



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

OFFICE OF
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

ASSISTANT DISTRICT COUNSEL,

FROM: HEATHER C. MALOY
ASSOCIATE CHIEF COUNSEL, INCOME TAX AND
ACCOUNTING DIVISION CC:ITA

SUBJECT: Restoration of amounts held under a claim of right

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LEGEND

Taxpayer =
Department =

X Corporation	=
a# of years	=
\$x	=
\$y	=
\$z	=
Year A	=
b# of years	=
c%	=

ISSUES

(1) Whether all prior years's underpayments resolved by the settlement payment from Taxpayer to the Department must be included in the computation under I.R.C. § 1341.

(2) Whether Taxpayer may calculate its tax under section 1341 by deducting a portion of the settlement payment attributable to some prior years under subsection (a)(4) and by claiming a credit for a portion attributable to other prior years under subsection (a)(5).

(3) Whether a portion of the settlement payment should be allocated to interest and excluded from the computation under section 1341.

CONCLUSIONS

(1) All prior years's underpayments resolved by the settlement payment must be included in the computation using the methodology described in Treas. Reg. § 1.1341-1(d)(3)(i).

(2) With respect to all prior years's underpayments resolved by the settlement payment, Taxpayer is not permitted to calculate its tax under section 1341 using subsection (a)(4) for some prior years and subsection (a)(5) for other years. Taxpayer must use the same subsection with respect to all prior years, whichever yields the lesser tax.

(3) A portion of the settlement payment should be allocated to interest and thus excluded from the computation under section 1341.

FACTS

Taxpayer is a subsidiary and member of the affiliated group of X Corporation, and is engaged in the oil and gas business.

The Department leases Federal and other types of land to private entities for natural resources exploration and extraction. Lessees are required to remit rental payments and royalties based on the value of natural resources extracted.

The Department performed an audit of Taxpayer and Taxpayer's predecessor's leases and determined that Taxpayer and its predecessor had underpaid royalties on certain leases. The Department determined underpayments of royalties involving a# of years. The Department determined that Taxpayer owed on the royalty underpayments and owed interest on the underpayments for the years.

Taxpayer calculated its exposure as a result of the Department audits for the a# of years. Taxpayer determined its exposure as \$x and the interest due on the underpayments as \$y (the interest calculated (\$y) was slightly greater than the amount owed (\$x)).

In Year A, Taxpayer and the Department settled all claims for royalty underpayments (and interest thereon) by an agreement whereby Taxpayer paid \$z, an amount which was approximately c% of the amounts Taxpayer had calculated as its exposure.¹

On its consolidated income tax return for Year A, X Corporation claimed a deduction for the \$z settlement payment, but did not compute its tax under section 1341. However, during the examination of that year's return, X Corporation filed a self-audit adjustment form in which it claimed a decrease in taxable income and a credit based on application of section 1341 with respect to the \$z settlement payment. In its calculation, X Corporation included the entire \$z; i.e., no portion was allocated to interest. In addition, the taxpayer's calculation only includes the first b# of years where royalty underpayments occurred, even though the settlement payment related to royalty underpayments for a# of years.

LAW AND ANALYSIS

Income received under a claim of right and without restriction as to its disposition is taxable when received, even though it might be later determined that the taxpayer is not entitled to retain the money. North American Oil Consolidated v. Burnet, 286 U.S. 417, 424 (1932). If a taxpayer who included an item of income in reported income under the claim of right doctrine is required to repay the amount in a subsequent year, the taxpayer may be entitled to a deduction in the year of repayment (under the cash method) or in the year when the liability to make repayment became fixed (under the accrual method), but the taxes due for the year of inclusion are not affected. United States v. Lewis, 340 U.S. 590 (1951); Healy v. Commissioner, 345 U.S. 278, 284 (1952); Whitaker v. Commissioner, 259 F.2d 379,

¹ That is, $\$z = c\% (\$x \text{ (underpayments)} + \$y \text{ (interest on underpayments)})$.

