INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

October 26, 2004

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Index (UIL) No.: 263A.00-00
CASE-MIS No.: TAM-136086-04

District Director
:

Taxpayer's Name:
Taxpayer's Address:

Taxpayer's Identification No
Years Involved:
Date of Conference:

LEGEND:

| | |
|---|---|
| Taxpayer | = |
| Products | = |
| Country X | = |
| Taxable Year | = |
| $A | = |
| $B | = |
| $C | = |
| $D | = |
| $E | = |
| $F | = |
| $G | = [1] |

[1] All amounts have been rounded to the nearest dollar.

ISSUE(S):

Whether refunds of anti-dumping and countervailing duties that were imposed, paid, and recovered through cost of goods sold in prior taxable years are includible in Taxpayer's gross income or treated as a reduction in the amount of duties (or other costs) capitalized under I.R.C. § 263A.

CONCLUSION(S):

Taxpayer must include refunds of anti-dumping duties in its gross income.

FACTS:

Taxpayer imports Products from Country X into the United States for distribution. Taxpayer used the first-in, first-out (FIFO) inventory cost-flow presumption. Taxpayer is often required to pay anti-dumping and countervailing duties on its Products in accordance with Title VII of the Tariff Act of 1930, as amended (19 U.S.C. § 1671 *and seq*.). Anti-dumping duties are levied by the Department of Commerce (DOC) on companies that allegedly market products in the United States at significantly lower prices than their domestic market prices (19 U.S.C. § 1673); countervailing duties are levied on companies whose products are allegedly subsidized by their own governments (19 U.S.C. § 1671).

Taxpayer's detail of duty expenses for the Taxable Year was as follows: Regular Duty Expense - $A, Countervailing Duty Expense - $B, Antidumping Duty Expense - $C, Antidumping Duty Bond Expense $D. These expenses totaled $E.

A company may appeal a final determination by DOC assessing antidumping and/or countervailing duties (hereinafter, antidumping duties). If a company appeals, DOC initiates a review process for antidumping duty rates applied to those products. As part of its review, DOC considers both information submitted by the company that paid the antidumping duties and the U.S. makers of the company's products. In cases where DOC concludes the antidumping duty was excessive or not justified at all, U.S. Customs issues refund checks to the company that had been required to pay the antidumping duties.

During Taxable Year, Taxpayer received $F in refunds of antidumping duties that were assessed and paid two to three years prior to Taxable Year. For tax purposes, Taxpayer had included these duties in inventory costs when incurred and recovered them through cost of goods sold in a taxable year prior to Taxable Year.

For financial statement purposes Taxpayer initially deducted $E of duties as cost of goods sold and included antidumping duty refunds in the amount of $F as other income (non-operating income). Taxpayer's independent auditors reclassified duty refunds from other income to cost of goods sold. Taxpayer not only offset its entire Taxable Year antidumping expense ($C), but also its entire countervailing duty expense ($B) and $G in general duties.

For tax purposes, Taxpayer now maintains that the duty refunds should be treated as a reduction of its section 263A costs for Taxable Year that are allocated between ending inventory and cost of goods sold. As a result of this treatment, income recognition of the part of the duty refunds allocated to ending inventory is effectively deferred.

LAW AND ANALYSIS:

Law:

I.R.C. § 61 generally provides that gross income means all income from whatever source derived.

Section 111(a) provides that gross income does not include income attributable to the recovery during the taxable year of an amount deducted in any prior taxable year to the extent such amount did not reduce the amount of tax imposed by Chapter 1 of the Internal Revenue Code.

Treas. Reg. § 1.263A-1(c)(1) provides, in part, that under section 263A, taxpayers must capitalize their direct costs and a properly allocable share of their indirect costs to property produced or property acquired for resale.

Section 1.263A-1(c)(2) provides, in part, that the amount of any cost required to be capitalized under section 263A may not be included in inventory or charged to capital accounts or basis any earlier than the taxable year during which the amount is incurred within the meaning of section 1.446-1(c)(1)(ii).

In Rev. Rul. 85-30, 1985-1 C.B. 20, the Service held, in pertinent part, that to the extent the cost of tires, for which a taxpayer received reimbursement of excise taxes, did not remain in ending inventory and had been recovered through cost of goods sold, the taxpayer should treat the reimbursement as an item of gross income.

In Rev. Rul. 88-95, 1988-2 C.B. 28, the Service held, in pertinent part, that inventory protection payments and first handler payments for cotton accrued by a taxpayer should be treated as an item of gross income to the extent the cost of cotton giving rise to the payments was deemed to have been relieved from inventory and accounted for through cost of goods sold as of the date the payments were accrued under the taxpayer's method of accounting.

