Office of Chief Counsel
Internal Revenue Service
Memorandum

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to:
Internal Revenue Agent
Large Business and International

from: Shannon J. Ryser
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subject: and Subsidiaries

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This memorandum supersedes our prior memorandum dated November 17, 2022.

Statement of Facts

, a subsidiary of bank holding company , acquired the assets of a failing bank in . entered into a Purchase and Assumption Agreement with the Federal Deposit Insurance Corporation as of . That Agreement included a Single Family Shared-Loss Agreement "for the reimbursement of loss sharing on certain single family residential mortgage loans" that had acquired and a Commercial and Other Assets Shared-Loss Agreement "for reimbursement of loss sharing expenses on certain other loans and assets". In grossly simplified terms, the agreements provided that each month would provide the FDIC with a certificate of losses claimed by and the FDIC would pay various percentages to . Upon termination of the

shared-loss agreements, there was a “true-up” if losses did not reach the expected level, in which case was obligated to repay a percentage of the excess.

As required by section 597 of the Internal Revenue Code[1] and the regulations promulgated pursuant to that section, from through included in its gross income payments of “Federal financial assistance” from the FDIC to pursuant to the terms of the shared-loss agreements. The maximum effective federal corporate income tax rate during those years was 35%. During , when the federal corporate income tax rate was 21%, repaid approximately $ to the FDIC pursuant to the shared-loss agreements.

On its federal income tax return, Form 1120, U.S. Corporation Income Tax Return, for the year ended , attached the following statement in response to Part III — Payments and Refundable Credits:

> Under the claim of right doctrine and pursuant to a Shared-loss Agreement entered into as of , the Taxpayer included shared loss receipts from the Federal Deposit Insurance Corporation (FDIC) in the determination of prior years' taxable income and paid regular tax on such receipts at a rate of 35%. During , a tax year in which the corporate income tax rate is 21% and pursuant to the Shared-Loss Agreement, the taxpayer made a $ shared loss repayment to the FDIC. As a result, the tax for has been calculated in accordance with IRC §1341(a)(5). Accordingly, pursuant to IRC §1341 and Treas. Reg. §1341-1(d)(3), the resulting $ decrease in prior years' tax is reported on Schedule J, Part III, Line 20(d).

That “other refundable credit” was flagged as an unusual credit.

If the above facts are incorrect, please let us know because that might affect this advice.

Issue

You have asked for advice about whether it was appropriate for to calculate its federal income tax pursuant to section 1341(a)(5) of the Code.

Conclusion

We have found no authority specifically supporting the application of section 1341 to a situation involving “Federal financial assistance” and contractual repayments pursuant to a shared-loss agreement. ,

[1] All references to the Internal Revenue Code or to the Code are to the Internal Revenue Code of 1986, as amended.

Law and Analysis

1. Federal Financial Assistance and Section 597

For purposes of Chapter 1 of the Internal Revenue Code, the treatment of any transaction in which "Federal financial assistance"[2] is provided to a bank is determined pursuant to regulations prescribed by the Secretary of the Treasury. I.R.C. § 597(a). In the case of certain acquisitions of assets, those regulations are required to provide that Federal financial assistance must be properly taken into account by a financial institution from which the assets were acquired, I.R.C. § 597(b)(1), and in the case of other transactions those regulations are required to provide for the proper treatment of Federal financial assistance and appropriate "adjustments" to basis or other tax attributes, I.R.C. § 597(b)(2).

The Treasury Regulations promulgated pursuant to that authority generally provide, "Except as otherwise provided in the regulations under section 597, all FFA is includible as ordinary income to the recipient at the time the FFA is received or accrued in accordance with the recipient's method of income." Treas. Reg. § 1.597-2(a)(1). FFA provided pursuant to a "Loss Guarantee" with respect to certain assets is included in the amount realized with respect to those assets, Treas. Reg. § 1.597-2(d)(2)(i), in which case the FFA included in the amount realized is not includible in ordinary income by paragraph (a)(1), Treas. Reg. § 1.597-2(d)(3).

If a financial institution pays money to an agency like the FDIC, the amount paid "is an adjustment to its FFA to the extent the amount paid and transferred exceeds the amount of money and the fair market value of any property" that the agency provides in exchange. Treas. Reg. § 1.597-2(d)(4)(i). The financial institution makes that

[2] "Federal financial assistance" includes "any money or other property provided with respect to a bank or domestic building and loan association by the Federal Deposit Insurance Corporation pursuant to section 11(f) or 13(c) of the Federal Deposit Insurance Act (or under any other similar provision of law)". I.R.C. § 597(c)(2). "Federal financial assistance" is abbreviated in the Treasury Regulations as "FFA". See Treas. Reg. § 1.597-1(b).