382 (5th Cir. 1958). Such a deduction is allowed only if some provision of the Internal Revenue Code permits the deduction. Wood v. United States, 863 F.2d 417 (5th Cir. 1989); National Life and Accident Insurance Company v. United States, 244 F. Supp. 135 (M.D. Tenn. 1965), aff'd, 385 F.2d 832 (6th Cir. 1968). In most cases, if the repayment is made in connection with the carrying on of a trade or business, the repayment is allowable as a deduction under section 162. Pike v. Commissioner, 44 T.C. 787 (1965).

In some cases, allowance of a deduction in the year of repayment produces a tax benefit less than the increase in tax attributable to inclusion in the year of receipt. For example, the tax rate in effect for the year of receipt may be higher than the tax rate in effect for the year of repayment. To ameliorate this inequity, section 1341 was enacted. United States v. Skelly Oil Co., 394 U.S. 678 (1969). If it is later determined that the income included under a claim of right has to be repaid or restored, section 1341 gives taxpayers the ability, in the year of restoration, to put themselves in the same position as if the income had never been reported.

Oil and gas development occurs through arrangements similar to partnerships. In the case of owners of mineral bearing property, the owners in effect contribute mineral development rights in exchange for a royalty to be paid out of production, usually a one-eighth interest. The lessee pays the share of production attributable to royalties and excludes this income both for income tax purposes and in computing the amount of gross income eligible for percentage depletion. Section 611(b)(1); Helvering v. Twin Bell Oil Syndicate, 293 U.S. 312 (1934). Thus, the royalties paid to the Department were excluded from Taxpayer's gross income. Consequently, the amounts of underpaid royalties in this case were an item included in Taxpayer's income for the a# of years, thus triggering section 1341 when the \$z settlement payment was made in Year A.

Section 1341 provides rules for determining the tax imposed for the year of repayment if (1) an item was included in gross income for a prior taxable year 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 the taxable year that the taxpayer did not have an unrestricted right to such item, and (3) the amount of the item exceeds \$3,000. If these three requirements have occurred, then the tax liability is the lesser of (i) the tax for the taxable year computed with such deduction, or (ii) the tax for the taxable year computed without such deduction minus the decrease in tax under Chapter 1 of the Code for the prior year (or years) that would result solely from the exclusion of such item from gross income for such prior taxable year (or years). Section 1341(a)(4) and (a)(5).

Allocation of section 1341 computation to all prior years

Treas. Reg. § 1.1341-1(d)(3)(i) provides as follows:

If the deduction otherwise allowable for the taxable year relates to income included in gross income under a claim of right in more than one prior taxable year and the amount attributable to each such prior taxable year cannot be readily identified, then the portion attributable to each such prior taxable year shall be that proportion of deduction otherwise allowable for the taxable year which the amount of the income included under the claim of right in question for the prior taxable year bears to the total of all such income included under the claim of right for all such prior taxable years.

The \$z settlement payment involved in this case related to underpaid royalties for a# of year period. Yet Taxpayer only calculated its section 1341 deduction and credit based on the first b# of those years.² This is inconsistent with the language of the regulation. Unless the taxpayer can readily establish that the royalty underpayments involved only certain years, the amount of the settlement payments must be allocated to all of the related prior years using the methodology described in Treas. Reg. § 1.1341-1(d)(3)(i). See Maier Brewing Company v. Commissioner, T.C. Memo. 1987-385, aff'd, 916 F.2d 716 (9th Cir. 1990).

Ability to use both subsections 1341(a)(4) and (a)(5) for the section 1341 computation

Taxpayer claimed a decrease in taxable income and a credit based on application of section 1341 with respect to the \$z settlement payment made in Year A. The issue is whether a taxpayer can take both a deduction and a credit based on a single section 1341 restoration payment, if that restoration payment involves more than one year.

The Court of Claims held that if a taxpayer repays an overcharge in one year that accrued during a period of several years, each year's overcharge is treated as a separate item, so that the taxpayer may deduct restoration payments under subsection 1341(a)(4) for some years and claim credits under subsection 1341(a)(5) for others years. Missouri Pacific Railroad Company v. United States, 91 Ct.Cl. 61, 423 F.2d 727 (Ct.Cl. 1970), cert. denied, 402 U.S. 944 (1971). The Service published an Action on Decision stating its disagreement with this opinion. 1971 AOD LEXIS 349 (March 25, 1971). The Service's position is that subparagraphs (a)(4) and (a)(5) of section 1341 may not be used interchangeably with respect to a single restoration made in one taxable year.

