



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

OFFICE OF  
CHIEF COUNSEL

CC:DOM:FS:IT&A

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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

FROM: DEBORAH A. BUTLER  
Assistant Chief Counsel CC:DOM:FS

SUBJECT:

This Field Service Advice responds to your memorandum dated September 29, 1998. 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:

X Corporation	=
Subsidiary	=
State A	=
Amount 1	=
Amount 2	=
Year 1	=
Year 2	=
Overcharge Period	=

ISSUES:

1. Whether section 1341(a) of the Internal Revenue Code of 1986 applies to amounts paid by the taxpayer in Year 2 to settle a price-fixing lawsuit initiated by its former customers regarding overcharges.

2. If section 1341(a) applies in this case, may X Corporation reduce both its income tax and alternative minimum tax by the same amount?

CONCLUSIONS:

1. We agree with your position that failure to satisfy the appearance of an "unrestricted right to income" requirement of section 1341(a) is a potential ground for denying the benefit of section 1341.

2. Even if X Corporation were eligible for section 1341 relief, the provisions of section 1341 do not allow X Corporation to reduce both its regular income tax and alternative minimum tax by the same amount.

FACTS:

X Corporation is engaged in the business of manufacturing and selling . In a statement attached to its consolidated return for Year 2, X Corporation notified the Service that it was claiming certain tax benefits under section 1341 relating to the settlement of a lawsuit in that year. According to the statement, in Year 2 X Corporation's subsidiary, Subsidiary, paid Amount 1 to settle a price fixing lawsuit brought by several current and former customers. As alleged in the statement, as well as in pleadings filed against Subsidiary in United States District Court for the Middle District of State A, during Overcharge Period Subsidiary sold its products in violation of the antitrust laws, and thereby "realized gross income which was recognized subject to a claim of right."

According to documents obtained from X Corporation, it appears that X Corporation applied sections 1341(a)(4) and 1341(a)(5) on a year-by-year basis to determine which section yielded the most favorable tax treatment.<sup>1</sup> As reflected on these documents, X Corporation claimed a refundable credit of Amount 2 for Year 2 under section 1341(a)(5), representing the sum of the additional income taxes attributable to the overcharges in those years.

In addition to claiming the refundable credit of Amount 2, it appears that X Corporation deducted the entire Amount 1 as an operating expense on its Year 2

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<sup>1</sup> Under Missouri Pacific Railroad Co. v. United States, 70-1 U.S.T.C. ¶ 9285 (Ct. C1. 1970), if the taxpayer restores amounts previously included in gross income in multiple years, he may apply section 1341 on "fragmented" basis by deducting restoration payments under section 1341(a)(4) for some years and claiming credits under section 1341(a)(5) for other years.

return. X Corporation claimed a deduction on its Year 2 Schedule M, which represents the Amount 1 settlement paid in Year 2, plus an additional amount for legal expenses relating to the price fixing litigation.<sup>2</sup> According to a summary prepared by X Corporation, the Amount 1 was allocated between the years Overcharge Period based on a percentage of sales in those years. X Corporation has also indicated that it accrued the liability for the legal settlement in Year 1 for book purposes but deducted the payments made in Year 2 under section 1341(a)(4).

In addition to claiming the Amount 2 as an estimated tax payment and reducing its Year 2 taxable income by the Amount 1 settlement payment, it appears that X Corporation claimed a third benefit in that same year relating to the settlement. Although it paid no regular income tax for Year 2, X Corporation reported a tentative minimum tax for that year in the amount of \$ . Alleging in the statement attached to its Year 2 return that the alternative minimum tax constitutes a "separate but parallel system," X Corporation also reduced its alternative minimum tax by the same Amount 2. Thus, it appears that X Corporation effectively claimed Amount 2 twice on its Year 2 return.

## LAW AND ANALYSIS

Section 1341 provides a special tax computation designed to prevent the inequity which arises if income held under a "claim of right" is restored in a later year and the benefit from the deduction in the year of restoration differs from the increase in taxes attributable to the original inclusion of the restored item. Section 1341 derives from the claim-of-right doctrine enunciated by the Supreme Court in North America Oil Consolidated v. Burnet, 286 U.S. 417, 424 (1932):

If a taxpayer receives earnings under a claim-of-right and without restriction as to its disposition, he has received income which he is required to [report on his] return, even though it may still be claimed that he is not entitled to retain the money, and even though he may still be adjudged liable to restore its equivalent.

