

Office of Chief Counsel
Internal Revenue Service
Memorandum

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subject: Section 1341 and Section 16(b) of the Securities Exchange Act of 1934

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

LEGEND

Taxpayers =

Executive =

Spouse =

Corporation =

Entity 1 =

Entity 2 =

Entity 3 =

Year 3 =

Year 1 =

Year 2 =

Period 3 =

Date 1 =

Date 2 =

Date 3 =

Date 4 =

Date 6 =

Date 7 =

Date 8 =

\$A =

\$B =

\$C =

\$D =

\$E =

\$F =

\$G =

\$H =

\$I =

\$M =

\$N =

\$O =

\$R =

\$T =

\$W =

A# =

B# =

C# =

D# =

E# =

H# =

ISSUE

Under the facts of this case, does the “claim of wrong” exception prevent Taxpayers from claiming the tax benefits of section¹ 1341 for payments to settle alleged violations of section 16(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78p(b)?

CONCLUSION

Under the facts of this case, the “claim of wrong” exception does not apply to prevent Taxpayers from calculating their tax liability under section 1341.

FACTS

Taxpayers filed an Application for Tentative Refund (Form 1045) for Year 3 on which they claimed entitlement to an overpayment of tax under section 1341(b)(1) of \$A. The Service paid that amount to Taxpayers as required by section 6411. The Service is examining that claim. Taxpayers consist of Executive and Spouse.

Executive founded Corporation of which Executive was a shareholder as well as its president and CEO. On Date 1, Corporation issued stock in an initial public offering. During Year 1, in return for annual annuity payments, Taxpayers transferred shares of Corporation stock that they owned to Entity 1 and Entity 2, with each Entity receiving A# shares. Entity 3 also purchased B# shares of Corporation stock from Taxpayers.

Taxpayers sold Corporation stock as follows: (1) C# shares on Date 2 for \$C, (2) D# shares on Date 3 for \$D, and (3) E# shares on Date 4 for \$E (collectively the gain sales).

During Period 3 Corporation stock split.

On their Year 2 federal income tax return Taxpayers reported capital gain on line 13 in the amount of \$B. That amount included long-term capital gain on their sales of Corporation stock for that year in the amount of \$F. In computing gain on the sale of

¹ With the exception of references to section 16(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78p(b), references to sections refer to sections of the Internal Revenue Code of 1986 as applicable to the taxable years under discussion.

the Corporation stock Taxpayers reported basis in the shares of \$G and \$H. Nothing explains the source of that basis. Taxpayers' total reported tax liability for Year 2 was \$I. Taxpayers reported no alternative minimum tax liability for Year 2.

The settlement required Taxpayers to pay a total of \$M. The settlement agreement received court approval on Date 6. Taxpayers have represented that on Date 7 and Date 8 they paid \$N and \$O respectively to Corporation.

Taxpayers filed a Form 1045 concurrently with their Form 1040 for Year 3. On the Form 1045 Taxpayers made application for a tentative refund under section 6411(d) of an alleged overpayment determined under section 1341(b)(1). On the Form 1045, Taxpayers computed their reduction in tax liability under section 1341(a)(5)(B) by excluding, for Year 2, some of the gain on the sale of Corporation Stock. Taxpayers computed a decrease in tax for Year 2 of \$R. Taxpayers reported that decrease as a payment of tax for Year 3 resulting in an overpayment of tax under section 1341(b)(1) of \$A (\$R – \$T (tax liability reported for Year 3)).

LAW AND ANALYSIS

Where it applies section 1341 allows a taxpayer to pay the lesser of: (1) the normal income tax for the year in which excess income is restored by the taxpayer with a deduction for the amount restored (section 1341(a)(4)) or, if less (2) a tax computed with a reduction in the amount that the tax for the year in which the taxpayer received the excess income would have been decreased if the amount restored had been excluded from income in that year (section 1341(a)(5)(A)-(B)). To qualify for the tax benefits of section 1341, the taxpayer must satisfy the following three requirements of section 1341(a):

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

(a)(2) a deduction must be allowable to the taxpayer for the current taxable year because it was established after the close of the taxable year (or years) of income inclusion that the taxpayer did not have an unrestricted right to the item or portion thereof, and

(a)(3) the amount of the deduction must exceed \$3,000.