It is the Service view that Taxpayer is not permitted to use subsection (a)(4) for some prior years and (a)(5) for other years, with respect to the single settlement

² Apparently, Taxpayer did not included that latter years in its section 1341 computation because Taxpayer would have received no tax benefit due to an overall limitation on those years because of other tax credits.

payment made in Year A. Taxpayer must use the same subsection with respect to all prior years, whichever yields the lesser tax.

Allocation of interest to the settlement payment and thus the effect on the section 1341 calculation

The Department performed an audit of Taxpayer and Taxpayer's predecessor's leases and determined that Taxpayer and its predecessor had underpaid royalties on certain leases. As part of its determination for reimbursement, the Department calculated royalty underpayments and interest on the underpayments for the years. Application of the interest to its claims against Taxpayer was proper and consistent with federal law. See 30 U.S.C. § 1701, *et seq.*, Federal Oil and Gas Royalty Management Act of 1982, § 1721 (oil and gas lessees are required to pay interest on royalty underpayments). Taxpayer's own exposure calculation determined an \$x underpayment and the interest due on the underpayments as \$y. Furthermore, in the Taxpayer's own exposure calculation, the interest calculated (\$y) was slightly greater than the amount owed (\$x).

The tax treatment of settlement payments is ascertained by reference to the origin of the claim and the basis upon which the settlement was reached. Keller Street Development Company v. Commissioner, 688 F.2d 675, 681-682 (9th Cir. 1982); Anchor Coupling Co. v. United States, 427 F.2d 429, 431-33 (7th Cir. 1970); Thomson v. Commissioner, 406 F.2d 1006, 1008 (9th Cir. 1969); Spangler v. Commissioner, 323 F.2d 913, 916 (9th Cir. 1963); Entwicklungs Und Finanzierungs A.G. v. Commissioner, 68 T.C. 749, 759 (1977).

Taxpayer's payment of \$z in Year A (which was approximately c% of what Taxpayer calculated as its total exposure, underpayments and interest on underpayments) resolved with the Department all claims for royalty underpayments and interest thereon. The \$z settlement payment, which settled the underpayments and interest associated with those underpayments, presumably is composed in some proportion of repayment of underpayments and repayment of interest.

The Tax Court has held that a lump-sum settlement payment had to be allocated between the portion excludable under section 104(a)(2) and the portion taxable as interest. Robinson v. Commissioner, 102 T.C. 116 (1994), *aff'd*, 70 F.3d 34 (5th Cir. 1995). The settlement in Robinson followed a jury verdict which awarded damages in the amount of \$59,260,000, plus interest in the amount of \$881,919.61. After the jury verdict, the case was settled for \$10,000,000, none of which was allocated to interest. The Tax Court first held that it was not bound by the allocation in the settlement. The Court then concluded that \$146,640 of the settlement proceeds should be allocated to taxable interest. In footnote 24 of its opinion, 102 T.C. at 135, the Tax Court explained how it calculated the interest portion of the settlement amount as follows:

We have determined the prejudgment interest of \$146,640 by deducing that (1) the prejudgment interest included in the \$10 million payment, divided by (2) the \$10 million payment less the amount of prejudgment interest included therein, is the same ratio as (1) the prejudgment interest awarded by the State trial court on the jury verdict, divided by (2) the jury verdict. In other words, mathematically speaking, assuming that the prejudgment interest included in the \$10 million payment equals "X", the ratio is as follows:

$$\frac{X}{10,000,000 - X} = \frac{881,919.61}{59,260,000.00}$$

See also Delaney v. Commissioner, 99 F.3d 20, 25 (1st Cir. 1996), aff'g T.C. Memo. 1995-378 (the First Circuit approved the Tax Court's allocation of a portion of a settlement payment to interest based the percentage of interest in the jury award); Spangler v. Commissioner, 323 F.2d at 916, aff'g T.C. Memo. 1961-341 (the Ninth Circuit affirmed the Tax Court's holding "that proration between principal and interest was proper where...the amount collected...was a lump sum settlement of the entire obligation..."). Allocation of \$z settlement payment into royalty underpayments reimbursement and interest on the underpayments is supported by the force of logic and case law.

