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Capturing a Permanent Tax Benefit from Previously Taxed Income

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Section 1341 may provide a permanent benefit in the form of rate relief, ability to use otherwise nondeductible capital losses, or an immediate refund for net operating loss positions. The section 1341 mitigation rule makes the taxpayer whole when the tax benefit of a current deduction related to refunding income is less than the tax imposed on the income when received. To be eligible, taxpayers must have received income under a claim of right in a prior year, restored or refunded that income to the payor, and must be otherwise entitled to a current deduction for the amount refunded.

With taxpayers now multiple years into the changes made by the Tax Cuts and Jobs Act (TCJA) for tax years beginning after 2017, most notably a reduction in the U.S. federal corporate rate from 35 to 21 percent, section 1341 of the Code[1] continues to be an overlooked tool when tax inequities otherwise result from the annual accounting concept for deductions allowed in lower rate tax years upon a repayment of income received and recognized under a claim of right in a previous, higher rate, tax year. Section 1341 is intended to mitigate the adverse impact of the tax rate differential when the deduction in the year of repayment does not provide a benefit proportionate with the tax liability generated when the item was previously included in income. The relief under section 1341 is also available in many states where a similar tax rate reduction may be experienced.

Many corporate taxpayers may have rightfully overlooked section 1341 in the past because the top corporate rate of 35 percent remained in place for nearly 25 years, thus creating limited scenarios for

[1] Unless otherwise indicated, section references are to the Internal Revenue Code of 1986, as amended (the "Code") or the applicable regulations promulgated pursuant to the Code (the "regulations").

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such mitigation. Now, those same corporate taxpayers may benefit from section 1341 because tax rates changed after 2017 and should be aware of the provision and its potential benefits.

The Basics

Pursuant to section 1341(a), if:

- An item was included in gross income for a prior tax year (or years) because it appeared that the taxpayer had an unrestricted right to such item;
- A deduction is allowable for the tax year because it was established after the close of such prior tax year (or years) that the taxpayer did not have an unrestricted right to such item or to a portion of such item; and
- The amount of the deduction exceeds $3,000,

Then the tax imposed for the tax year shall be the lesser of two separately calculated amounts as follows:

- The tax for the tax year computed *with* the deduction; or
- The tax for the tax year computed *without* the deduction *minus* the decrease in tax for the prior tax year (or years) that would result solely from the exclusion of the item (or portion thereof) from gross income for the prior tax year (or years).

Section 1341(b)(2) provides, however, that it does not apply to: (1) restorations from the sale of inventory or property held for sale in the ordinary course of business ("the inventory exception"), (2) bad debts, or (3) legal fees and other expenses incurred by a taxpayer in contesting the restoration of an item previously included in income.[2] However, the inventory exception does not apply to public utilities claiming deductions for refunds or repayments due to rate changes. Section 1341 does apply to adjustments to income from services, long-term construction contracts, and the sale of capital assets.

The rules under section 1341, when applicable, put the taxpayer in the same tax position it would have been in during the prior year if the item of gross income had not been taxable in that prior year. The mitigation relief is in the form of a multistep, "with and without" calculation as follows:

Step 1. Compute current year tax liability including the repayment amount as a deduction.

Step 2. Compute current year tax liability without including the repayment amount as a deduction.

Step 3. Recompute prior year tax liability without including the repayment amount in gross income.

Step 4. Determine the decrease in prior year tax by subtracting the result in Step 3 from the original prior year tax liability.

[2] Section 1341(b)(2); section 1.1341-1(f), (g), and (h).

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Step 5. Subtract the decrease in tax determined in Step 4 from the current year tax liability computed without including the repayment amount as determined in Step 2 above.

Step 6. If the result in Step 5 is less than the result in Step 1, report current year taxable income and tax liability in accordance with Step 5.

Section 1341 Example

A numerical example illustrating the application of section 1341 is as follows: In 2017 (35 percent corporate tax rate), Taxpayer A included $5,000,000 in gross income on its Form 1120 because Taxpayer A appeared to have an unrestricted right to the income. In 2020 (21 percent corporate tax rate), Taxpayer A established that it did not have an unrestricted right to that income and repaid the amount, resulting in a deductible expense.

