DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

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MEMORANDUM FOR

FROM: DEBORAH A. BUTLER
ASSISTANT CHIEF COUNSEL (FIELD SERVICE)
CC:DOM:FS

SUBJECT: Accrual of Insurance Reimbursement

This Field Service Advice responds to your request dated February 3, 2000. 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.

LEGEND

Taxpayer	=
Year A	=
Year B	=
Year C	=
Year D	=
Year E	=
Year F	=
Year G	=
Consumer product	=
State 1	=
State 2	=

ISSUES

1. Whether Taxpayer's right to receive insurance reimbursements from third-party insurers, associated with liabilities for certain tort claims, was fixed in the final two of the years at issue (Years E and F).

2. Whether Taxpayer's right to receive insurance reimbursements from third-party insurers, associated with all other non- liabilities, was fixed in the final two of the years at issue.

3. Whether Taxpayer's right to receive insurance reimbursements from its captive insurer, associated with various tort claims, including and non- claims, was fixed in the years at issue.

4. Whether Taxpayer's informal request for refund based on its attempt to change the treatment of its insurance reimbursements for tort claims was a change in method of accounting.

5. Whether Taxpayer's change in the treatment of its insurance reimbursements in Year E for non- tort claims was a change in method of accounting.

6. Whether Taxpayer's reversal in Year E of previously accrued insurance reimbursement income for all non- tort claims was proper.

7. Whether Taxpayer's right to receive an insurance reimbursement from a third-party insurer, associated with a specific site environmental tort claim, was fixed in Year E.

CONCLUSIONS

1. Because of litigation involving Taxpayer and its insurers over liability for certain tort claims, Taxpayer's right to receive insurance reimbursement income for the tort claims was not fixed in Years E and F.

2. Because none of the insurers expressly denied liability for the non- tort liabilities, Taxpayer's right to receive insurance reimbursement income for those claims was fixed for all the years at issue (Years D, E, and F).

3. Because Taxpayer's captive insurer never denied or contested liability for either or non- tort claims in the years at issue, Taxpayer's right to receive insurance reimbursement income from the captive insurer was fixed for the years at issue.

4. Taxpayer's informal request for a refund based on a change in treatment of its insurance reimbursements for tort claims (for amounts above the captive insurer's primary layer) was not a change in accounting method. While the change in treatment affected timing, the change was caused by a change in underlying fact: the dispute over liability engendered by the litigation between and among Taxpayer and its insurers.

5. Taxpayer's change in treatment of its insurance reimbursements in Year E for non-medical tort claims was a change in method of accounting. The change in treatment affected a material item which impacted on the timing of insurance reimbursement income. Taxpayer made an improper change in method of accounting without the Commissioner's consent.

6. Taxpayer's reversal in Year E of previously accrued insurance reimbursement income for all non- tort claims was improper. The reversal was based on an improper and unauthorized change in accounting method.

7. Taxpayer's right to receive an insurance reimbursement from a third-party insurer, associated with a specific site environmental tort claim, was fixed in Year E. In Year E, Taxpayer's insurer had admitted, through a counter-offer, liability up to a certain amount; such amount was fixed in that year.

FACTS

Taxpayer is a manufacturer of various industrial and consumer products. The years at issue are Years D through F. From Years A through B, Taxpayer had a division which produced and sold a consumer product. In Year B, Taxpayer sold the division. Under the sales agreement, Taxpayer agreed to indemnify the acquiring company against any claims made against the consumer product prior to the sale date.

Taxpayer was heavily insured against product liability claims under its general comprehensive insurance coverage. For many years, Taxpayer was covered for all general comprehensive insurance first by a captive foreign insurance subsidiary, which handled the first layer (up to $5 or $7 million). Coverage above this primary coverage was issued in various layers, with various insurers in each layer. Insurers would sign on for specific portions of each layer and receive a corresponding share of the premium for that layer. Apparently, there were over a hundred policies issued.

For years through Year B and one year afterward, the general comprehensive insurance was "occurrence" insurance coverage. Occurrence-based insurance indemnifies the insured for covered events that take place (occur) during the policy period, regardless of when the claim or suit is brought. For all years since then, Taxpayer had “claims-made” insurance coverage. Claims-made insurance coverage generally limits indemnification to claims made during the policy period.