Accordingly, an amount associated with the interest must be carved out from the \$z settlement payment. Furthermore, the full amount of \$z settlement payment cannot be taken into account in calculating the section 1341 calculation.

The section 1341 calculation is restricted to the portions of the settlement payments that represent items previously included in the taxpayer's income. Section 1341 only applies where an item was included in a taxpayer's income because it appeared that taxpayer had an unrestricted right to such income, but it was later established the taxpayer's claim of right was defective and taxpayer did not have an unrestricted right to such item. Sections 1341(a)(1) and (a)(2). "This language requires that the taxpayer's obligation to repay must arise out of the specific 'circumstances, terms and conditions' of the transaction whereby the amount was originally included in his income. Bailey v. Commissioner, 756 F.2d 44, 47 (6th Cir. 1985) (citations omitted). See also Treas. Reg. § 1.1341-1(d)(2)(i)

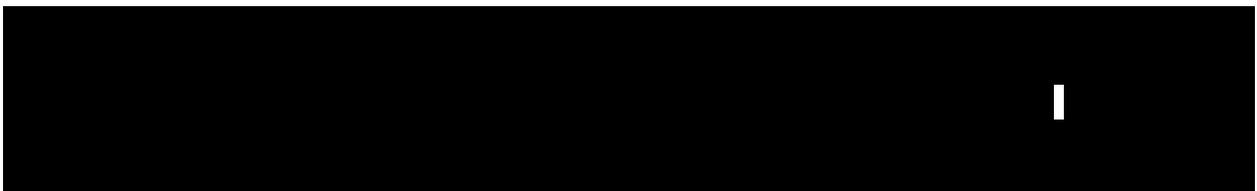
Because the portion of the \$z settlement payment allocated to interest does not represent items previously included in Taxpayer's income, section 1341 does not apply to that portion of the settlement. See Bailey, 756 F.2d at 47; Maier Brewing

Company v. Commissioner, T.C. Memo. 1987-385, aff'd, 916 F.2d 716 (9th Cir. 1990).

As to the determination of what portion of the \$z settlement payment is properly section 1341 reimbursement and what portion is properly interest, the only calculation of royalty underpayments and interest thereon is Taxpayer's exposure calculation. Taxpayer determined its exposure as \$x and the interest due on the underpayments as \$y (the interest calculated (\$y) was slightly greater than the amount owed (\$x)). Of course, in Year A, when Taxpayer and the Department settled all claims for royalty underpayments (and interest thereon) by an agreement, Taxpayer paid \$z, an amount which was approximately c% of the amounts Taxpayer had calculated as its exposure. While neither the Taxpayer nor the government is bound by calculations made by Taxpayer prior to settlement, such calculations indicate two points: (1) some amount of the \$z settlement payment must be allocated to interest and (2) the amount allocated to interest arguably is as much as slightly more than half the \$z settlement payment.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

We have generally agreed with your incoming request for field service advice. The amount Taxpayer has used in its section 1341 reimbursement, \$z, must be (1) allocated over all fifteen years rather than only the first b# of years and (2) must be reduced for some portion associated with interest



[REDACTED]

As for the allocation of interest, we believe case law clearly supports some allocation to interest. Further, the allocation could logically be similar to the allocation determined by Taxpayer. Using the methodology applied in Robinson, Delaney, and Spangler, approximately half of the settlement should be allocated to interest. However, Taxpayer's exposure calculations are not binding either party but do support your view that a substantial portion of the settlement amount represented interest. The actual calculations would have to be based on the amounts claimed by Department and the applicable interest rates for royalty underpayments. [REDACTED]

Please call if you have any further questions.

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