"adjustment" by reducing the amount of FFA that is otherwise includible in the financial institution's income for the taxable year and then reducing the balance in its deferred FFA account. Treas. Reg. § 1.597-2(d)(5)(i). If the amount of the adjustment exceeds the sum of those two amounts, then the financial institution "***may deduct*** the excess to the extent the deduction does not exceed the amount of FFA included in income for prior taxable years reduced by the amount of deductions allowable under this paragraph (d)(5)(ii) in prior taxable years." Treas. Reg. § 1.597-2(d)(5)(ii) (emphasis added).

Therefore, as a starting point, to the extent that paid money to the FDIC during , the Treasury Regulations authorize to reduce the FFA it received during by the amount of its payments to the FDIC, then reduce the balance (if any) in its deferred FFA account, and then claim a deduction for any excess amounts paid to the FDIC.[3]

2. Claim of Right Doctrine and Repayment

The claim of right doctrine generally provides that a taxpayer who receives income pursuant to a claim of right that is free of restrictions must include that income in gross income during the year that it was received. *North American Oil Consol. Co. v. Burnet*, 286 U.S. 417 (1932). A taxpayer who included a receipt in gross income pursuant to the claim of right doctrine and who is subsequently required to repay that amount is entitled to a deduction during the year of repayment, *Id.*, if there is a provision of the Internal Revenue Code specifically granting a deduction. *National Life & Accident Ins. Co. v. United States*, 244 F. Supp. 135 (M.D. Tenn. 1965), *aff'd*, 385 F.2d 832 (6th Cir. 1976). A taxpayer's federal income tax shall be computed as provided pursuant to section 1341 and the Treasury Regulations promulgated thereunder if "the taxpayer is entitled ***under other provisions*** of chapter 1 of the internal Revenue Code of 1954 to a deduction of more than $3,000". Treas. Reg. § 1.1341-1(a)(1) (emphasis added).

A deduction for a repaid claim of right amount might not decrease the taxpayer's subsequent tax liability by the same amount as the previous increase in the taxpayer's tax liability caused by the original inclusion of that amount in the taxpayer's gross income. Therefore, the Internal Revenue Code provides for a taxpayer's tax liability to be calculated as the lesser of those two amounts if the taxpayer is able to satisfy three criteria. If (1) an item was included in a taxpayer's gross income during a prior taxable year because it appeared that the taxpayer had an unrestricted right to that item, (2) a deduction is allowable for the current taxable year because it was established after the close of the prior taxable year that the taxpayer did not have an unrestricted right to that item, and (3) the amount of the deduction is greater than $3,000, then the tax imposed will be the lesser of the tax for the current year calculated with the deduction and the tax for the current year calculated without the deduction but reduced by the decrease in tax

[3] In its response to IDR8, asserted that it would have been entitled to a deduction pursuant to Treas. Reg. § 1.597-2(d)(5) and did not identify any other provision of the Code on which it was relying as authority to claim a deduction for the FFA repaid to the FDIC during .

for the prior taxable year if the item had not been included in the taxpayer's gross income. I.R.C. § 1341(a).[4]

For purposes of section 1341, "'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". Treas. Reg. § 1.1341-1(a)(2). Historically, the Internal Revenue Service has taken the position that section 1341 only applies when the taxpayer appeared to have an unrestricted right to the item that was subsequently repaid and that section 1341 does not apply when the taxpayer had an actual unrestricted right to that item. For example, the Service ruled that a taxpayer's repayment of prepaid interest on a promissory note after the borrower paid the principal early did not qualify for section 1341 treatment because the taxpayer actually had "an unrestricted right to receive the total amount of the prepaid interest" during the original year of inclusion rather than what "only 'appeared' to be" an unrestricted right. Rev. Rul. 58-226, 1958-1 C.B. 318. The Service ruled, "Thus, if due to prepayment of the principal amount of the second trust note, or any part thereof, the taxpayer in a subsequent year credits the payer with any of the prepaid interest, it will not be because it is established after the close of the taxable year in which the prepayment of interest occurred that the taxpayer did not have an unrestricted right thereto in such prior year, but because a liability on his part has later accrued which does not in any way establish that he had no right to the interest when received." *Id.* Similarly, the Service has ruled that an employee's contractual obligation to reimburse his employer for a portion of his salary as liquidated damages when he resigned within a certain time after beginning employment did not qualify for section 1341 treatment because the employee "did, in fact, have an unrestricted right to receive the amount" and "the obligation to repay arose as the result of subsequent events". Rev. Rul. 67-48, 1967-1 C.B. 50; see also Rev. Rul 68-153, 1968-1 C.B. 371 (stating that section 1341 does not apply when "subsequent events" require a taxpayer to repay an amount because those subsequent events did not negate the taxpayer's absolute right to retain the amount during the year of receipt or when "mere errors" prevented the taxpayer from realizing that it had no right to an amount and instead section 1341 applies only when a taxpayer "had the semblance of an unrestricted right in the year of inclusion and it could not be established in fact and in law until a subsequent year that it did not have an unrestricted right to the amounts").

