INTERNAL REVENUE SERVICE

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

MEMORANDUM FOR

FROM: Deborah A. Butler
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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 =
B =
Year 1 =
Year 2 =
Year 3 =
Amount X =
Amount Y =
Amount Z =

ISSUE:

Whether settlement payments made by A to B, stemming from litigation regarding the underpayment of rents and royalties on sales of gas and oil, permit A to use the special computation of tax set forth in I.R.C. § 1341.

CONCLUSION:

It appears that A may be entitled to the benefits of section 1341. [redacted]. Section 1341 requires an appearance of an unrestricted right to income. This requirement would not be met if there was 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.

FACTS:

A had contracts with B for oil field leases to extract oil and gas and in return agreed to pay B a royalty equal to a percentage of the value of the oil and gas extracted as well as a percentage of the net profits from oil sales. Sometimes amounts owed were referred to as rent. A calculated and paid royalties/rent to B under its interpretation of various terms of the lease agreement. A dispute arose between A and B over the computation of the profits and value figures. B contested the method used in calculating royalties due it. A was alleged to have understated royalties in connection with production from Year 1 to Year 2.

The dispute was settled in Year 3, and A paid Amount X, consisting of Amount Y in royalties and Amount Z in interest. The agreement was denoted "royalty settlement agreement." A contends that the amounts paid in settlement of the litigation are amounts that should have been excluded from gross income in earlier years because its gross income as originally reported included these amounts (rents and royalties) which are gross income exclusions.

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, 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 the same position as if the income had never been reported.

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 when it subsequently has been obliged to restore amounts included in gross income in the prior year because it appeared that it had an unrestricted right to such amount. 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). Thus, the purpose of section 1341 was to place such a taxpayer at least in no worse a tax position than he would have been had he never received the income originally. Rev. Rul. 72-551, 1972-2 C.B. 508, 509.

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 previous 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.

ANALYSIS:

Item included in gross income in a previous year

At issue in this case are royalty and/or rent underpayments. 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. The lessee pays the share of production attributable to royalties and excludes this income both for income tax purposes and in computing the amount of gross income eligible for percentage depletion. § 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 this share of income allocated to them.

Payments which are not dependent on production, i.e., rent in the traditional sense paid in a fixed amount regardless of production, will not qualify as a royalty excluded from the producer's gross income. A net profits interest, though, qualifies as a royalty. In Kirby Petroleum Co. v. Commissioner, 326 U.S. 599 (1946), the Court examined the transaction to determine whether the payments constituted a complete sale, in which case the seller would retain no economic interest in the subject property and no share of depletable gross income. The

Court found that the lease for a share of net profits was more "of the quality of rent rather than of a sale." Id. at 607. Thus, the lessor retained an interest in the underlying property and had a net profits interest, which was the same as a direct share of production since the lessor's return of its investment was still dependent upon production. Hence, such payments qualify as royalties.

Thus, as long as the lessor/renter has not parted with all interest in the underlying property and as long as the rent is dependent upon a share of production (including a net profits interest), the proceeds will qualify as a royalty. If on the other hand, a fixed amount is paid regardless of production, it would not qualify as a royalty, excluded from the producer's gross income. In this case all payment due to B were dependent on production and qualify as royalties.

Because royalties payable to B are excludible from A's gross income, rather than deductible from A's gross income, the underpaid royalties in this case were an item included in A's gross income for purposes of section 1341.

The concept of included in gross income is further demonstrated by Coon v. United States, 87-1 U.S.T.C.¶ 9150 (S.D. W.Va. 1987) where a sole shareholder received a liquidating distribution from the company, and it was later determined that the company had outstanding liabilities and that a portion of the shareholder's previously received distribution was subject to the liabilities. The shareholder provided the funds for payment of the liabilities, and the court allowed the shareholder to use section 1341 based on the restoration of the liquidating distribution. The shareholder's payment restored a portion of the same liquidating distribution that was included in the shareholder's income in a prior year. See also Rev. Rul. 78-25, 1978-1 C.B. 270 (former shareholder restored assets received on liquidation and eligible to use section 1341).

Item included under a claim of right; 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 income. This section 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.

The Service's position is that the appearance of an unrestricted right test incorporates a requirement that the facts which are subsequently determined to have undermined the taxpayer's right to the income in the earlier years must have been in existence in the earlier year (but not known or knowable during the earlier year). That is, for section 1341 to apply to the repayment of an item of income, a taxpayer must be found not to have been completely entitled to the item in the taxable year in which it is included in the taxpayer's gross income. Accordingly, there must be a factual or legal uncertainty concerning the taxpayer's right to the item of income in that year.

Furthermore, if the taxpayer's right to the income is absolute and undermined by facts arising in a year subsequent to the year the income was received, 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, and the taxpayer voluntarily pays the income back in a subsequent taxable year. 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.

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), 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.

Based on the facts available to us, there does not appear to be any willful misconduct or fraud by A. The settlement agreement refers to "past liability" and that the parties have agreed on values to settle A's royalty obligations. The settlement agreement entered into between A and B settled and resolved specified royalty disputes. The settlement payment was a restoration of previously included income, and there was no allegation of intentional wrongdoing. As noted, intentional withholding of funds owed to another fails to meet the section 1341 requirement that income be held with an apparent unrestricted right.

Was the settlement payment a restoration of underpaid rents and royalties

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 a settlement agreement which provided for a "fair royalty value". We believe that under the facts of this case 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.

We do note that the payment of interest (or penalties) does not repay or restore items of gross income taken into account in prior years, and Amount Z was paid by A as interest. Therefore, section 1341 cannot apply to this portion of the settlement payments.

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. v. United States, 647 F.Supp. 1083, 1092 (U.S.D..C., E.D. Cal. 1986). The Service accepts a settlement, in lieu of a judgment, as sufficiently involuntary and as meeting the "established" requirement of section 1341.

For section 1341 to apply to the repayment of an item of income, there must be a factual or legal uncertainty concerning the taxpayer's right to the item of income in that year. Thus, section 1341 does not apply if a taxpayer has an absolute right to income in the taxable year it is included in the taxpayer's gross income, but the taxpayer voluntarily pays the income back in a subsequent taxable year, nor does section 1341 apply if a taxpayer has a right to income based on facts existing at the close of the taxable year of inclusion, but loses the right to that income in a subsequent year based on a subsequent event. The unrestricted right test of section 1341 means that the facts which are subsequently determined to have undermined the taxpayer's right to the income in the earlier years must have been in existence in the earlier year (but temporarily unknown). Rev. Rul. 67-48, 1967-1 C.B. 50. We believe that the facts, as we understand them at this time, point to A learning after the years of income inclusion that it did not have an unrestricted right to income in the amount of the underpaid royalties. B filed claims and instituted litigation seeking restitution of underpaid royalties.

As to the deductibility of the settlement payment, 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

The 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 (U.S.D.C., S.D.Cal., 1963), 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 over, the taxpayer later had to restore to his joint venturer money which was due him from the profits. Once the funds were received by the taxpayer and should have been sent to the other party, the funds were no longer considered included in the income of the taxpayer due to the sale or other disposition of stock in trade or other property includible in inventory. Rather, the income at issue was withheld in contravention of an income splitting agreement. Consequently, in this case the taxpayer was permitted to use section 1341.

The present case involves a royalty agreement between A and B that is similar to the income splitting arrangement in Killeen, supra. Thus, the section 1341 (b)(2) exception does not apply because the income at issue was included in A's gross income by reason of A's withholding of royalties owed to B, not by reason of a sale or other disposition by A of inventory or stock in trade.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

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