Prior to the years at issue, an occasional claim for tort liability was made against Taxpayer related to the consumer product. Generally, Taxpayer resolved those claims and was indemnified (i.e., reimbursed) by its occurrence-based insurers. However, beginning prior to Year D, the amount of claims associated with the consumer product increased significantly. Because of this significant jump, Taxpayer altered its accounting treatment for the claims in Year E. Also in Year E, Taxpayer encountered trouble with its occurrence-based insurers over these tort claims.

As the number of claims against Taxpayer for the consumer product rose in the years prior to and during the years at issue, Taxpayer encountered resistance regarding coverage from its occurrence-based insurers. In Year E, some of Taxpayer’s occurrence-based insurers filed suit against Taxpayer and all its other occurrence-based insurers, as well as its claims-made insurers in state court in State 1 seeking an adjudication of certain coverage issues and a determination concerning allocation among insurers for coverage under the terms of the various insurance policies. A few months later in Year E, Taxpayer filed its own suit in state court in State 2 (which was later removed to a federal district court in State 2) against all its occurrence-based insurers seeking a determination concerning allocation among its occurrence-based insurers and adjudication of its overlapping policies. This action was later stayed pending resolution of the State 1 litigation. Due to arbitration provisions, the claims-made insurers were dismissed from the first law suit in Year F.

The lawsuit brought by some of Taxpayer’s occurrence-based insurers alleged that the other insurers were either partly or completely liable for the insurance reimbursements to Taxpayer. That is, those occurrence-based insurers alleged that the consumer product’s coverage event did not occur during the policy period. Furthermore, those occurrence-based insurers disputed whether some of the costs, including certain defense costs, were covered under the policies. The lawsuit has continued until the present time, although the Taxpayer has substantially prevailed on most issues in the suit, including definition of the event for coverage and the allocation of coverage. Because of these victories, the Taxpayer has received in recent years substantial reimbursement payments by a number of its occurrence-based insurers for the tort claims.

Furthermore, apparently because of the litigation filed in Year E, the insurers, both the other occurrence-based insurers but primarily the claims-made insurers, refused to pay claims for non- product liabilities pending outcome of the tort claims litigation, even though there was no formal denial of such claims.

In all years, Taxpayer's captive insurance company was not part of the suits and never denied coverage for its primary insurance layer.

For at least Years E and F, Taxpayer estimated for book purposes significant liabilities and expenses associated with the tort claims. Simultaneously, Taxpayer estimated receivables for expected insurance reimbursements of the same amount (after a one-time charge and deductibles). Taxpayer's annual reports and other filings with the public for those years noted the litigation over the tort claims and a belief by the Taxpayer that, except for the one time charge taken in Year E, it fully expected complete reimbursement of the estimated liabilities and associated expenses (after deductibles).

Prior to Year E, Taxpayer accounted on its books for its product liability claims (and non-) on a net basis. That is, when a liability claim was made, Taxpayer estimated both the cost of the existing and potential claims (including estimated damages and defense-related costs) and the amount of the expected reimbursement. In most cases, because of the extensive insurance carried by the Taxpayer, the estimated cost, after deductibles, was totally offset by the estimated insurance reimbursement.[1] For Year E onward, Taxpayer accounted for the liability claims separate from other product liability claims.

In Year E, for all non- liability claims, Taxpayer for tax purposes stopped including into income the estimated reimbursement income associated with the expenses paid and taken into account during the year. From Year E forward, Taxpayer took into account as a deduction non- product liability claims actually paid; however, it only included in income funds actually received as reimbursement. Taxpayer essentially went to a cash-type treatment of non- liability claims expenses and income.

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[1] For tax purposes, Taxpayer reversed any unpaid product liability costs (net of actual recovery) that remained unpaid as a Schedule M-1 adjustment, because of the economic performance rules under I.R.C. § 461(h). Thus, for tax purposes, Taxpayer took into account expenses actually paid in the year; it also included in income expected reimbursement proceeds associated with product liability claims.

When Taxpayer altered its treatment of the expected reimbursement income in Year E for non- liabilities and moved to a cash-type basis, Taxpayer had substantial receivables accrued for reimbursement income (income recognized for tax purposes but for which Taxpayer had not received the actual cash reimbursements). The amounts had been previously recognized in income. When Taxpayer altered its treatment in Year E, it took a Schedule M-1 tax deduction for the amount of the receivable, thus offsetting the prior treatment of these amounts as income.

