 taxable years following the year of the loss.

Under § 172(b)(1)(C), in the case of a taxpayer that has a specified liability loss (as defined in § 172(f)) for a taxable year, the specified liability loss shall be a net operating loss carryback to each of the 10 taxable years preceding the taxable year of such loss.

Section 172(f)(1)(B)(i) defines a specified liability loss, in part, as any amount taken into account in computing the net operating loss for the taxable year and that is allowable as a deduction under Chapter 1 of the Code (other than § 468(a)(1) or 468A(a)) which is in satisfaction of a liability under a Federal or State law requiring the remediation of environmental contamination or a payment under any workers compensation act (within

the meaning of § 461(h)(2)(C)(i)). Under § 172(f)(1)(B)(ii), a liability is a specified liability loss only if (I) the act (or failure to act) giving rise to such liability occurs at least 3 years before the beginning of the taxable year, and (II) the taxpayer used an accrual method of accounting throughout the period or periods during which such act (or failure to act) occurred. Under § 172(f)(2), the amount of a specified liability loss for a taxable year cannot exceed the amount of the net operating loss for the taxable year.

Section 263A(a) provides that the direct costs and indirect costs properly allocable to property that is inventory in the hands of the taxpayer shall be included in inventory costs.

Section 1.263A-1(a)(3)(ii) of the Income Tax Regulations requires a manufacturer of inventory to include in inventory costs (1) all direct costs of producing the inventory, and (2) the inventory's allocable share of indirect costs. Section 1.263A-1(e)(3)(i) provides that indirect costs are properly allocable to produced inventory when the costs directly benefit or are incurred by reason of the performance of production activities. Examples of indirect costs that must be allocated to inventory include cost recovery, production facility repair and maintenance costs, and scrap and spoilage costs, such as waste removal costs. *See* § 1.263A-1(e)(3)(ii)(I), (O), and (Q).

Section 1.263A-1(c)(2)(i) provides that any cost which (but for § 263A and the regulations thereunder) may not be taken into account in computing taxable income for any taxable year is not treated as a cost properly allocable to property produced or acquired for resale under § 263A and the regulations thereunder.

Section 1.263A-1(c)(2)(ii) provides that the amount of any cost required to be included in inventory under § 263A may not be included in inventory before the taxable year during which the amount is incurred within the meaning of § 1.446-1(c)(1)(ii).

Under § 461(h), in determining whether an accrual method taxpayer has incurred an amount for any item during the taxable year, the all events test shall not be treated as met any earlier than when economic performance occurs.

Section 1.263A-1(e)(3)(ii)(D) defines "employee benefit expenses" to include "all other employee benefit expenses [not described in § 1.263A-1(e)(3)(ii)(C)] to the extent such expenses are otherwise allowable as deductions under chapter 1 of the Internal Revenue Code . . . includ[ing] worker's compensation."

Rev. Rul. 94-38, 1994-1 C.B. 35, addressed costs incurred to clean up land and to treat groundwater that a taxpayer contaminated with hazardous waste from its business. The land was not contaminated when the taxpayer acquired the land, and the soil remediation and groundwater treatment restored the land to the same condition that existed before it was contaminated. The ruling holds that the soil remediation expenditures and ongoing groundwater treatment expenditures are deductible by the taxpayer as ordinary and necessary business expenses under § 162. The ruling further holds that the construction of groundwater treatment facilities, including a proper share

of allocable indirect costs of their construction, are capital expenditures under § 263 and § 1.263(a)-2(a).

Rev. Rul. 2004-18, 2004-1 C.B. 509, holds that environmental remediation costs that a taxpayer incurs to clean up land that was contaminated during its ordinary business operations of manufacturing inventory are properly allocable to the inventory that the taxpayer produces under § 1.263A-1(e)(3)(i). The ruling holds that the taxpayer must include the otherwise deductible environmental remediation costs in inventory costs under § 1.263A-1(c)(3).

Rev. Rul. 2005-42, 2005-2 C.B. 67, addressed five factual situations involving the treatment of environmental remediation costs of taxpayers that manufacture inventory. In each of the situations, the taxpayer was required to include the otherwise deductible amounts in inventory costs under § 263A.

ANALYSIS

Sections 172(f)(1)(B)(i)(IV) and (V) specifically identify workers compensation payments and environmental remediation costs as specified liability losses. LMSB asks whether these costs fail to qualify as specified liability losses if the taxpayer is a manufacturer who is required to include these costs in inventory under § 263A and recover them through cost of goods sold. LMSB indicates that the introductory language in § 172(f)(1)(B)(i) requires that workers compensation payments and remediation costs be "allowable as a deduction" under Chapter 1 of the Code. LMSB questions whether an expenditure is "allowable as a deduction" where that expenditure is required to be included in inventory under § 263A and recovered through cost of goods sold.