Applying section 1341(a)(5), Taxpayer A will perform the following analysis:

	2020 (With)	2020 (Without)	2017 (With)	2017 (Without)
Gross Income	$ 55,000,000	$ 55,000,000	$ 20,000,000	$ 15,000,000
Expenses	$ (5,000,000)	$ (5,000,000)	$ (5,000,000)	$ (5,000,000)
Repayment Deduction	$ (5,000,000)	$ -	$ -	$ -
Taxable Income	$ 45,000,000	$ 50,000,000	$ 15,000,000	$ 10,000,000
Tax Rate	21%	21%	35%	35%
Tax Liability	$ 9,450,000	$ 10,500,000	$ 5,250,000	$ 3,500,000
	A	B	C	D

Step 1: Current year tax liability with repayment deduction	$ 9,450,000
Step 2: Current year tax liability without repayment deduction	$ 10,500,000
Step 3: Recompute prior year tax liability without repayment in income	$ 3,500,000
Step 4: Decrease in prior year tax	$ 1,750,000
Step 5: Subtract Step 4 result from Step 2	$ 8,750,000

The 2020 tax liability is $8,750,000 because that amount is less than $9,450,000. Taxpayer A should forego claiming the $5,000,000 deduction on its current year tax return, and compute its current year tax liability taking into account the section 1341 credit instead.

In this example, by applying section 1341, the taxpayer has a permanent reduction in taxes of $700,000, which is the amount of the repayment, multiplied by the difference in tax rates between the year of inclusion and year of repayment ($5,000,000 x 14 percent).

While section 1341 relief may seem like a relatively straightforward concept, there are a number of complexities and conditions that must be analyzed in determining applicability of the provision. First, there must be more than one tax year involved. As noted above, the taxpayer must first include the item as gross income in the year of receipt, under a claim of right due to the “appearance” of having an unrestricted right to the income. Further, in a subsequent year, the taxpayer must establish that it did

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not have an unrestricted right to the item included in gross income in the prior year, and make a payment related to the item in the current tax year that is otherwise allowable as a current deduction.

"Appearance" of an Unrestricted Right and Impact of Subsequent Events

In the U.S. Supreme Court case, *North American Oil Consolidated v. Burnett,*[3] the Court concluded that income received must be taxed in the year of receipt if the taxpayer has free and unrestricted use of the funds even though another party may possess a claim against the income. Later, in *United States v. Lewis*[4] the Court held that a Chief Executive Officer, Lewis, should include in gross income during the year of receipt the total amount of an incorrectly computed bonus payment[5] under the claim of right doctrine previously promulgated. In the case, Lewis maintained that he should be allowed to amend his federal income tax return for the year the erroneous bonus was received and taxed. The Court held that under the annual accounting concept, while Lewis would not be permitted to amend his tax return, he should be permitted a deduction in the year the bonus amount was repaid to his company. The issue, however, was that Lewis experienced a tax inequity as a result because his marginal tax rate in the year of receipt was higher than in the year of repayment; thus, this case was the impetus for the addition of section 1341 to the Code.

As discussed above, the primary requirement for section 1341 to apply to a repayment is that the related item was included in gross income in a prior tax year(s) because it "appeared" that the taxpayer had an unrestricted right to an item of gross income. The Internal Revenue Service (IRS) and courts have historically disagreed on the interpretation of this requirement. Specifically, the IRS generally differentiates between an "appearance of an unrestricted right" and an "absolute" right to an item of income, the latter of which it argues would prohibit section 1341 treatment. The IRS's historical view, which it appears to continue to follow, is that the underlying facts causing the taxpayer to determine that it does not to have an unrestricted right to the income must have been in existence at the time of receipt but not known or knowable in the prior year.[6] At the same time, the IRS has been inconsistent in its view that a refund may not result from subsequent events for section 1341 to apply. In Revenue Ruling 78-25, which is still in effect, the IRS found that section 1341 applied to a contingent sales price adjustment when the facts did not appear to be in existence in the year of sale. Additionally, when a taxpayer has "no right at all" to the item of gross income at the time of receipt (for example in situations of fraud or embezzlement), section 1341 will not apply.

Nevertheless, and contrary to the IRS's inconsistent interpretation of the appearance requirement, the courts have consistently rejected the notion that a restoration must not result from subsequent events. In *Dominion Resources, Inc. v. United States*,[7] the Fourth Circuit interpreted the "appearance" requirement as a concept intended to broaden rather than limit what would otherwise be a narrow provision of the tax code if section 1341 only applied to taxpayers who actually had an unrestricted right

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[3] 286 U.S. 417 (1932).

[4] 340 U.S. 590 (1951).

[5] The bonus payment was incorrectly based on a percentage of the corporation's pre-tax income while it should have been computed as a percentage of the corporation's after-tax income.

[6] 1999 IRS NSAR 10782 (Apr. 21, 1999).

[7] 219 F.3d 359 (4th Cir. 2000).

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to an item of income. Said differently, the Fourth Circuit concluded that the use of the word "appeared" in the provision is merely semantics, and that it was the intent of Congress to provide relief to both taxpayers that only seemed to have an unrestricted right to the income, in addition to those that actually had an unrestricted right to the income at the time of receipt.