Taxpayer did not change its treatment of liabilities for Years E and thereafter for tax purposes. For tax purposes, expenses actually paid and expected reimbursement associated with tort claims were taken into account as expenses and income. Unpaid expenses were not taken into account and were reflected on the Schedule M-1. However, during the course of the examination of Taxpayer, Taxpayer has filed an informal claim for a refund for Year E, backing out the accrual of reimbursement income, and moving to the cash-type treatment it adopted for its non- liabilities, where only actual expenses and actual income received are recognized for tax purposes.

Taxpayer was also insured by various insurance companies under comprehensive general liability (CGL) insurance policies throughout its corporate history. During certain years when Taxpayer was covered by occurrence-based CGL policies, it engaged in manufacturing operations which produced hazardous wastes. Taxpayer was ordered to clean up these hazardous sites. At least prior to Year C, Taxpayer did not accrue expected reimbursement income associated with these environment claims, as there remained the issue whether such clean-up costs were covered damages under the CGL policies (Taxpayer had deducted actual costs of clean-up). Around Year C, State 1's Supreme Court ruled that such costs were in fact covered damages. Many of the costs were then reimbursed.

In Year D, Taxpayer requested reimbursement for a specific site clean-up from the primary CGL insurance carrier. The reimbursement request was based on a sum for past clean-up and a sum for expected future clean-up. By letter sent in early Year E, Taxpayer's primary CGL insurance carrier offered to reimburse Taxpayer, but using different sums for past and future clean-up costs. Taxpayer countered that offer with yet different figures, which the primary CGL carrier re-countered with a fourth set of sums (all this occurred in Year E). No further settlement negotiations have been held. For book purposes in Year E Taxpayer included accrued reimbursement income reflecting sums approximately equal to the primary CGL carrier's final offer. Taxpayer included no amounts in income for tax purposes.

DISCUSSION

Section 446(a) provides that taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books.

Section 451(a) provides that any item of gross income is included in the taxable year when received, unless, under the method of accounting used to compute income, such amount is to be properly accounted for in a different period. Since Taxpayer used the overall accrual method of accounting, the principles of that method rather than actual receipt govern the year when insurance reimbursements are included in gross income.

Under general principles of accrual accounting, two conditions must be met for income to be accrued in a given taxable year: the taxpayer must have a clear right to the income and the amount of the income must be ascertainable. United States v. Anderson, 269 U.S. 422, 441 (1926); Continental Tie & Lumber Co. v. United States, 286 U.S. 290, 297 (1932); Dixie Pine Co. v. Commissioner, 320 U.S. 516, 519 (1944). These requirements have been formalized in Treas. Reg. § 1.451-1(a).

Treas. Reg. § 1.451-1(a) provides, in part, that under the accrual method of accounting, income is includible in gross income when all events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy.

Section 446(b), which is an exception to the general rule of section 446(a), provides that if no method of accounting has been regularly used by the taxpayer, or if the method used does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Secretary, does clearly reflect income.

The Commissioner's determination with respect to clear reflection of income is entitled to more than the usual presumption of correctness, and the taxpayer bears a heavy burden of overcoming a determination that a method of accounting does not clearly reflect income. Hamilton Industries v. Commissioner, 97 T.C. 120 (1991). Whether a particular method of accounting clearly reflects income is a question of fact which must be decided on a case-by-case basis. Peninsula Steel Products & Equipment Co. v. Commissioner, 78 T.C. 1029, 1045 (1982).

Treas. Reg. § 1.446-1(a)(1) provides, in part, that the term "method of accounting" includes not only the over-all method of accounting of the taxpayer but also the accounting treatment of any item.

Treas. Reg. § 1.446-1(e)(2)(ii)(a) provides, in part, that a change in the method of accounting includes a change in the overall plan of accounting for gross income or deductions or a change in the treatment of any material item used in such overall plan. A material item is any item which involves the proper time for the inclusion of the item in income or the taking of a deduction.

Treas. Reg. § 1.446-1(e)(2)(ii)(b) provides that a change in method of accounting does not include a change in treatment resulting from a change in underlying fact.

Section 446(e) and Treas. Reg. § 1.446-1(e)(2)(i) state that a taxpayer which changes its method of accounting on the basis of which it keeps its books must, prior to changing to a different method, secure the consent of the Commissioner. Consent must be secured regardless of whether the method a taxpayer is changing is proper or permitted. Treas. Reg. § 1.446-1(e)(2)(2)(i); Commissioner v. O Liquidating Corp., 229 F.2d 225 (3d Cir. 1961), cert. denied, 368 U.S. 898 (1961).