In a manufacturing business, "cost of goods sold" reduces the selling price of property in arriving at gross income; it is not a trade or business expense deduction allowed by § 162(a). *See* § 1.61-3(a). Although an amount recovered through cost of goods sold reduces taxable income to the same extent as an equivalent amount of allowed "deductions," case law arising in contexts outside of § 172(f) distinguishes deductions from cost of goods sold. *See B.C. Cook & Sons, Inc. v. Commissioner*, 65 T.C. 422 (1975), nonacq., 1977-2 C.B. 1, *aff'd per curiam*, 584 F.2d 53 (5th Cir. 1978) (court rejected the government's argument that an amount included in cost of goods sold was a deduction for purposes of § 1312(2)); *Max Sobel Wholesale Liquors v. Commissioner*, 630 F.2d 670 (9th Cir. 1980) (court rejected the government's argument that § 162(c)(2), which prohibits a deduction for illegal payments, precludes a taxpayer from recovering the payments through its cost of goods sold).

In our view, Congress used the phrase "allowable as a deduction" in § 172(f)(1)(B)(i) to mean amounts that may be taken into account in computing taxable income. Congress did not mean to distinguish "deductions" from "cost of goods sold." For example, amounts such as fines and penalties that are nondeductible by reason of § 162(f) cannot qualify as specified liability losses. This interpretation is consistent with § 263A.

Section 1.263A-1(c)(2)(i) prohibits taxpayers from treating as inventoriable costs amounts that "may not be taken into account in computing taxable income for any taxable year." As an example, the regulations refer to the § 274(n) disallowance of meal and entertainment expenses.

Unlike fines and penalties disallowed by § 162(f), and meals and entertainment disallowed by § 274(n), environmental remediation costs and workers compensation payments, though not deductible by a manufacturer under § 162(a), are "allowable" deductions that can be taken into account in computing taxable income under the Code. As "allowable" deductions, environmental remediation costs and workers compensation payments are both (1) eligible to be allocated to inventory to the extent required by § 263A, and (2) eligible for treatment as a specified liability loss to the extent the other requirements of § 172(f) are met.

An interpretation of § 172(f)(1)(B)(i) that prohibits manufacturers from treating environmental remediation costs and workers compensation payments as specified liability losses would limit the application of that provision to service providers and others not subject to § 263A. That reading would produce an unintended limitation because manufacturers are much more likely to incur environmental remediation and workers compensation costs than are service providers. If Congress had intended to limit § 172(f) so, it would have stated it explicitly. We see nothing in the legislative history of § 172(f) indicating that Congress intended to exclude manufacturers from obtaining specified liability loss treatment for the amounts identified in § 172(f)(1)(B)(i).

We conclude that Congress did not intend the phrase "allowable as a deduction" in § 172(f)(1)(B)(i) to disqualify expenditures merely because those expenditures are allocated to inventories under § 263A and recovered through cost of goods sold. However, we emphasize that § 172(f)(1) requires that amounts must be "taken into account in computing the net operating loss for the taxable year." Environmental remediation costs and workers compensation payments that are allocated to inventory under § 263A are taken into account in computing the net operating loss for the taxable year only to the extent they are included in cost of goods sold for that year. Environmental remediation costs and workers compensation payments allocated to inventory that remains on hand at the end of the taxable year (ending inventory) are not "taken into account in computing the net operating loss for the taxable year." Those costs may be treated as specified liability losses for the year that they are actually recovered through cost of goods sold, assuming the taxpayer has a net operating loss for that year. It is the taxpayer's responsibility to keep sufficient records as required by § 6001 of the Code to document the portion of any future year's cost of goods sold that constitutes a specified liability loss.

For example, assume that in taxable year 20X1, Manufacturer's gross receipts are $20x and cost of goods sold (CGS) is $15x. Manufacturer incurs $10x of environmental remediation costs, $2x of which is properly allocable to CGS (and is included in the $15x CGS amount above) and the remaining $8x of which is properly allocable to

ending inventory. In addition, Manufacturer incurs $25x of ordinary and necessary business expenses deductible under § 162(a), none of which constitutes a specified liability loss. Manufacturer's net operating loss (NOL) of $20x and specified liability loss of $2x are computed as follows:

NOL Computation for 20X1

Gross receipts	$20x	
CGS	(15x)	(including $2x attributable to remediation costs)
Gross income	5x	
§ 162(a) Deductions	(25x)	
NOL	$(20x)	

Specified Liability Loss Computation for 20X1

Amount of NOL	$20x
Environmental Remediation Costs Included in CGS	$2x
Specified Liability Loss (Lesser of NOL or § 172(f) Amounts)	$ 2x

The $8x of environmental remediation costs that is included in ending inventory for 20X1 will be included in the subsequent taxable year's beginning inventory. This $8x will generate a specified liability loss in the taxable year in which the cost of that inventory is included in Manufacturer's cost of goods sold, provided Manufacturer has a net operating loss in that taxable year.

Pursuant to § 6110(k)(3) of the Code, this document may not be used or cited as precedent. Please call Stephen J. Toomey at (202) 622-4920 if you have any further questions.