Similarly, courts have generally concluded that section 1341 is applicable if the terms and conditions giving rise to the subsequent liability were present at the time of the earlier gross income inclusion, even if the triggering events were not. For example, in the *Van Cleave*[8] case, although the taxpayer's obligation to repay a portion of his compensation arose from a subsequent event (i.e., determination in an IRS exam that the compensation was excessive), the court held that section 1341 was applicable since the requirement to repay in the event of the determination was due to an agreement in place at the time of receipt.[9]

Character Matters

Section 1341 can also be a useful tool when a taxpayer would otherwise not be able to currently realize the full benefit of a deduction due to the character of the deduction or a net operating loss position; for example, when the deduction is capital in nature.[10] Under the "relation back" doctrine espoused by the Supreme Court in *Arrowsmith v. Commissioner,*[11] the character of a deduction (i.e., ordinary or capital) must be determined with reference to the character of a prior year's transaction to the extent that the two transactions are integrally related.[12] In *Arrowsmith*, the Supreme Court addressed the character of amounts paid by shareholders of a liquidated corporation to creditors of the corporation, when the shareholders had reported long-term capital gain on the liquidation and in a subsequent year were required to make a payment to creditors pursuant to a judgment against the corporation. The Supreme Court held that the payments by the shareholders were so integrally associated with the prior capital gains that they must be treated as capital losses, as opposed to ordinary deductions. Even if on a transactional basis the taxpayer's total gain in the earlier year exceeds the restoration such that there is a net gain for the transaction, the separation of the restoration as a capital loss in a year without other gains to offset it operates as an effective bar on the deduction. This harsh result is overcome by the application of section 1341, which results in a transactional rather than annual tax impact for the transaction as a whole.

Examples of Section 1341 Applicability

While the inventory exception limits the application of section 1341 in certain industries, there are a few industry applications worth highlighting. Most common is the regulated utilities industry where taxpayers' rates for the sale of electricity—which is considered inventory—are subject to even a general

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[8] 718 F.2d 193, 197 (6th Cir. 1983).

[9] Contrast *Blanton v. Commissioner*, 46 T.C. 527 (1966), in which the court held that section 1341 was inapplicable because the terms of the repayment were agreed to subsequent to employee's receipt.

[10] Pursuant to section 1.1341-1(c), the determination of whether the taxpayer is entitled to the benefits of section 1341 for a deduction that is capital in nature shall be made without regard to the net capital loss limitation imposed by section 1211.

[11] 344 U.S. 6 (1952).

[12] *See also* Rev. Rul. 78-25, 1978-1 C.B. 270.

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market authority of the Federal Energy Regulatory Commission ("FERC"). In Private Letter Ruling 200901029, the inventory exception under section 1341(b)(2) was not applicable to a publicly regulated utility for amounts paid to a purchaser of electricity to settle claims asserted against predecessor members of the utility's affiliated group. The conclusion reached in the private letter ruling could also extend into the oil and gas industry to the extent rates are regulated and subject to FERC market authority.

In the financial service and other customer service sectors, section 1341 opportunities may arise out of market conduct claims and customer settlement payments, such as anti-trust and price-fixing settlements or customer refunds paid related to erroneous billing (for example interest rate or fee overcharges). Additionally, real estate owners and operators may be subject to various tenant claims and settlements for previously received lease payments. In the construction industry, contractors may be subject to customer claims relating to the contract price. In each instance above, section 1341 treatment should be evaluated.

Following is a list of fact patterns to which section 1341 could potentially apply:

- Settlement payments for alleged violations of law (e.g., consumer protection) or breach of contract
  - Market misconduct
  - Customer overcharges
- Cost of service adjustments for regulated utilities (based on judgment of regulator vs. contractual)
- Implied warranties or indemnification under agreement for services
- Sale of business or assets with claw back provisions
  - Reps and warranties
  - Earnout shortfalls
  - Other contingencies
- Repayments based on government mandates
  - Medicare/Medicaid overcharges
  - Contract redeterminations
  - Public utilities – rate overpayments

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Conversely, taxpayers would generally be precluded from applying section 1341 to the following fact patterns, due to one of the exceptions discussed above:

- Overcharges relating to sales of products
- Payments to suppliers relating to price fixing
- Patent or copyright infringement (since prior income received from customers and payment made to infringed party)

Procedures and Filing Considerations

Section 1341 is applied in the year of repayment as opposed to the prior year of receipt, and its application could result in computing current year tax liability with a current year deduction for any repayment amounts, or in computing tax liability without the deduction but with a credit computed under section 1341(a)(5). In calculating the hypothetical net reduction in tax liability for the prior year, attribute usage must be considered for all years prior to the current year of deduction in determining how much tax liability would have been reduced had the income not been received. Further, section 1341(b) treats the excess of the decrease in tax recomputed in the prior year over the tax liability for current year without repayment deduction as a “payment of tax” for the tax year, thus effectively making the section 1341 credit refundable. Adjustments may be necessary in filing state and local tax returns if there is either a state only benefit or there is a federal benefit in a state that does not follow section 1341.

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