INTERNAL REVENUE SERVICE

Number: **200036017**
Release Date: 9/8/2000
CC:DOM:FS:IT&A
TLN-2771-93
UILC: 1341.02-00

INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE
June 1, 2000

MEMORANDUM FOR

FROM: Deborah A. Butler
Assistant Chief Counsel CC:DOM:FS

SUBJECT: Entitlement to use Section 1341

This Field Service Advice responds to your memorandum dated January 20, 2000. 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:

A	=	Year 4	=
B	=	Year 5	=
C	=	Year 6	=
Year 1	=	Amount X	=
Year 2	=	Amount Y	=
Year 3	=	Amount Z	=
		Date 1	=

ISSUES

1. Whether A may apply section 1341 of the Internal Revenue Code where damages were paid in settlement to C and others for a liability resulting from understated rents and royalties.

2. Whether A may apply section 1341 where damages were paid in settlement of a class action suit that alleged anti-trust violations resulting in scarce oil supplies and high retail prices for oil products.

3. Whether A may apply section 1341 because it was subject to increased environmental remediation costs to redispose of earlier refining, manufacturing, and processing wastes, which at the prior time, were disposed of in accordance with industry standards and applicable regulations.

CONCLUSIONS:

1. We cannot determine, based on the available information, whether A is entitled to the benefits of section 1341. In order to make this determination, further factual development is needed as to any allegation of fraud or wrongdoing in the audit results of A by B. Also, further factual development is needed as to whether A could have known, based on the available information, that A was not paying B the entire amount of royalties to which B was entitled. Section 1341 requires an appearance of an unrestricted right to income. This requirement would not be met if there were fraud or other intentional wrongdoing on A's part resulting in an underpayment to B, or if A could have known, based on the available facts, that B was being underpaid.

2. A may not apply section 1341 for damages paid related to overpricing its products because section 1341(b)(2) provides an exception for the restoration of income received from the sale of inventory. Furthermore, A's claim for section 1341 treatment fails because A paid damages in settlement of alleged anti-trust violations and thus restored income obtained through wrongdoing.

3. A does not qualify to apply section 1341 for increased environmental remediation costs because A did not include an item in gross income which was later restored. Also, A is ineligible to apply section 1341 due to the inventory exception of section 1341(b)(2).

FACTS:

A is a large multinational oil, gas, and chemical company and has submitted section 1341 claims with respect to three different factual scenarios in which it alleges to have received and included in gross income certain income items that were partially restored in later years.

1. Royalty Issue

A had contracts with B from Year 1 to Year 2 for the lease of oil fields, and A agreed to pay B a royalty equal to a percentage of the value of oil extracted plus a percentage of the net profits from oil sales (denoted "rent"). A operated via a consortium with four other companies. The five companies did the drilling and sold the oil to themselves. Thus, they jointly had control over the posted price and the amount payable to B by A.

In Year 3, State C on behalf of itself, B, and other local governments and later B on behalf of itself filed a series of lawsuits against the five companies, challenging their practices on grounds of anti-trust violations, breach of contract, conspiracy, monopoly, fraud, and deceit. A characterizes the dispute as an issue of contract interpretation regarding how much money should have been paid to B for rent and royalties. The

cases were ultimately settled with A paying damages of Amount X as its share of the liability to State C and other political subdivisions.

2. Pricing Issue

A, as well as other oil companies, were subjects of a class action lawsuit filed in Year 3 by State C and joined by three other states, charging sales practices that violated anti-trust rules. Specifically, the suit alleged that A and the other companies had conspired to keep oil supplies low, thereby creating artificially high retail prices. The states represented themselves, their political subdivisions, and retail consumers as a class. The plaintiffs allegations repeatedly referred to overpricing.

The settlement agreement signed in Year 4 required A to pay damages of Amount Y to State C for disbursement among the plaintiffs. The payment presumably represented a "refund" of the excessive sales income, but there was no assurance that the same consumers who paid for overpriced oil products would be reimbursed for their overpayments.

