

Office of Chief Counsel
Internal Revenue Service

memorandum

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to: Christopher Dyess, Senior Team Coordinator, LMSB - NRC Group 1392

from: Associate Area Counsel (Large & Mid-Size Business)

subject:

**Section 1341 -
U.I.L. 1341.00-00**

Pursuant to your request of September 22, 2003, this memorandum addresses the use of I.R.C. Section 1341 for payments made by

to settle lawsuits pending against it by certain and other parties. This memorandum should not be cited as precedent.

Issue

was sued by several

and other parties over allegations of violations of various Federal and state laws in connection with the

products in the years . In , settled this suit by agreeing to pay . May utilize the relief provisions of I.R.C. Section 1341 when deducting these settlement payments? Does the inventory exception of section 1341(b)(2) bar the application of section 1341 relief for the settlement payments?

Short Answer

Section 1341 is a statute of limited applicability. In order to qualify for relief, a taxpayer must not only meet certain statutory conditions, but also avoid several statutory exceptions. In the case at hand, has failed to meet at

least one of these conditions and falls within the inventory exception to the statute.

Factual Analysis

In _____, the states _____, certain _____ located in those states _____ and a certain class of consumers who purchased _____ products at _____ or other retail outlets in the States, during a defined time period, (_____) filed suit in Federal Court against _____ . The suit alleged that the defendant _____ companies "agreed to eliminate or restrict competition, including, but not limited to, price competition in the States in the sale of _____, and that purchasers of _____ in the States paid higher prices than they would have otherwise paid."

On _____, _____ and the other defendants settled the disputes. _____ agreed to pay the plaintiffs, excluding the _____. Payments were made to the _____ and placed in escrow for distribution to claimants applying for settlement funds and/or as the court directed. Additionally, _____ totaling _____ were made available to and redeemable by the _____ in settlement of their claims. All of the defendants were liable for a portion of these _____ which were not administered by the State nor placed into escrow.

The settlement agreement also provided that the payment was to be used for purposes other than to make the various plaintiffs whole for the alleged price-fixing. Specifically, the settlement funds would be used to reimburse the costs of notice to the plaintiffs, future costs, accumulated interest and attorney fees.

Of particular significance is the amount of attorney fees that could be awarded. Counsel for plaintiffs were allowed to seek an award of attorney fees not to exceed twenty-five percent of the total settlement sums, accumulated interest, and value of the _____, less the disbursements

otherwise allowed.

It is our understanding that _____ has not provided a break down of the amount of its settlement payment which was used to reimburse these costs.

The settlement agreement expressly provided that the settlement payments did not constitute:

(i) a payment of a fine or penalty of any type under federal, state or local law, (ii) a payment in settlement of actual or potential liability for a fine or penalty of any type under federal, state or local law, (iii) a payment in lieu of the foregoing, or (iv) a payment of punitive damages or other similar form of assessment for any alleged offenses.
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The settlement agreement also expressly provided that "no amount paid or other consideration given by any of the settling defendants under this Settlement Agreement, including the _____, constitutes damages for or settlement of any action on account of, based on, or related to any alleged criminal violations of the Federal antitrust or similar laws." . Furthermore, under the settlement agreement, the plaintiffs agreed to release, waive and forever discharge the settling defendants and to refrain from bringing any suit or action against the settling defendants based upon similar claims.

On its Federal income tax return, _____ deducted its settlement payment of _____¹. _____ contends that it had included in its gross income sales revenue from the _____ which were the subject of the lawsuits. As a result of the inclusion, _____ gross income was overstated by the same amounts in the respective years. Moreover, since the tax rates applicable to the amounts reported as gross income in the previous years _____ were higher than the tax rate of 34% applicable to

_____, the year the amounts were repaid, _____ alleges that I.R.C. section 1341(a)(5)(B) allows for a reduction of tax in the year of repayment equal to the decreases in tax that would have occurred if such amounts had not been included in gross income for those

¹ This payment represents the amount paid into the State escrow account. It is our understanding that _____ did not seek section 1341 relief for any amount under the _____.

years. The settlement payment was allocated to the tax years on a prorata basis:

.² No legal basis was given for this allocation.

In , filed a claim for refund claiming a reduction in its tax liability under §1341 for the settlement payment. Of the payment, determined that related to the period. Pursuant to their computation, claims that §1341(a)(5)(B) entitles it to reduce its tax in by with respect to of the settlement payment.