The governing principles for determining the year of accrual of insurance reimbursement remains whether a taxpayer has a fixed right to receive the income and reasonable estimation of the amount to be received.[2] The Service has adhered to a position that an accrual basis taxpayer would be required to recognize gain in the year when the damages were sustained, even though the insurance payment was not received until the following year. See G.C.M. 34163, Cental Tablet Mfg. Co., I-3498 (July 14, 1969). Thus, if the insurer does not contest liability, income accrues in the year of the loss. Max Kurtz v. Commissioner, 8 B.T.A. 679, 684 (1927) (accrual required where insurance company had admitted liability and conceded the bulk of the loss claimed by the taxpayer in the year of loss); Rite Way Products, Inc. V. Commissioner, 12 T.C. 475 (1949) (extent and amount of liability of insurance company known in year of loss); Cappel House Furnishing Co. v. United States, 244 F.2d 525 (6th Cir. 1957) (liability and approximate amount determined in year of fire; liability was both clear and could be approximated). "[T]he general rule [is] ... that when there is no contest over liability and its measure does not depend on future events or contingencies, income accrues after liability becomes fixed, although the exact amount may not be determined until later."

[2] The sole issue in this Field Service Advice is whether the right to receive the insurance reimbursement income was fixed; there is no issue regarding the reasonable estimation of those amounts.

Cappel House Furnishing Co., 244 F.2d at 529. Even though there was no unequivocal admission of liability by the insurer, the record showed that the concern of the insurer was not so much with the question of liability but with its measure. Id. at 530.

On the other hand, "where an insurance company does not admit liability in the year of the loss, or takes a position in negotiations which makes it quite uncertain whether the bulk of the claim will be recoverable, accrual is improper." Central Tablet Manufacturing Co. v. United States, 417 U.S. 673, 698-99 (1974) (dissenting opinion), citing in footnote 2 of the dissent, Georgia Carolina Chem. Co. v. Commissioner, No. 14,242 (T.C. Memo. 1944) (extent of liability not fixed in year of loss because of uncertainty as to whether co-insurance clause, which would reduce coverage, would be invoked by insurance company); Luckenback Steamship Co. v. Commissioner, 9 T.C. 622 (1947) (amount of recovery on war risk insurance uncertain in years of loss because of controversy between War Shipping Administration and Comptroller General); Thalimer Brothers v. Commissioner, 27 T.C. 733 (1957) (where fire occurred six days prior to completion of tax year, insurance proceeds did not accrue because extent of damage still uncertain); Curtis Electro Lighting v. Commissioner, 60 T.C. 633 (1973) (accrual not required because insurance company had never admitted to liability in any amount in taxable year); Maryland Shipbldg & Drydock Co. v. United States, 409 F.2d 1363 (Ct. of Claims 1969) (accrual not required because extent of liability contested by insurance company in negotiations not completed in taxable year). "With an accrual basis taxpayer ..., it is crystallization of the right to receive income, not prior expectation, nor subsequent receipt, that determines the year in which the income must be declared for federal tax purposes." Id. at 1366. The "crystallization" only occurs if there is an admission of liability by the insurer. "An insurer's tacit recognition of the fact and general extent of damage suffered by its insured, ..., does not meet or displace this central requirement of admission of liability." Id. at 1369.

Issues 1, 2, and 3

Whether Taxpayer has a right to receive insurance reimbursements depends upon an analysis of all the facts and circumstances. Based on the case law, we believe admission of liability is the linchpin for determining whether the right to receive insurance reimbursement is fixed. And we believe that Taxpayer's right to receive insurance reimbursements from the occurrence-based insurers for certain tort claims was not fixed in Years E and F due to the litigation instituted in Year E.[3] In Year D, some of Taxpayer's occurrence-based insurers filed suit

[3] We are talking about insurance reimbursements above the primary layer held by Taxpayer's captive insurer.

against Taxpayer and all its other occurrence-based insurers, as well as its claims-made insurers, in state court in State 1 seeking an adjudication of certain coverage issues and a determination concerning allocation among insurers for coverage under the terms of the various insurance policies. A few months later in Year E, Taxpayer filed its own suit in state court in State 2 (which was later removed to a federal district court in State 2) against all its occurrence-based insurers seeking a determination concerning allocation among its occurrence-based insurers and adjudication of its overlapping policies. This action was later stayed pending resolution of the State 1 litigation. Due to arbitration provisions, the claims-made insurers were dismissed from the first lawsuit in Year F.