Section 1341 alleviates some of the harsh effect of the claim-of-right doctrine in special situations. United States v. Skelly Oil Co., 394 U.S. 678, 681 (1969). It permits a refund of taxes paid in an earlier year on income to which the taxpayer

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<sup>2</sup> It also appears that X Corporation may have offset a portion of the Schedule M deduction. As reflected on the Schedule M reconciliation, X Corporation increased its Year 2 taxable income by an amount designated as "Legal Settlement- Sec 1341." It is unknown how X Corporation arrived at this figure or what it actually represents.

appeared to have an unrestricted right, but ultimately did not. Section 1341(a) sets forth the circumstances under which relief is available:

SEC. 1341(a). GENERAL RULE. -If-

(1) an item was included in gross income for a prior taxable year (or years) because it appeared that the taxpayer had an unrestricted right to such item;

(2) a deduction is allowable for the taxable year because it was established after the close of such prior taxable year (or years) that the taxpayer did not have an unrestricted right to such item or to a portion of such item; and

(3) the amount of such deduction exceeds \$3,000,

Thus, in order to obtain the benefits of section 1341, each of five conditions must be satisfied: 1) the item at issue was included in gross income in a previous taxable year; I.R.C. § 1341(a)(1); 2) the inclusion occurred because the taxpayer appeared to have an unrestricted right to the item, section 1341(a)(1); 3) in a later tax year, the taxpayer is entitled to a deduction on account of the repayment, section 1341(a)(2); 4) the deduction is allowable because it was established after the close of the year of inclusion that the taxpayer did not have an unrestricted right to the item, 1341(a)(2); and 5) the amount of the deduction exceeds \$3,000.

In the instant case we agree with your conclusion that section 1341 relief is not available to the X Corporation because Subsidiary does not appear to have had an unrestricted right to the item. The term “appeared” as used in section 1341(a)(1) and Treas. Reg. § 1.1341-1(a)(2) refers to a semblance of an unrestricted right in the year received as distinguished from an unchallengeable right (which is more than an “apparent” right) and from absolutely no right at all (which is less than an apparent right). Rev. Rul 68-153, 1968-1 C.B. 371. Thus, section 1341 does not apply to the repayment of embezzled funds because embezzled funds are included in gross income under an invalid claim of right or without any semblance of entitlement but not under a valid or unrestricted claim of right as is required by section 1341. See, e.g., Rev. Rul 68-153; Rev. Rul. 65-254, 1965-2 C.B. 50; McKinney v. United States, 574 F.2d 1240 (5th Cir. 1978), cert. denied, 439 U.S. 1072 (1979). Not only does section 1341 not apply to embezzled income, it also does not apply to any type of “ill-gotten” gains, such as smuggling and kickbacks. See, e.g., Wood v. Commissioner, 863 F.2d 417 (5th Cir. 1989); Zandoff v. United States, 86-2 U.S.T.C. ¶ 9567 (S.D.N.Y. 1986); Perez v. United States, 553 F. Supp. 558 (M.D. Fla. 1982); Hankings v. United States, 403 F. Supp 257 (N.D. Miss. 1975), aff'd by unpub. op., (5th Cir. 1976). Additionally, section 1341 is not applicable where the taxpayer did in fact have an unrestricted right to receive the income amount and where the obligation to repay arose as the result of subsequent events. Rev. Rul. 67-48, 1967-1 C.B. 50.

In Parks v. United States, 96-2 U.S.T.C. (CCH) ¶ 50,645 (W.D. Pa. 1996), the district court reiterated the proposition that ill-gotten gains including income obtained by fraud are never obtained by unrestricted right. As rationale for that proposition, the court stated that if one commits an intentional wrongdoing, one always does so at the risk of discovery and the potential of disgorgement, restitution, civil penalties, criminal liability, and the like.