Based upon an examination of claim, you propose to disallow the use of §1341 for the following reasons:

1. The original item included in income was never received under a claim of right as it was derived from an alleged fraud or intentional wrongdoing.
2. The settlement payment was repayment for overcharges from the sale of stock in trade or inventory.

Legal Analysis

Section 1341 was enacted to eliminate the inequity occasioned by such claim of right cases as North American Oil Consolidated v. Burnet, 286 U.S. 417 (1932), and United States v. Lewis, 340 U.S. 590 (1951). In North American Oil, the Supreme Court held that if a taxpayer receives earnings under a claim of right without restriction as to its disposition, it has received income which it is required to report, even though it may later be adjudged liable to restore it. 286 U.S. at 424. Section 1341 enables taxpayers to ameliorate the sometimes harsh result of the claim of right doctrine, which requires reporting the income in the year of receipt. If it is later determined that the income must be repaid or restored, section 1341 gives taxpayers the ability in the year of restoration to put themselves in at least no worse a tax position than if the income had never been received. Rev. Rul. 72-551, 1972-2 C.B. 508, 509.

In cases where income tax rates decrease between the year an

² We specifically do not address nor comment upon allocation of the settlement payment among the tax years.

item was included in gross income and the year the item is restored, Congress recognized that a deduction for the restoration would not reduce tax as much as the inclusion in income subjected the taxpayer to tax. The legislative history of section 1341 indicates that it was enacted to adequately compensate a taxpayer for the tax it paid for a prior year. H.R. Rep. No. 1377, 83d Cong., 2d Sess., 86-87 (1954); S. Rep. No. 1622, 83d Cong., 2d Sess., 118, 451 (1954); See also 108 Cong. Rec. S22531 (daily ed. October 5, 1962) (Statement of Senator Kerr).

Section 1341(a) provides that (1) if 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; and (2) a deduction is allowable for the current, taxable year because it was established after the close of such prior year (or years) that the taxpayer did not have an unrestricted right to such item; and (3) the amount of such deduction exceeds \$3,000, 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 Ch. 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, therefore, enunciates five basic conditions that must be satisfied in order for its provisions to apply:

- The item was included in gross income in a prior taxable year;
- The inclusion was made under a claim of right and the taxpayer appeared to have an unrestricted right to the item;
- In a later taxable year the taxpayer is entitled to a deduction on account of the repayment of the item;
- 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; and
- The amount of the deduction exceeds \$3,000.

Section 1341(b)(2) provides an exception to section 1341(a). Section 1341(a) does not apply to any deduction allowable with respect to an item which was included in gross income by reason of the sale or other disposition of stock in trade of the taxpayer (or other property of a kind which would properly have been included in the inventory of the taxpayer if on hand at the close of the prior taxable year) or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business.

Treas. Reg. §1.1341-1(a)(1) further provides that a taxpayer is entitled to the benefits of section 1341 if the taxpayer is entitled to a deduction of more than \$3,000 because of the restoration to another of an item which was included in the taxpayer's gross income for a prior taxable year (or years) under a claim of right. Treas. Reg. §1.1341-1 (a)(2) provides that "income included under a claim of right" means 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 the prior taxable year (or years) that the taxpayer did not have an unrestricted right to all or a portion of the item included in gross income.

Analysis of the taxpayer's right to claim the benefits of section 1341 requires meeting each of the five conditions as well as not falling within the purview of the inventory exception.

Was the item included in gross income in a previous tax year?

Allegedly, _____ was involved in price-fixing which resulted in overcharging retail consumers. As such, it can be presumed that this resulted in consumers paying too much for its _____ products. Consequently, _____ overpriced its inventory and included the excessive sale price in gross income. Therefore, an item was included in gross income under section 1341.

However, it appears that _____ settlement payment also included amounts for costs, interest and attorney's fees. Obviously, these amounts were not included in

gross income as was the overpriced inventory sales. Accordingly, that portion of the settlement payment which is attributable to these amounts must be excluded from any tax recomputation under section 1341.

Did the taxpayer appear to have an unrestricted right to the item?

Treas. Reg. §1.1341-1(a)(2) defines "income included under a claim of right" to mean 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 the item. This provision further notes that section 1341 requires it be established, after the year of inclusion, that the taxpayer did not have an unrestricted right to the item of income in the year of inclusion.

By requiring that it be established that the taxpayer 'did not have an unrestricted right,' the statutory language indicates that the lack of the right to the item of income must be a condition in existence in the taxable year of inclusion. It is only a determination, or establishment, that the taxpayer lacks an unrestricted right that occurs after the close of the taxable year. If in the taxable year of inclusion the taxpayer's right to the item of income is absolute and the right is undermined by facts arising in a subsequent year, the taxpayer does not satisfy the appearance of an unrestricted right test.