The lawsuit brought by some of Taxpayer's occurrence-based insurers alleged that the other insurers were either partly or completely liable for the insurance reimbursements to Taxpayer. Furthermore, those occurrence-based insurers disputed whether some of the costs, including certain defense costs, were covered under the policies (scope of coverage).

Clearly, the litigation expressly disavows the liability of those occurrence-based insurers who brought the suit in Year E. Arguably, the remaining insurers liability for the certain tort claims is also disavowed, at least indirectly. That is, by inclusion of the other occurrence-based insurers and the claims-based insurers in the first suit, along with the counter-suit brought by the Taxpayer, there was no ability for the remaining insurers to admit liability. We believe this applies for all the occurrence-based insurers, as all were involved in the litigation in the years at issue.[4] Because of the contested liabilities as expressed in the litigation, there was no fixed right to receive the income in Years E and F.[5] See Curtis Electro, 60 T.C. at 636 ("The record does not show that the insurance companies,

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[4]As to the claims-made insurers, their inclusion in the initial litigation appears to have been improper, as their coverage did not include years already covered by the occurrence-based insurers. This is borne out by their dismissal from the State 1 litigation in Year F. Additionally, prior to Year E, when Taxpayer paid a claim, apparently it was the occurrence-based insurers who provided indemnification. Regardless, for these claims, it is clear the claims-made insurers clearly disavowed liability, as they did not provide coverage for such claims.

[5]According to attachments to your request for field service advice, by Year F the district court in State 1 had determined that the occurrence-based insurers were in fact liable, although the scope of coverage was not yet determined. At that point, for at least some of the liability, it was a question of when and not whether Taxpayer would received insurance reimbursements. Based on the district court's holding, Taxpayer's right to receive some reimbursement would be fixed in Year F.

..., acknowledged liability for petitioner's business losses, ..."); Maryland Shipbldg. & Drydock, 409 F.2d at 1369 ("An unqualified recognition of liability by the obligor is the essence of accrual by the prospective recipient.")

With respect to non- claims filed against Taxpayer in Years E and F (presumably involving almost exclusively the claims-made insurers), Taxpayer's various insurers refused to make any payments until the tort claims litigation was completed, even though there was no formal denial of the claims. The rationale of the insurers was that if they should be found liable to indemnify Taxpayer for the tort claims, coverage limits might be exceeded and thus liability for non- claims might be beyond coverage limits. However, while that rationale might be applicable to insurers (and only on an insurer by insurer basis), it is not applicable to Taxpayer. Taxpayer's product liability coverage was so extensive that it ultimately could expect reimbursement in full for all non- tort liabilities.

While there was no express admission of liability, neither was there any formal denial of the claims for the non- tort claims. Prior to Year E, Taxpayer accrued for tax purposes the right to receive insurance reimbursement. Because of the litigation generated over the tort claims, the insurers simply stopped making payments, and Taxpayer decided to stop accruing the reimbursement amounts for tax purposes. We believe this situation is closer to Cappel House Furnishing Co., where the Sixth Circuit laid down the general rule "that when there is no contest over liability and its measure does not depend on future events or contingencies, income accrues after liability becomes fixed, although the exact amount may not be determined until later." Id. at 529. The situation here is similar in that even though there was no unequivocal admission of liability by the insurer (as in Cappel House Furnishing Co.), the record showed that the concern of the insurer was not so much with the question of liability but with its measure. Id. at 530. Here, too, the concern of the various insurers, none of whom denied liability, was the measure of the liability for non- tort claims. We believe that the right to receive the insurance reimbursements for non- tort claims remained fixed in Years E and F, as there was no direct contest over liability, only an indirect contest over the measure of such liability.

As for the issue of whether Taxpayer had a right to receive insurance reimbursements from its captive insurer for the years at issue, for both and non- tort claims, we believe the right to receive reimbursements was fixed for all the years in issue. At no time did the captive insurer contest or in any way expressly deny its liability to Taxpayer. While payment was not made in the years at issue, presumably in part due to the lawsuits over the tort liabilities, there remained a complete absence of a contest or dispute over the reimbursement.