The district court in Parks disagreed with the approach of the Tax Court in Barrett v. Commissioner, 96 T.C. 713 (1991), nonacq., AOD CC-1992-008 (Mar. 23, 1992), to section 1341(a)(1). In Barrett, the Tax Court did not directly address, but implicitly accepted, the notion that it appeared that the taxpayer had an unrestricted right to the funds pursuant to section 1341(a)(1). There, taxpayer allegedly received funds through unlawful securities trading activities subjecting him to both civil and criminal actions. The criminal charges were dismissed and, though maintaining his innocence, taxpayer made a payment in settlement of the civil suit. In deciding that taxpayer was entitled to the benefits of section 1341, the Tax Court decided not to look behind the settlement agreement under the notion that it is important public policy to foster settlement of cases.

The district court in Parks viewed the Tax Court's approach in Barrett as effectively reading the "appeared that the taxpayer had an unrestricted right" language out of section 1341(a)(1). The district court stated that following Barrett would eliminate the government's opportunity to demonstrate that the income was derived from wrongdoing, and that a corresponding refund would reward the wrongdoing, contrary to section 1341.

The district court stated that in cases where there are allegations of wrongdoing in the claim of unrestricted right to the income in the first instance, taxpayers may be required to undergo trial by operation of section 1341 to vindicate that right, even though they may have settled direct claims of liability for the same alleged wrongdoing. The court noted that since taxpayers would be claiming the benefits of section 1341, they would bear the initial burden of demonstrating the facts that support appearance of the unrestricted right to the refund, and the subsequent establishment that they did not have such unrestricted right. However, they would not be compelled to demonstrate as part of their prima facie case that they did not commit wrongdoing, e.g, fraud. Rather, according to the district court, the government, as a defense to the taxpayers' claim, would be required to prove the facts and circumstances that interfered with the appearance of taxpayers' unrestricted right to income.

As a procedural matter we point out that in Barrett, the Commissioner did not challenge whether the taxpayers had an unrestricted right to the item, pursuant to section 1341(a)(1). Thus, in that case the Tax Court did not rule upon the issue of

whether section 1341 applies to “ill gotten gains” or income received under an invalid claim of right or without any semblance of entitlement. Because the issue was not raised in Barrett, the holding there can not be said to bear on considerations of whether amounts received pursuant to an alleged price fixing scheme are received under a claim of right.

Turning to the fourth criteria needed to obtain section 1341 relief, section 1341 does not apply unless the taxpayer repays the income item in question because it is determined that the taxpayer does not have an unrestricted right to the income item and the lack of an unrestricted right existed in the year in which the income inclusion occurred. I.R.C. § 1341(a)(2); Van Cleave v. United States, 718 F.2d 193 (6th Cir. 1983). Consequently, the taxpayer's repayment must be involuntary. See, e.g., Cal-Farm Ins. Co. v. United States, 647 F. Supp. 1083 (E.D. Cal. 1986). In this regard, although a judicial determination adverse to the taxpayer is not a prerequisite to a conclusion that the repayment is involuntary, Adams v. Commissioner, 58 T.C. 41 (1972), the repayment must arise out of a determination that any claim pursued against the taxpayer would be resolved adversely to the taxpayer. Pike v. Commissioner, 44 T.C. 787 (1965), acq., 1968-2 C.B. 2. Additionally, there must be a nexus or direct relationship between the income that was taxed and the amount later claimed as a repayment of the income. Uhlenbrock v. Commissioner, 67 T.C. 818 (1977). Thus, in Uhlenbrock, the Tax Court held that section 1341 relief was not available for an executor's reimbursement of an estate's late filing penalty because the reimbursement was not a repayment of commissions previously included in gross income and would have been required even if no commissions been received. Id.

In Barrett, the Tax Court addressed the requirement of section 1341(a)(2) where the restoration was made pursuant to a settlement. There, in 1981 taxpayer allegedly received insider trader profits subjecting him to both civil and criminal actions. Although the Securities and Exchange Commission contacted the taxpayer about the insider profits it did not pursue administrative proceedings or criminal charges against taxpayer. However, upon private civil suit, taxpayer paid third parties \$54,400 in settlement.