Also, of course, section 1341 does not apply if a taxpayer has no right whatsoever to income in the taxable year it is included in the taxpayer's gross income. Thus, for example, although the proceeds of embezzlement constitute gross income in the year of embezzlement, they are held without any semblance of entitlement whatsoever and therefore a restoration of embezzled amounts does not come within the general rule of section 1341. Rev. Rul. 68-153, 1968-1 C.B. 371; Rev. Rul. 65-254, 1965-1 C.B. 50. Nor does it apply if the taxpayer voluntarily pays the income back in a subsequent taxable year.

Section 1341 does not apply to any "ill-gotten" gains. See, e.g., Wood v. Commissioner, 863 F.2d 417 (5th Cir. 1989). For example, in McKinney v. United States, 574 F.2d 1240 (5th Cir. 1978), cert. denied, 439 U.S. 1072 (1979), the taxpayer embezzled from his employer, repaid the money and sought to take advantage

of section 1341's tax recomputation. In holding against the taxpayer, the court noted that when the item was embezzled funds, it is clear that it could not appear to the taxpayer that he had any right to the funds, much less an unrestricted right to them. 574 F.2d at 1243. See also Rev. Rul. 68-153, supra.; Rev. Rul. 65-254, supra. Similarly, in Parks v. United States, 96-2 U.S.T.C. ¶50,645 (W.D. Pa. 1996), the court stated that "[I]f 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." Id. at ¶86,287.

was the subject of class action lawsuits alleging a conspiracy to set artificially high retail prices. The facts as presented involve damages paid in settlement of this alleged wrongdoing. Accordingly, the Service should assert that section 1341 does not apply because it could not have appeared to

that it had an unrestricted right at the time of inclusion to the item of income for which it seeks section 1341 treatment.³

Was the settlement a restoration of the item previously included in income?

The determining factor when characterizing damages received in the settlement of a claim or cause of action "is the nature of the basic claim from which the compromised amount was realized." Raytheon Production Corp. v. Commissioner, 1 T.C. 952 (1943), aff'd, 144 F.2d 110, 114 (1st Cir.), cert. denied, 323 U.S. 779 (1944).

paid damages for the overpricing of inventory to the for disbursement. The amount was placed in escrow to await a final determination of who was entitled to claim a part of the settlement⁴. Entitlement to an amount

³ For federal income tax purposes the settlement agreement cannot be relied upon to establish that actually engaged in price-fixing. Since

is claiming the benefit of section 1341, they will bear the initial burden of demonstrating the facts that support appearance of the unrestricted right to the income from the sale of products, and the subsequent establishment that they did not have such unrestricted right. The Service, as a defense to claim, should be prepared to prove the facts and circumstances which interfered with the appearance of unrestricted right to income.

⁴ For purposes of this memorandum we have assumed that the settlement payment is deductible when made to the

was based upon being part of the settling plaintiffs who had been determined to have been allegedly harmed by the actions of the defendants. Therefore, we believe under these facts that the damages paid are a restoration of an item as required by section 1341.

Was the settlement payment deductible because it was established after the year of the item's inclusion in income that the taxpayer did not have an unrestricted right to the item?

Section 1341 requires that there be a legal obligation to restore the funds before a taxpayer is entitled to use the tax recomputation relief of section 1341. The Code states that "it was established . . . that the taxpayer did not have an unrestricted right to such item. . . ." Thus, voluntary repayments are outside the scope of section 1341. Cal-Farm Insurance Co. v. United States, 647 F. Supp. 1083, 1091-92 (E.D. Cal. 1986). Under the facts of this case the Service would accept a settlement, in lieu of a judgment, as sufficiently involuntary and as meeting the "established" requirement of section 1341.

The deductibility of the settlement payments made by in similar contexts to those at issue have been allowed as either section 162 business expenses or as section 165 losses. See, e.g., United States v. Skelly Oil Co., supra.; McKinney v. United States, 574 F.2d at 1241 (taxpayer embezzled from employer and repaid funds; government does not dispute a business loss deduction). In Barrett v. Commissioner, 96 T.C. 713 (1991), nonacq. AOD CC-1192-008 (Mar. 23, 1992), the taxpayer purchased stock based on insider information and then sold it for a profit. Following private civil suits, he paid third parties in settlement. Although the Service did not agree with the court that the taxpayer was eligible to use section 1341, there was no disagreement over treating the settlement payment as a section 162 deduction. As such, meets this condition.