Because the captive insurer did not contest its liability, income accrues to Taxpayer in the year of the loss. See Max Kurtz v. Commissioner, 8 B.T.A. 679, 684 (1927) (accrual required where insurance company had admitted liability and conceded the bulk of the loss claimed by the taxpayer in the year of loss); Rite Way Products, Inc. V. Commissioner, 12 T.C. 475 (1949) (extent and amount of liability of insurance company known in year of loss); Cappel House Furnishing Co. v. United States, 244 F.2d 525 (6th Cir. 1957) (liability and approximate amount determined in year of fire; liability was both clear and could be approximated).

Issues 4, 5, and 6

Taxpayer initially did not change its treatment of liabilities for Years E and thereafter for tax purposes. For tax purposes, expenses actually paid and expected reimbursement associated with tort claims were taken into account as expenses and income. Unpaid expenses were not taken into account and were reflected on the Schedule M-1 due to section 461(h). However, during the course of the examination of Taxpayer, Taxpayer has filed an informal claim for a refund for Year E, backing out the accrual of reimbursement income, and moving to the cash-type treatment it adopted for its non- liabilities, where only actual expenses and actual income received are recognized for tax purposes.

We believe Taxpayer's informal claim for refund is proper, but only for amounts above the captive insurer's primary layer, based on our conclusion that Taxpayer's right to receive reimbursement income for its tort liabilities was not fixed in Years E and F.[6] Taxpayer's method of accounting for its tort liabilities was the accrual method of accounting. Under that method, accrual of reimbursement income is governed by the all-events test under section 451, as the deduction of claims paid is governed by the all-events test and economic performance rules of section 461(h).

Treas. Reg. § 1.446-1(a)(1) provides, in part, that the term "method of accounting" includes not only the over-all method of accounting of the taxpayer but also the accounting treatment of any item. A material item is any item which involves the proper time for the inclusion of the item in income or the taking of a deduction. Treas. Reg. § 1.446-1(e)(2)(ii)(a). The material item in this case is the accrual of insurance reimbursement.

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[6] As noted in Footnote 5, it appears that by Year G the courts had resolved the issue of who among the occurrence-based insurers was liable to reimburse Taxpayer. Thus, in that year, the only question was the scope of coverage and when the reimbursement monies were to be actually received. Accordingly, in Year G Taxpayer's right to receive a significant amount of the reimbursement was fixed.

In Years E and F, Taxpayer right to receive the reimbursement income for the consumer product tort claims (above the captive insurer's primary layer) was not fixed due to the lawsuits filed in Year E. The contest of the liability by some of the occurrence-based insurers, including by counter-suit all of Taxpayer's occurrence-based insurers (with the claims-made insurers denying liability due to their lack of coverage during the years giving rise to the claims), prevented the right to receive the income from becoming fixed. While the inclusion in income in Year E or not affects timing, in this case the change in treatment of the income is due to a change in facts. Treas. Reg. § 1.446-1(e)(2)(ii)(b) provides that a change in method of accounting does not include a change in treatment resulting from a change in underlying fact. The litigation calling into question any and all liability of the insurers for reimbursement of the consumer product tort claims was a change in facts affecting Taxpayer's right to the income. Accordingly, this is not a retroactive change in method of accounting, for which Taxpayer needs the consent of the Commissioner. See Section 446(e).

In Year E, for all non- liability claims, Taxpayer for tax purposes stopped including into income the estimated reimbursement income associated with the expenses paid. When Taxpayer altered its treatment of the expected reimbursement income for all non- liabilities in Year E and moved to a cash-type basis, Taxpayer had substantial receivables accrued for reimbursement income. It took a Schedule M-1 deduction for the amount of the receivables, thus offsetting the prior treatment of these amounts as income.

We believe that Taxpayer's change in its treatment of non- liabilities in Year E was an improper change in method of accounting. Taxpayer's method of accounting for reimbursement income was the accrual method of accounting under section 451. Under that method, for years up to Year E, Taxpayer properly included into income expected reimbursement income on certain product liability claims. We have concluded that there was no contest preventing the fixing of the right to receive insurance reimbursement income for Years E and F, except for the tort liabilities. Accordingly, it was improper for Taxpayer to unilaterally stop accruing into income amounts expected to be reimbursed.