3. Environmental Remediation Issue

In past years, A expended funds for waste disposal and pollution cleanup. The portion of these expenditures that related to refining, blending, storage, and distribution activities (rather than selling) was treated as cost of goods sold (COGS). Its disposal and cleanup practices at that time were in accord with acceptable industry standards and applicable state and federal regulations, and thus A believed that its COGS had been properly computed. It was subsequently determined that A's waste disposal and storage and handling practices at numerous sites were insufficient to prevent environmental contamination, and A was forced to incur additional environmental remediation costs in excess of Amount Z. These additional expenditures were incurred between Year 5 and Year 6. A asserts that the most recent disposal costs are components of COGS.

A argues for the application of section 1341 as a vehicle for matching the current remediation expenses with the income from earlier years when remediation expenses were inadequate. A states that it only had an apparent right to the income from earlier years. A's position is that because the current remediation expenses were not paid or incurred and were not included in COGS in a prior year, gross income (as defined in Treas . Reg. 1.61-3(a) for manufacturing businesses as gross receipts less COGS) was not decreased by the amount of the expenses. Thus, A argues that gross income for the prior year was overstated in the amount of unpaid, unincurred expenses, and the overstatement of gross income was an item included in gross income for purposes of 1341.

LAW:

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 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. 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). Specifically, section 1341(a) does not apply to any deduction allowable with respect to an item that 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 that 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.

ANALYSIS OF ISSUES ONE AND TWO

Item included in gross income in a previous year

Issue one concerns royalty underpayments. 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 amount both for income tax purposes and in computing the amount of gross income eligible for percentage depletion. IRC §611(b)(1); Helvering v. Twin Bell Oil Syndicate, 293 U.S. 312 (1934). The royalty holders are treated as having an "economic interest" in the property entitling them to a share of production, and they compute percentage depletion on the share allocated to them.

The share of production that should have been paid to B was included in A's gross income. Even if there was fraud or wrongdoing with respect to the underpaid royalties, they were still includible in income. Rev. Rul. 65-254, 1965-1 C.B. 50; Rev. Rul. 61-185, 1961-2, C.B. 9 (proceeds of embezzlement constitute gross income to embezzler in year of embezzlement). Because the royalties that should have been paid to B would have been excluded from A's gross income if paid, the underpaid royalties in this case were an item included in A's income for purposes of section 1341. This is to be contrasted with underpaid expenses, where the failure to claim a deduction affects only the amount of taxable income and does not involve the inclusion of an item in gross income. Section 1341 does not apply to taxpayers who have missed an opportunity to take a business expense deduction; there is no evidence that Congress intended "item included in gross income" to be read so broadly. Cal-Farm Insurance Co. v. United States, 647 F. Supp. 1083, 1091-92 (E.D. Cal. 1986).

In issue two, A overpriced its inventory and included the excessive sales prices in gross income. Therefore, an item was included in gross income under section 1341.

Item included under a claim of right, i.e., taxpayer appeared 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. The provision further notes that section 1341 requires that 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 a right to the item of income must be a condition in existence in the taxable year of inclusion. Only the determination (or establishment) that the taxpayer lacks an unrestricted right to the item 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 or the taxpayer voluntarily pays the item back, the taxpayer does not satisfy the appearance of an unrestricted right test.

Of course, section 1341 does not apply if a taxpayer has no right whatsoever to an item of income in the taxable year it is included in the taxpayer's gross income. 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.

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 is embezzled funds, it is clear that it could not have appeared 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.

Based on the facts as we understand them in issue one, for a portion of the time period at issue, there does not appear to be any willful misconduct or fraud by A. A letter dated Date 1, from B to A sets forth the results of the royalty computation and payment analysis for some of the years at issue. The letter disagrees with how A computed its royalty liability but does not allege any intentional wrongdoing. We note, however, that we do not have information about any results indicating royalty underpayments for the remainder of the years at issue, and this would need to be explored before a determination can be made whether A engaged in any fraudulent conduct.

In addition, if A could have known, based on the available facts, that B was being underpaid and the underpayment was the result of A's mere error, section 1341 would not apply because the appearance of an unrestricted right test would not be satisfied. In the case of a mere error, all the facts available to the taxpayer would have indicated that the taxpayer had no right to the item. Rev. Rev. 68-153, 1968-1 C.B. 371 (Situation 2). If, however, B's right to additional royalty payments arises from facts and circumstances in existence during the period of underpayment, which were not known to A or knowable by A, it is likely that section 1341 relief would be available.