The primary issue in this case concerns whether it appeared, as required by section 1341(a)(1), that Taxpayers had an unrestricted right to the profits on the gain sales, subsequently required to be disgorged to Corporation pursuant to the settlement agreement, when Taxpayers included those profits in gross income in Year 2.

To be entitled to the tax benefits of section 1341, a taxpayer must restore in the taxable year an item that was included in gross income under a claim of right in a prior taxable year. Treas. Reg. § 1.1341-1(a). Treas. Reg. § 1.1341-1(a)(2) defines “income included under a claim of right” as an item included in gross income because it appeared from all the facts available in the year of inclusion that the taxpayer had an unrestricted right to such item and “restoration to another” means a restoration resulting because it was established after the close of such prior taxable year that the taxpayer did not have an unrestricted right to such item (or portion thereof).

The taxpayer must have a bona fide claim to the item of income to qualify the income as included under a claim of right. Consequently, although one who embezzles funds must include those funds in gross income under section 61, such income is not included under a claim of right for purposes of section 1341(a). See e.g. *Yerkie v. Commissioner*, 67 T.C. 388 (1976); *McKinney v. United States*, 574 F.2d 1240 (5th Cir. 1978), *cert. denied*, 439 U.S. 1072 (1979); *Hankins v. United States*, 403 F.Supp. 257 (N.D. Miss. 1975), *aff’d without published opinion*, 531 F.2d 573 (5th Cir. 1976); Rev. Rul. 65-254, 1965-2 CB 50. Likewise, this “claim of wrong” exception to the application of section 1341 has been applied in a variety of contexts involving intentional wrongdoing. See e.g. *Perez v. United States*, 553 F.Supp 558 (M.D. Fla. 1982) (income from kickback payments resulting in taxpayer’s conviction of mail fraud); *Culley v.*

United States, 222 F.3d 1331 (Fed. Cir. 2000) (money obtained through bribery and kickback scheme and fraud in the sale of a business); *O'Hagan v. Commissioner*, T.C. Memo 1995-409 (lawyer improperly using client funds for personal purposes, convicted of theft by temporary control); *Wang v. Commissioner*, T.C. Memo 1998-389, *aff'd*, 2002-1 U.S. Tax Cas. (CCH) P50443 (9th Cir. 2002), *cert. denied*, 538 U.S. 910 (2003) (taxpayer obtaining money illegally through selling insider information).

Although most “claim of wrong” cases have involved obtaining income through criminal wrongdoing, the exception is not limited to criminal cases. In *Parks v. United States*, 945 F.Supp. 865 (W.D. Pa. 1996), the taxpayers sought section 1341 tax treatment for amounts they paid to settle civil fraud allegations. There was no judgment establishing that the taxpayers committed fraud. However, the court did not view the settlement in the civil action as precluding the government from proving fraud as a bar to the application of section 1341 in a federal tax proceeding. The court concluded that any income obtained through intentional wrongdoing failed to qualify for the tax benefits of section 1341:

If the taxpayer commits fraud to obtain income, this court would not accept that such conduct can create the appearance of an unrestricted right to an item of income. If one commits an intentional wrongdoing, one always does so at the risk of discovery and the potential for disgorgement, restitution, civil penalties, criminal liability, and the like. As argued elsewhere by the government in a section 1341 case, ill-gotten gains are never obtained by unrestricted right. [citing *Perez*].

Id. at 866.

In applying the claim of wrong exception in *McKinney*, the Fifth Circuit Court of Appeals stated:

The language of § 1341(a)(1), *i.e.* ‘because it appeared that the taxpayer had an unrestricted right to such item’, must necessarily mean ‘because it appeared *to the taxpayer* [emphasis in original] that he had an unrestricted right to such item.’

574 F.2d at 1243. Likewise, in *Perez*, articulating its standard for applying the claim of wrong exception the district court stated:

This Court must therefore conclude that the reasoning and result in *McKinney* cannot be limited only to embezzlers; instead, the statute’s ‘unrestricted right’ language must be read to exclude from its coverage all those who receive earnings knowing themselves to have no legal right thereto.