Taxpayer contended that he was entitled to a credit under section 1341 equal to the tax attributable to the inclusion of \$54,400 in his 1981 gross income. The Commissioner contended that taxpayer was not entitled to the credit because the taxpayer had not established that, within the meaning of section 1341(a)(2), that he "did not have an unrestricted right" to the \$54,400 of proceeds from insider trading activities. The Tax Court stated that to satisfy section 1341(a)(2), a taxpayer has to show that he or she had a legal obligation to restore the item or that the payee must have at least the ability to legally compel the repayments before the repayments can be deducted by the payor. The Tax Court observed that, in Barrett, the

settlement was made in good faith, at arm's length, and that there was no suggestion that the settlement was collusive. The court concluded therefrom that the settlement, whether or not embodied in a judgment, established the fact and the amount of taxpayer's legal obligation. In concluding that taxpayer was entitled to the section 1341 credit, the Tax Court held that a bona fide, arm's length settlement between taxpayer and the party that sued him pursuant to which he disgorged \$54,400, established that he did not have an unrestricted right to that sum. The Tax Court noted that to conclude taxpayer restored the \$54,400 voluntarily without regard to any legal obligation would in its view be "ludicrous."

It is the position of the Commissioner that the opinion in Barrett is wrong because no evidence was introduced to establish the nexus between the obligation to repay and the original profit from insider trading. In AOD CC-1992-008, the Commissioner issued a nonacquiescence to the opinion in Barrett. In the AOD, the Commissioner stated that the Tax Court failed to consider whether there was a nexus between the obligation to repay and the original insider trading profits received by the taxpayer. In this regard, the Commissioner explained that no documents were submitted as evidence to the Tax Court by taxpayer to substantiate his characterization of the settlement payments as a disgorgement of profits. The Commissioner noted that in future cases the Service would seek to distinguish Barrett on its facts.

We also point out that where appropriate, section 1341 relief is the lesser of either the tax for the taxable year computed with the deductions or the decrease in tax which would result solely from the exclusion of such item from gross income for such prior taxable years. Section 1341(a)(4) and (a)(5). To the extent that X Corporation both claimed a refundable credit of Amount 2 for Year 2 under section 1341(a)(5) and deducted the entire Amount 1, X Corporation has effectively claimed a double deduction.

2. In the statement attached to its Year 2 return, X Corporation asserted that it was entitled to reduce both its regular income tax and alternative minimum tax by the same Amount 2 because they represent a "separate, but parallel system [of tax]" Under this theory, X Corporation claimed credits totaling \$ \_\_\_\_\_, rather than the refundable credit computed under section 1341(a)(5).

If section 1341 relief is available, then section 1341(a) provides that the tax imposed by this chapter for the taxable year shall be the lesser of the following:

- (4) the tax for the taxable year computed with such deduction; or
- (5) an amount equal to-
  - (A) the tax for the taxable year computed without such deduction, minus

(B) the decrease in tax under this chapter (or the corresponding provisions of prior revenue laws) for the prior taxable year (or years) which would result solely from the exclusion of such item (or portion thereof) from gross income for such prior taxable year (or years).

Hence, the tax rate is computed in one of two ways: 1) the taxpayer can take the allowable deducted in the current year or the taxpayer may compute its tax without the deduction and then reduce the tax so computed by the amount of tax attributable to the inclusion of the amount restored in income in the earlier year. Thus, if X Corporation were eligible for section 1341 relief, it may either take the allowable deduction pursuant to section 1341(a)(4) or recompute its tax pursuant to section 1341(a)(5), but it may not apply both.

The legislative history of section 1341 of the Code indicates that it was enacted to adequately compensate a taxpayer for the tax he paid for a prior year when he subsequently has been obliged to restore amounts he had included in gross income in the prior year because it appeared that he had an unrestricted right to such amount. Senate Report No. 1622, Eighty-third Congress, at pages 118 and 451. See also 108 Congressional Record 22531 (daily edition, October 5, 1962) (Senator Kerr). Thus, the purpose of section 1341 was to place such a taxpayer at least in no worse a tax position than he would have been had he never received the income originally. Rev. Rul. 72-551, 1972-2 C.B. 508.