In issue two, A was the subject of a class action lawsuit alleging a conspiracy to set artificially high retail prices. The facts as presented involve damages paid in settlement of wrongdoing. Hence, section 1341 does not apply because it could not have appeared to A that it had an unrestricted right to the item of income for which it seeks section 1341 treatment.

Was the settlement payment a restoration?

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).

In this case, a claim for underpaid royalties resulted in the settlement agreement, which provides in para. 2 that all claims, refunds, etc. between the parties as to A's royalty obligations are satisfied, released, discharged, etc. We believe under the facts of this case that the settlement agreement compromises an underlying claim for underpaid royalties, and accordingly, for purposes of section 1341, the settlement amount paid by A restores royalties previously included in gross income by A.

With respect to issue two involving the overpricing of inventory, A paid damages to C for disbursement, but there was no assurance that the same consumers who paid for overpriced oil products would be reimbursed for their overpayments. The Eighth Circuit in Chernin v. United States, 149 F.3d 805 (8th Cir. 1998), sustained the Commissioner's view that restoration means to restore an item to the original payor. Therefore, we believe under these facts that the damages paid are not 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 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. 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 Ins. Co., supra. The Service accepts a settlement, in lieu of a judgment, as sufficiently involuntary and as meeting the "established" requirement of section 1341.

As to the deductibility of the settlement payments in issues one and two, deductions 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), 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.

Deduction exceeds $3,000

Each deduction at issue exceeds $3,000, and thus meets this qualification.

Section 1341(b)(2) inventory exception

Killeen v. United States, 63-1 U.S.T.C. ¶9351 (S.D. Cal. 1963), involved an income splitting arrangement in which one party failed to pay over the correct share of profits to the other party. Because the correct amount was not paid, the taxpayer later had to restore to his joint venturer the share that 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, the taxpayer was permitted to use section 1341.

Issue one involves a royalty agreement between A and B that is similar to the income splitting arrangement in Killeen. Thus, the section 1341(b)(2) exception does not apply because the income at issue is considered to have been included in A's gross income by reason of A's withholding of royalties owed to B, not by reason of the sale of inventory.

On the other hand, issue two concerns income included in A's gross income by reason of the overpricing of inventory. Therefore, the settlement payment falls within the exception of section 1341(b)(2), and section 1341 does not apply.

ANALYSIS OF ISSUE THREE

Item included in gross income in a previous year under a claim of right

Section 1341(a)(1) states that the statute does not apply unless "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." A's position involves a purported overstatement of the amount of gross income caused by a failure to include unpaid, unincurred expenses in COGS. We do not view COGS as a factor in determining whether an item was included in gross income under section 1341. This view was applied in favor of the taxpayer in Rev. Rul. 72-28, 1972-1 C.B. 269.

Rev. Rul. 72-28 held that, although Treas. Reg. 1.61-3(a) defines gross income for manufacturers as gross receipts less COGS, only the gross receipts component is considered in determining whether an item was included in gross income under section 1341. In the ruling, a public utility company was subjected to a contingent rate increase on its gas purchases from suppliers. The company passed on the rate increase by charging an equivalent rate increase to customers, then properly reported in gross receipts the additional amount collected from them. In the same year, the company properly included in COGS the additional cost of gas paid to suppliers. With respect to these transactions, the company's gross receipts and COGS increased by the same amount, leaving gross income as defined under Treas. Reg. 1.61-3(a) unaffected.

In a subsequent year, the company received refunds from its suppliers of some of the cost increases paid in the prior year. As it was bound to do, the company made refunds in an equivalent amount to customers. The company included the supplier refunds in gross income for the year and sought section 1341 treatment for the refunds to customers. The issue in the ruling was whether section 1341 applied where gross income, as defined under Treas. Reg. 1.61-3(a), was zero in the prior year because gross receipts and COGS had been increased by the same amount. Arguably, no item had been included in gross income for purposes of applying section 1341.