The deduction for the item exceeds \$3,000

The settlement payment and the deduction for it exceeds \$3,000, and thus meets this condition.

rather than as amounts are distributed to the claimants from the escrow fund. For this to be the case the escrow fund must constitute a qualified settlement fund as defined in Treas. Reg. §1.468B-1(c). We express no opinion regarding whether the escrow fund constitutes a qualified settlement fund.

Section 1341(b)(2) Inventory Exception

Independent of the above analysis, the inventory exception to section 1341 must be considered. In other words, even if the taxpayer was found to have met each of the five conditions enumerated above, section 1341 relief could still be denied due to this exception.

Under the inventory exception of section 1341(b)(2), the relief provided by section 1341(a) should be denied where the deduction arises out of an adjustment made to the stock in trade or similar items within the limiting provisions of Treas. Reg. §1.1341-1(f) (inventory items, stock in trade). In the case at hand, the item included in gross income stems from the gross receipts from the sale of

to retail consumers. In other words, the item included in gross income stems from the sale of inventory or "stock in trade" to the customers of .

Applicable regulations have construed the special rule of section 1341(b)(2) as disqualifying, for section 1341 relief, deductions with respect to adjustments of stock in trade or similar items made to customers. Treas. Reg. §1341-1(f) provides in part: ". . . This section is, therefore, not applicable to sales returns and allowances and similar items."

To justify their claim, argues that the inventory exception applies only to matters involving sales returns and allowances. The argument is not supported by the language of the statute. The first sentence of section 1341(b)(2) provides that section 1341 does not apply where a deduction is allowable with respect to an item that was included in gross income by reason of the sale or other disposition of inventory. However, the second sentence in section 1341(b)(2) provides that "this paragraph shall not apply if the deduction arises out of refunds or repayments with respect to rates made by a regulated public utility . . . if such refunds are required to be made by the Government." Refunds with respect to public utility rates do not involve sales returns or allowances. Therefore, it cannot be said that the inventory exception in the first sentence applies only to sales returns and allowances because, if it were so, the second sentence regarding refunds by regulated public utilities would be superfluous.

To further justify their claim that the inventory exception

does not apply, has cited to Killeen v. United States, 63-1 U.S.T.C. ¶9351 (S.D.Cal. 1963). Killeen involved an income splitting arrangement in which one party failed to pay over the correct share of the profits to the other party. Because the correct amount was not paid, the taxpayer later had to restore to his joint venturer the share which was due him from the profits. Once the funds were received by the taxpayer upon the sale of inventory, the share of profits that should have been forwarded to the other party was no longer considered income from the sale of inventory with respect to the taxpayer. Rather, with respect to the taxpayer, the income at issue was income withheld in contravention of an income splitting agreement. Consequently, in this case the taxpayer was permitted to use section 1341.

The present case does not involve an income splitting arrangement and is thus distinguishable from Killeen. Also, we do not believe that the inventory exception of section 1341(b)(2) is limited to situations involving sales returns and allowances and similar items. Rather, the language of section 1341(b)(2) is sufficiently broad to encompass other situations not involving sales returns and allowances and similar items.

Accordingly, we believe that if was not otherwise precluded from using section 1341, the inventory exception would bar its use for the settlement payment. To the extent not otherwise accounted for, the settlement payment involves a reimbursement for overpriced products sold by to retail consumers. Consequently, the inventory exception makes section 1341 inapplicable to this situation.

Conclusion

Five conditions must be met for section 1341 to apply. From the facts as provided, it appears that has failed the condition that it appear that the taxpayer had an unrestricted right to such item when it was originally included in income (i.e., the income item stemmed from the alleged fraud or intentional wrongdoing of). Furthermore, if were not otherwise precluded from using section 1341, the inventory exception would bar its use for the settlement payment. Lastly, it does not appear that has substantiated that all of the settlement payment was for reimbursement of an item previously included in income (i.e., notice costs, attorney fees, etc.). Accordingly, it is the opinion of our office that section 1341 is not applicable to the settlement payment.

In accordance with Chief Counsel Notice CC-2003-003, this

memorandum has been prereviewed by the Office of Chief Counsel prior to its issuance to you.

Disclosure Statement

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney-client privilege. If disclosure becomes necessary, please contact this office for our views.

BERNARD B. NELSON
Area Counsel (LMSB - NRC)

By:

JOHN S. REPSIS
Associate Area Counsel
(Large & Mid-Size Business)