Section 446(e) and Treas. Reg. § 1.446-1(e)(2)(i) state that a taxpayer which changes its method of accounting on the basis of which it keeps its books must, prior to changing to a different method, secure the consent of the Commissioner. Consent must be secured regardless of whether the method a taxpayer is changing is proper or permitted. Treas. Reg. § 1.446-1(e)(2)(2)(i); Commissioner v. O Liquidating Corp., 229 F.2d 225 (3d Cir. 1961), cert. denied, 368 U.S. 898 (1961).

A change in method of accounting includes a change in treatment of a material item. A material item is an item which affects the timing of income. The year of accrual of insurance reimbursement income affects timing. Thus, the change in treatment of the non- insurance reimbursement is a change in method of accounting, unless it is shown that there is a change in facts instead. However, the facts in Year E had not changed; Taxpayer's insurers did not contest liability for non- tort liabilities. Accordingly, Taxpayer changed its method of accounting for insurance reimbursement from accrual to a cash-type method without the Commissioner's approval. Furthermore, Taxpayer's reversal of its prior reimbursement accounts receivable in Year E was likewise improper, as taxpayer improperly changed its method of accounting without the Commissioner's approval.

Issue 7

Taxpayer engaged in manufacturing operations which produced hazardous wastes. Taxpayer was ordered to clean up these hazardous sites. In Year D, Taxpayer requested reimbursement for a specific site clean-up from the primary CGL insurance carrier. The reimbursement request was based on a sum for past clean-up and a sum for expected future clean-up. By letter sent in early Year E, Taxpayer's primary CGL insurance carrier offered to reimburse Taxpayer, but using different sums for past and future clean-up costs. Taxpayer countered that offer with yet different figures, which the primary CGL carrier re-countered with a fourth set of sums (all this occurred in Year E). No further settlement negotiations have been held. For book purposes in Year E Taxpayer included accrued reimbursement income reflecting sums approximately equal to the primary CGL carrier's final offer. Taxpayer included no amounts in income for tax purposes.

We believe that Taxpayer's right to receive the amount offered in the primary CGL carrier's final offer in Year E was fixed and should have been accrued into income for tax purposes.

> An example of insurance proceeds meeting the criteria for accrual in a taxable period prior to that of receipt is found in Max Kurtz, et al., 8 B.T.A. 679, 684 (1927), where the Board found a prompt admission of liability by the insurer coupled with an unqualified concession as to the bulk of the loss claimed by the insured to be sufficient to sustain an accrual in the earlier period.

Maryland Shipbldg. & Drydock, 409 F.2d at 1369. We believe the final counter-offer by the insurer admitted liability to the extent of the counter-offer, as thus the right to that amount of reimbursement income was fixed in Year E. "[T]he general rule [is] ... that when there is no contest over liability and its measure does not depend on future events or contingencies, income accrues after liability becomes fixed, although the exact amount may not be determined until later." Cappel House Furnishing Co., 244 F.2d at 529. Taxpayer's CGL carrier had essentially admitted liability, but disputed the exact amount. In these situations, the right to receive the reimbursement income is fixed to the extent of the amount of the final offer from the insurance carrier.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

As stated in the discussion, we believe that the litigation started by some of the occurrence-based insurers in Year E expressly disavows their liability. (We concluded that the claims-based insurers disavowed liability on the basis that their policies were not in effect when the Taxpayer made the consumer product.) We also stated that the remaining occurrence-based insurers liability for the certain medical tort claims is also disavowed, at least indirectly. However, we believe further facts should be developed to determine [redacted]

Our conclusion in the discussion is that the litigation among and between Taxpayer and the occurrence-based insurers essentially prevents all those insurers from admitting liability. Perhaps our net is cast too wide. Perhaps other occurrence-base insurers did not disavow liability, but simply waited for clearer determination of the liability allocation. If further factual development suggests this is the case, then Taxpayer's right to receive reimbursement income from those occurrence-based insurers might in fact be fixed in the years at issue. If so, then with respect to those insurers there would be a unauthorized change in method of accounting which we should deny.

Another issue for clarification regards the primary layer and the captive insurer. We agree with you that the right to receive reimbursement income from the captive insurer is fixed in all years at issue. However, we suggest reviewing the facts regarding [redacted]. If any of the captive insurer's primary layer are included in the change in treatment of the medical liabilities (where we concluded that no change in method has occurred), those amounts should not be refunded, as the right to receive those amounts were not affected by the litigation.

[redacted]

If you have any further questions, please call (202) 622-7870.

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