Various courts have rejected the Service's approach in those Revenue Rulings. In *Dominion Resources Inc. v. United States*, 219 F.3d 359 (4th Cir. 2000), the Court of Appeals for the Fourth Circuit held that a public utility's repayment of amounts that it had collected from customers in anticipation of its future income tax liability entitled the utility to calculate its income tax pursuant to section 1341 during a year when the tax rate was lower than the years of receipt by the utility. Rejecting the apparent versus

[4] Section 1341 does not apply to deductions attributable to bad debts. Treas. Reg. § 1.1341-1(g). Although it is notable that in its response to IDR3 stated that the FFA was included in its income as "Other Income, Other Deductions and Bad Debts", it does not appear that it claimed a deduction for bad debts pursuant to section 166 of the Code.

actual test, the court noted, “Things very often ‘appear’ to be what they ‘actually’ are. As a matter of plain meaning, the word ‘appeared’ generally does not, as the IRS urges, imply only *false* appearance, and generally does not exclude an appearance that happens to be true.” *Id.* at 364. In doing so, the court held that “the requisite lack of an unrestricted right must arise out of the circumstances, terms, and conditions of the original payment of such item to the taxpayer.” *Id.* at 367 (quoting *Pahl v. Commissioner*, 67 T.C. 286 (1976)). See also *Van Cleave v. United States*, 718 F.2d 193 (6th Cir. 1983) (holding that a taxpayer was entitled to the benefit of section 1341 after repaying salary that the taxpayer had received conditioned upon repayment if the Internal Revenue Service found the compensation to be excessive) and *Prince v. United States*, 610 F.2d 350 (5th Cir. 1980) (holding that a taxpayer was entitled to the benefit of section 1341 after repaying amounts that the state supreme court ruled should not have been paid to the taxpayer). The Third Circuit applied the same “circumstances, terms, and conditions” test in *Alcoa, Inc. v. United States*, 509 F.3d 173 (3rd Cir. 2007). Although in that case the court denied the taxpayer the benefit of section 1341 for the current payment of environmental remediation expenses, it is factually distinguishable because the taxpayer had argued that its previous “insufficient environmental expenses . . . amounted to the inclusion of an item in gross income under an apparent claim of right”. *Id.* At 178.

The Tax Court follows a ruling issued by the Court of Appeals to which the decision of the Tax Court would be appealable if that ruling is squarely on point. *Golsen v. Commissioner*, 54 T.C. 742, 757 (1970), *aff'd*, 445 F.2d 985 (10th Cir. 1971). In a case involving a corporation, the decision of the Tax Court is appealable to the Court of Appeals for the circuit in which the corporation’s principal place of business is located. I.R.C. § 7482(b)(1)(B). is incorporated in , but its registration as a foreign corporation in states that its principal office is in . The company’s website also states that its headquarters is in . Therefore, a decision of the Tax Court would be appealable to the Court of Appeals for the Fourth Circuit, and the Tax Court should follow the decision of the Fourth Circuit in the *Dominion* case. The Tax Court has previously been presented with the issue of whether to adopt the circumstances, terms, and conditions test applied by the Court of Appeals in the *Dominion* case but was able to postpone that decision because the Tax Court held that the taxpayer did not otherwise qualify for a deduction and therefore did not satisfy the second prong of section 1341. *MidAmerican Energy Co. v. Commissioner*, 114 T.C. 570 (2000). As a result, the Tax Court did not need to reach a conclusion on the first prong regarding whether the item had been included in the taxpayer’s gross income during a prior taxable year because it “appeared” that the taxpayer had an unrestricted right to that item.

Notwithstanding the cases decided by the Fourth, Fifth, and Sixth Circuits, the Court of Federal Claims rejected the approach of those cases and adopted the position of the Internal Revenue Service distinguishing between an apparent right and an actual right to an item. *Cinergy Corp. v. United States*, 55 Fed.Cl. 489 (Fed.Cl. 2003). In that case, despite initially describing the government’s position as a “radical approach”, *Id.* at 501, the court held that section 1341 did not apply when a utility refunded amounts that it had

previously collected from its customers for deferred taxes. Although the court noted that the *Dominion* case was factually similar, it nonetheless held that "the claim of right doctrine simply does not apply where an individual receives an item of income under an 'absolute' right." *Id.* at 503-04.