In Rev. Rul. 77-344, 1972-1 C.B. 269, the Service concluded that to permit a taxpayer to carryback a net operating loss of a subsequent year and offset it against the total income of the prior year of inclusion, which has already been treated as not including the restored item, under the provisions of section 1341(a)(5) would permit a double benefit. In order to compensate for that inequity, the Commissioner concluded that although section 1341(a)(5) does not provide for opening the prior taxable year to recompute taxable income or the tax paid, such taxable income and tax paid would be deemed to have been reduced by the amount of restoration and the tax refunded therefrom in order to determine the amount available to be absorbed by the net operating loss carryback. Rev. Rul. 77-344. Accordingly, the amount of taxable income from the carryback year available to be absorbed by the net operating loss carryback from the loss year was the original taxable income reduced by the amount of the restored income treated as reducing the income of the carryback year under the provisions of section 1341(a)(5). Such adjustments were made in order to avoid the type of double benefit sought by X Corporation. Accordingly, consistent with that same rationale, the taxpayer is not entitled to both claim a deduction pursuant to section 1341(a)(4) while also reducing its alternative minimum tax by Amount 2.

Assuming X Corporation did qualify for section 1341 relief, Exam would need to determine which method results in the lesser tax. In computing the tax under section 1341(a)(5), Treas. Reg. § 1.1341-1(b)(1)(ii) provides that the decrease in tax liability for the year in which the repaid item was included in gross income caused by excluding that item for the computation of that year's tax liability is adjusted by any increase in alternative minimum tax resulting from that exclusion. Hence, the only permissible adjustment to the alternative minimum tax computation of the section 1341(a)(5) amount would be an increase in the AMT, not the reduction which X Corporation claimed.

Finally, we point out that to the extent that Y Corporation incurred legal fees with respect to an amount eligible for section 1341 relief, relief is not available for the legal fees. Treas. Reg. § 1.1341-1(h).

#### CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

In the instant case, there are litigation hazards in arguing that X Corporation is not entitled to the benefit of section 1341 on the basis that the corporation does not satisfy the appearance of an unrestricted right to income requirement of section 1341(a)(1). This is because in the settlement agreement, Subsidiary denied any wrongdoing and stated that it was settling the case to avoid the expense and burdens associated with a trial, just as the taxpayer in Barrett, never admitted to wrongdoing in settling the civil suit. Further, although the Commissioner could argue that X Corporation has the burden of proving that it meets the requirements for section 1341 relief, it is uncertain to what extent such an argument would be successful in light of Barrett. However, the pleadings did allege conspiracy to fix, raise, maintain and stabilize prices and other wrongful act in violation of the antitrust laws. Thus, because the facts support the position that Subsidiary was engaged in wrongful acts, we agree with your position that a potential ground for denying the benefit of section 1341 is that the "appearance of an unrestricted right to income" requirement of section 1341(a) is not satisfied.

We concur in your view that X Corporation's reduction of the AMT as well as claiming the regular income tax deduction for the year ■■■■ is impermissible. In our view, the taxpayer's position conflicts with the regulations and the general purpose of section 1341 which is placing taxpayers in the same position they would have been in had they not included the items in question under a claim of right. To the extent that section 1341 relief is available to a taxpayer, the computation of the deduction is made pursuant to either section 1341(a)(4) or section 1341(a)(5) but not both.

In the incoming request, you also asked for advice about whether section 1341(b)(2) precludes the application of section 1341(a) in ■■■■ to items (i.e.,

overcharges) included in gross income in prior years attributable to the sale of property held by the taxpayer primarily for sale to customers in the ordinary course of its trade or business. This office has previously determined that this is a novel legal issue and field service advice is not the appropriate vehicle for addressing the question you have raised. In informal telephone conversations [REDACTED] of your office advised Deborah Clark that a response to the other questions submitted for field service advice will likely result in settlement of this adjustment. In the event that the issue is not resolved and Examination continues to seek assistance with this issue, the appropriate vehicle would be submission of a request for a Technical Advice Memorandum.

If you have any further questions, please call (202) 622-7900.

DEBORAH A. BUTLER  
Assistant Chief Counsel

[signed] Gerald M. Horan  
By: \_\_\_\_\_  
GERALD M. HORAN  
Senior Technician Reviewer  
Associate Chief Counsel (Domestic)