Rev. Rul. 2001-8, 2001 C.B. 726, clarified Rev. Rul. 85-30 and Rev. Rul. 88-95. Rev. Rul. 2001-8 held, in pertinent part, that payments made or received for floor stocks affect gross income to the extent the invoice price or production cost of the goods on hand that gave rise to the payments had been included in cost of goods sold thus not included in ending inventory under the taxpayer's cost-flow assumption.

Analysis:

The tax benefit rule is a judicially developed principle designed to allay the inflexibilities of the annual accounting system; it is used in situations where strict adherence to an annual accounting system would create transactional inequities. Hillsboro National Bank v. Commissioner, 460 U.S. 370, 377 (1983). Unless a statutory nonrecognition provision applies, the tax benefit rule generally requires the inclusion of income when events occur after an earlier deduction that are fundamentally inconsistent with the deduction. Hillsboro at 372. The subsequent event is one that was unforeseen at the time of the deduction and that would have foreclosed the deduction had it occurred in the same year. Hillsboro at 383-84.

The recovery of a previously deducted bad debt is a classic example of the operation of the tax benefit rule. A taxpayer deducts the amount of a supposedly bad debt from income in one year, thinking the debt is worthless. In a later year, the debt is paid. Repayment of a debt, that is, the recovery of capital, normally is not taxable. Under the tax benefit rule, the subsequent payment is an event fundamentally inconsistent with the prior deduction because it would have foreclosed the deduction had it occurred in the same year. Furthermore, no nonrecognition provisions of the Internal Revenue Code apply to the subsequent payment. Accordingly, the taxpayer in the example must include the subsequent payment in income in the year received, even though it represents a return of capital.

Section 111 is a legislative acknowledgment of the judicially-created tax benefit rule. It does not codify the tax benefit rule. Rather, Section 111(a) is an exception to the rule, providing that gross income will not include income attributable to the recovery during the tax year of an amount previously deducted if the previously deducted amount did not reduce the amount of tax in the year of the deduction. Under section 111(a), if Taxpayer did not benefit from its deduction of the anti-dumping duties in the prior years, the refund in a later year will not be included in its income for the year of the ruling. No such showing has been made here, so section 111(a) is inapplicable.

Here, Taxpayer correctly capitalized the gross amount of the current duties under section 263A on its return for the Taxable Year and likewise correctly initially included refunds of previously imposed antidumping duties in its gross income (as non-operating income) in the year received. This was the correct treatment because, under the tax benefit rule, the refund was fundamentally inconsistent with the prior inclusion of the antidumping duties in cost of goods sold.

Taxpayer now maintains, however, that the refunds should be netted against Taxpayer's current duty expense. This is not the proper treatment of the refunds, because the previously imposed duties (from which the refunds stem) were capitalized and recovered through cost of goods sold. The amount of the antidumping duties to be capitalized in the current year is the amount of duties actually imposed in the year, regardless of the recovery or refund of the prior years' antidumping duties. Therefore, Taxpayer is required to include the refund of the antidumping amounts in its taxable income for the Taxable Year, rather than netting it against current duty expense.

Case law supports this conclusion. In Turtle Wax, Inc. v. Commissioner, 43 T.C. 460 (1965), the petitioner purchased watches from several manufacturers as promotional items. The watches were subject to a federal excise tax that was included on the invoice. The petitioner currently deducted the excise taxes. In a later year the petitioner was entitled to a refund of the excise taxes. The Tax Court held that petitioner was required to include the refund of excise taxes in taxable income in the year of receipt because it had realized a tax benefit in the year it deducted the excise taxes.

Here, Taxpayer is virtually in the same position as the petitioner in Turtle Wax. The antidumping duties, like the excise taxes, were reduced income in a prior year. In a later year, a portion of the antidumping duties was refunded, just as the excise taxes were refunded. Having received a tax benefit in the year it included the antidumping duties in cost of goods sold, Taxpayer must therefore include the refund in taxable income in the year of receipt.

Additionally, the Service has published several rulings concluding that, to the extent an expense has been included in cost of goods sold (and the taxpayer received a resulting tax benefit), refunds of the expense in a subsequent year must be included in the taxpayer's gross income. Rev. Rul. 85-30, 1985-1 C.B. 20; Rev. Rul. 88-95, 1988-2 C.B. 28; Rev. Rul. 2001-8, 2001 C.B. 726.

Here, Taxpayer has capitalized, i.e., included in inventory costs, all of its duties under section 263A. Each year, Taxpayer currently included a portion of the duties in cost of goods sold and allocated the remaining duty expense to ending inventory. Based on Taxpayer's FIFO cost- flow assumption, the refunded anti-dumping duties allocated to inventory have already been included in cost of goods sold in an earlier tax year (and reduced its tax liability for the year). Taxpayer has clearly received a tax benefit for the entire amount of the duties. Consequently, Taxpayer is required to include refunds of anti-dumping duties in its gross income in the year of receipt.

CAVEAT(S):

A copy of this technical advice memorandum is to be given to the taxpayer(s). Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.