The ruling held that section 1341 was applicable, and the fact that the taxpayer had increased COGS in the prior year had "no relevancy in determining the application of section 1341." GCM 35403, 1973 IRS GCM Lexis 177, clarified the ruling, stating that "included in gross income" under section 1341 means "included in the computation of gross income." This interpretation allowed for consideration of items included in gross receipts, which are included in the computation of gross income under Treas. Reg. 1.61-3(a). If "included in gross income" were not so interpreted, the utility company would have been precluded from applying section 1341 to items received in prior years (and restored in later years) to the extent COGS was equal to or greater than gross receipts. Such a result may be viewed as contrary to section 1341(b)(2), which specifically allows a utility company to apply the statute.

Moreover, looking to gross receipts enables us to comply with the requirement of section 1341 that an "item" have been included in gross income under a claim of right. If we were instead to adopt A's position and use the definition under Treas. Reg. 1.61-3(a), no "items" would remain after the calculation of gross income. On this issue, GCM 35403 stated: "all that would remain would be a net aggregate amount. In no case…would it be possible to identify an item of gross income….It must necessarily be

possible to identify the various component items of gross income in order for section 1341 to have any vitality."

<u>Was there a restoration of an income item?</u>

The basis for A's current deduction is not with respect to the restoration of an item that was included in gross income in a prior year. Section 1341(a)(2) states that the statute applies if "a deduction is allowable for the taxable year because it was established after the close of the [taxable year in which an item was included in gross income] that the taxpayer did not have an unrestricted right to such item or to a portion of such item." Treas. Reg. 1.1341-1(a)(2) clarifies that a deduction must be allowable because an item received and included in gross income in a prior year has been restored to another. Restoration means to restore an item to the original payor. <u>Chernin</u>, <u>supra</u>. The payment of a currently deductible expense that would have been included in COGS had it been paid or incurred in a prior year does not restore to an original payor an item previously included in gross income.

For example, in the present case, A will incur expenses for the necessary environmental remediation and will likely make deductible payments to third parties who will physically clean up the company's property; but a payment to a third party is not a restoration to an original payor of an item previously included in gross income.

<u>Deduction exceeds $3,000</u>

The amount at issue exceeds $3,000. However, this amount may not be deductible as A has characterized this amount as a component of COGS in support of its argument that gross income was previously overstated.

<u>Section 1341(b)(2) inventory exception</u>

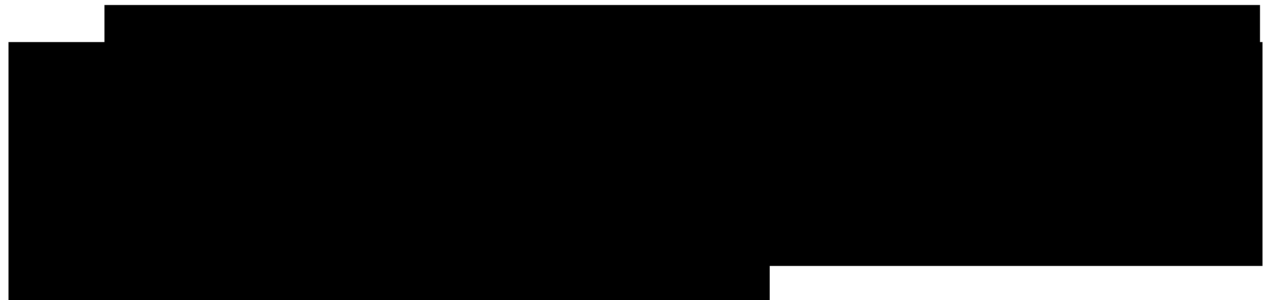
Even if we were to accept A's view that the requirements of section 1341(a)(1) and (2) are satisfied, A would be precluded from obtaining the benefits of the statute. An applicable exception in the statute, referred to as the "the inventory exception" is found in section 1341(b)(2) and provides that the statute 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 property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business."

A argues that its gross income was overstated in prior years because unpaid, unincurred expenses were not included in COGS. A concludes that (i) the overstatement of gross income from the sale of inventory is an item included in gross income, and (i) the payment of a currently deductible expense that would have been included in COGS had it been incurred or paid in prior years is a restoration of

overstated gross income from the sale of inventory. A's position, therefore, involves the restoration of inventory receipts, and A is precluded from obtaining the benefits of section 1341 because, as provided under section 1341(b)(2), the statute does not apply in cases where inventory receipts are restored.

Some taxpayers argue 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.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:



DEBORAH A. BUTLER