553 F.Supp. at 561.

The above quotes raise the question of whether the claim of wrong exception is based on an objective standard or applies based on the taxpayer’s subjective intent. That is, must the taxpayer actually be aware that the taxpayer is obtaining income through

wrongful means for the exception to apply or can it be applied based on how a reasonable person would have viewed the behavior in question. In *Wood v. United States*, 863 F.2d 417 (5th Cir. 1989), a case involving the forfeiture of a portion of the proceeds from marijuana sales, this question was raised but not required to be resolved. However, in footnote 9 to *Zadoff v. United States*, 638 F.Supp 1240, 1244 (S.D. N.Y. 1986), a case involving kickbacks from a supplier to an employee of the supplier's customer, the court stated that "[a] mere unreasonable belief by a taxpayer that he has a right to income, without more, will not entitle the taxpayer to § 1341 treatment upon repayment."

Section 16(b) imposes liability on certain parties who derive profits from purchasing and selling or selling and purchasing certain equity securities within a period of less than six months. This provision imposes strict liability requiring neither negligence nor wrongdoing for its application. It is not necessary for us to resolve the issue of whether the claim of wrong exception could ever apply in the context of section 16(b). It is clear, however, that the exception does not apply under the facts of this case.

Because there was a bona fide legal issue regarding Taxpayers' liability under section 16(b), Taxpayers had an appearance of an unrestricted right to the income in question. The claim of wrong exception does not apply here to prevent the application of section 1341 to the amounts at issue.

Additional Issues

A. Restoration

Taxpayers disgorged profits to Corporation rather than to the parties who purchased their Corporation stock. To qualify as a restoration for purposes of section 1341, the disgorgement of income need not be to the party who was the original payor of the income. It is only necessary that the taxpayer pay the disgorged income to its rightful owner. See Example at Treas. Reg. § 1.1341-(1)(h).

B. Settlement as Establishing Liability

Section 1341(a)(2) requires that a deduction be allowable because it was established after the close of the taxable year (or years) of income inclusion that the taxpayer did

not have an unrestricted right to the item included in gross income. Pursuant to the establishment requirement, the deduction must arise because the taxpayer is under a legal obligation to disgorge the income. See *Barrett v. Commissioner*, 96 T.C. 713 (1991); *Kappel v. United States*, 437 F.2d 1222 (3d Cir.), *cert. denied*, 404 U.S. 830 (1971). This legal obligation need not be established by a final judgment. See Rev. Rul. 58-456, 1958-2 C.B. 415. Under the facts of this case, the Trial Court judgment together with the settlement of that liability during the appeal process establishes Taxpayers legal obligation to disgorge the profits at issue for purposes of section 1341(a)(2). Cf. *Barrett*² (good faith arms-length settlement of civil suits seeking disgorgement of profits from option trading established liability for purposes of section 1341).

C. Exclusion of Interest

Even if Taxpayers are entitled to compute a reduction in tax under section 1341(a)(5)(B), the exclusion of gross income attributable to the restoration payment cannot include the portion of the settlement payment allocable to interest. Section 1341 only applies to the portion of the settlement payment that constitutes disgorged profits.

D. Attorney Fees

On their Year 3 Schedule D, Capital Gains and Losses, Taxpayers claimed \$W of legal fees incurred in the section 16(b) litigation as a long-term capital loss. This treatment is in accord with the treatment allowed in *Barrett*. If the fees were paid in Year 3, the fees appear to be properly claimed as a long-term capital loss for that year. Legal fees incurred in contesting a liability to disgorge income that qualifies for the tax benefits of section 1341 do not themselves qualify for such benefits. Treas. Reg. § 1.1341-1(h).

E. Alternative Minimum Tax

In computing the reduction in tax for a prior taxable year under section 1341(a)(5)(B), the statute requires a computation of what the tax imposed under chapter 1 of the Code would have been if the disgorged income had not previously been included in gross income. The excess of the chapter 1 tax originally imposed over the recomputed chapter 1 tax, if any, is treated as a payment of tax for the taxable year of restoration. This amount does not affect the computation of either regular tax or alternative minimum tax liability for the taxable year of restoration. It is simply treated as one of the payments, like an estimated tax payment, applied against that liability which either reduces the amount due or constitutes an overpayment if in excess of that liability. However, because the tax imposed under chapter 1 of the Code includes both regular tax and alternative minimum tax, it is necessary to recompute both of these taxes for the prior taxable year when performing a section 1341(a)(5)(B) computation.

² Although the Service issued a nonacquiescence in *Barrett*, see AOD 1992-08, this nonacquiescence was based on the deficiency of the record in that case rather than on the principle that a settlement agreement could never establish liability for section 1341(a)(2) purposes.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

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