Here, the FFA received by was included in the gross income of during tax years through , and the Treasury Regulations regarding FFA specifically create a deduction for amounts repaid to an agency. We have found no authority specifically applying section 1341 to a situation involving FFA and contractual repayments pursuant to a shared-loss agreement.

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As noted above, Treasury Regulations specifically mandate the inclusion of FFA in the recipient's gross income. "Except as otherwise provided in the regulations under section 597, all FFA is includible as ordinary income to the recipient at the time the FFA is received or accrued in accordance with the recipient's method of income." Treas. Reg. § 1.597-2(a)(1). Section 1341 applies only if an item was included in a taxpayer's gross income because it appeared that the taxpayer had an unrestricted right to that item.

As noted above, section 1341 applies if an item was included in a taxpayer's gross income during a prior taxable year because it appeared that the taxpayer had an unrestricted right to that item and a deduction is allowable for the current taxable year because it was established after the close of the prior taxable year that the taxpayer did not have an unrestricted right to that item.

[redacted][5] As originally articulated by the Supreme Court, for the claim of right doctrine to apply the taxpayer must receive income, the taxpayer must receive that income under a claim of right, and the taxpayer must receive the income "without restriction as to its disposition". *North American Oil*, 286 U.S. at 424. Therefore, the "restriction" noted by the Supreme Court that would prohibit application of the claim of right doctrine was a restriction on the use of the income, not a contingent repayment obligation. The Supreme Court went on to say that the taxpayer would receive income pursuant to the claim of right doctrine "which he is required to return, ***even though he may still be adjudged liable to restore its equivalent***". *Id.* (emphasis added). So a contingent repayment obligation does not necessarily equate to a restriction on disposition of the receipt as that concept is used in the claim of right doctrine. The Service has also previously taken the position that payments by customers to a public utility must be included in the utility's gross income pursuant to the claim of right doctrine despite a pending appeal of a rate increase that created a contingent repayment obligation by the utility. Tech. Adv. Mem. 200632015 (Aug. 11, 2006). In that Technical Advice Memorandum, the National Office favorably relied on Tax Court opinions, which stated:

> As we have stated, "The mere fact that income received by a taxpayer may have to be returned at some later time does not deprive it of its character as taxable income when received" (*Woolard v. Commissioner*, 47 T.C. 274, 279 (1966); citations omitted), and the claim of right doctrine will apply "notwithstanding that the taxpayer may be under a contingent obligation to restore the funds at some future point" (*Professional Insurance Agents of Michigan v. Commissioner*, 78 T.C. 246, 270 (1982); citations omitted).

Id. (quoting *Nordberg v. Commissioner*, 79 T.C. 655 (1982)). In reaching that conclusion, the Service distinguished *Houston Indus. Inc. and Subsidiaries v. United States*, 125 F.3d 1442 (Fed. Cir. 1997). In that case, a public utility charged customers amounts for its fuel costs that were later determined to exceed its actual fuel costs, referred to as "overrecoveries". The court, without specific reference to the claim of right doctrine, held that the overrecoveries received by the taxpayer were not includible in gross income because they were "contingent upon a statutory obligation of repayment." *Id.* at 1445.

The Supreme Court has also addressed prepayments, which might ultimately have to be refunded, in a series of cases involving automobile clubs. In *Automobile Club of Michigan v. Commissioner*, 353 U.S. 180 (1957), the Supreme Court affirmed a holding that prepaid dues must be included in the taxpayer's income, noting that the Service had "determined that the petitioner received the prepaid dues under a claim of right, without restriction as to their disposition", even though there was a possibility that the

[5] Section 1341 does not explicitly refer to the claim of right doctrine or even use the phrase "claim of right", but section 1341 is generally viewed as having been enacted by Congress to correct unfairness created by the claim of right doctrine. See *Cinergy*, 55 Fed.Cl. at 500.

taxpayer would have to refund the prepayments; however, the court's opinion predominantly relied on method of accounting principles. *Id.* at 188-89. In a subsequent case, *American Auto Ass'n v. United States*, 367 U.S. 687 (1961), the Supreme Court again held that prepaid dues must be included in the taxpayer's income. The majority opinion was again based on methods of accounting; the dissenting opinion noted that the Service "abandoned' its claim of right argument. *Id.* at 700.

Please call me at (816) 823-0910 if you have any further questions.

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