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DOMINION RESOURCES: POWERING SECTION 1341 TOWARD EQUITY?

by

Edward J. Schnee*

Administrative concerns occasionally override other aspects of tax policy. One example is the imposition of an annual reporting cycle which leads taxpayers to make assumptions about future events so that items can be reported on regularly scheduled returns. This can result in reporting items as income that are not actually earned by the taxpayer. For example, under the claim of right doctrine, created because of the annual reporting requirement, taxpayers must report certain receipts as income even though they are later required to return these amounts to the payor. In most cases they are permitted a deduction in the year that the cash is returned. However, this deduction may not fully offset the prior taxation due to rate changes and other items.¹ As a partial remedy Congress enacted Section 1341 which allows taxpayers to calculate the tax reduction from the repayment based on the tax paid on the inclusion. The IRS has attempted to limit the application of Section 1341. In *Dominion Resources*,² the courts reviewed the rules adopted by IRS and prior courts and applied a better reasoned, more equitable approach. The limited scope of the case did not permit the court to review all of the limitations imposed on this Section over the years and apply a consistent approach. This article will discuss the case as well as areas in which the court could, in the future, adopt its reasoning to arrive at a more equitable approach to Section 1341.

I. SECTION 1341

In *North American Oil Consolidated*,³ taxpayer and the U.S. Government disagreed over beneficial ownership of oil land. The income from the property for 1916 was paid to a trust. The government lost its battle over the property in the District Court in 1917 and the funds were paid to

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¹ As with many of the existing rules, no consideration is given to the detriment that flows from the time value of money.

² *Dominion Resources Inc. v. United States*, 48 F. Supp. 2d 527 (E.D. Va. 1999), *aff'd by*, *Dominion Resources, Inc. v. United States*, 219 F.3d 359, 369 (4th Cir. 2000).

³ *North Am. Oil Consolidated v. Burnet*, 286 U.S. 417 (1932).

taxpayer and included on its 1917 tax return. In 1920 the Court of Appeals affirmed the District Court's decision and in 1922 the appeal to the Supreme Court was dismissed. The issue before the Court in *North American Oil* was to determine the proper year the funds were taxable. The Court ruled that 1917 (the year received although a future refund might be mandated) was the proper year and its decision on this issue has become the accepted description of the claim of right doctrine. The often quoted part of the decision states:

If a taxpayer receives earnings under a claim of right and without restriction as to its disposition, he has received income which he is required to return, even though it may still be claimed that he is not entitled to retain the money, and even though he may still be adjudged liable to restore its equivalent.

The Court noted that if North American Oil had been ordered to repay the proceeds it would have been entitled to a deduction in the year of repayment. In *Healy*,⁴ the Court discussed the impact of the deduction being claimed in the year of repayment. They noted that placing the deduction in a year different from the year the receipt was taxable could be either beneficial or detrimental as a result of rate or bracket changes. One solution would be to allow taxpayers to file an amended return for the year the income was reported. In many cases, requiring taxpayer to file an amended return would be detrimental because the year would be closed due to the statute of limitations. Consequently the repayment would never actually be deducted. Given the potential that the prior year may be closed, the most reasonable approach is to allow a deduction in the year of repayment acknowledging that this may not completely offset the prior inclusion.

In 1954, after several cases recognized the limitation of the then existing rules concerning the deduction of the repayment, Congress enacted Section 1341. This Section was designed to eliminate the detrimental effect of the deduction occurring in a different year from the year that the income was included in certain cases.⁵ It contains special tax computation rules that approximate filing an amended return without an actual amended return having to be filed.

Section 1341 provides that a taxpayer who has included an amount in income in a prior year ". . .because it appeared that taxpayer had an unrestricted right to such item" and is entitled to a deduction for a repayment of the item that exceeds \$3000 in the current year be-

⁴ *Healy v. Commissioner*, 345 U.S. 278 (1953).

⁵ See *United States v. Skelly Oil Co.*, 394 U.S. 678, (1969), which references the committee report, H.R. REP. No. 83-1337 (1954).

cause he did not have an unrestricted right to the item, may calculate his tax for the current year either by claiming the deduction or a credit equal to the tax reduction for the prior year that would occur by omitting the item reported as income. If omitting the prior reported income results in a net operating or capital loss in the prior year, this recomputed loss may be carried over under the normal carryover rules.⁶ Section 1341(b)(2) denies the relief contained in subsection (a) to taxpayers as a result of deductions related to prior sales of inventory except for refunds by regulated public utilities. Section 1341 was designed to relieve taxpayers of the detrimental effect of having previously included an item in income under the claim of right doctrine that should not have been taxed. By giving taxpayer the option of a current deduction or a credit equal to the recomputed prior tax, taxpayer is permitted to maximize the benefit from the allowable deduction.

II. DOMINION RESOURCES

To take advantage of Section 1341, taxpayer must meet the following four requirements:

- 1) the taxpayer must appear to have had an unrestricted right to an item that was included in gross income for a prior taxable year;
- 2) it must have been established after the close of the prior year that the taxpayer did not have an unrestricted right to the item;
- 3) the taxpayer must be entitled to deduct the amount of the item upon repayment; and
- 4) the amount of the deduction must exceed \$3000.⁷

The first requirement has generated a significant amount of litigation and was the primary issue in *Dominion Resources*. Although the Code requirement that generated the first condition uses the phrase income to which taxpayer appeared to have an unrestricted right, the regulations discuss the item as income reported under a claim of right. Regulation Section 1.1341-1(a)(2) defines income included under a claim of right as income included because it appeared that taxpayers had an unrestricted right to the income based on all the facts available at the time of inclusion. In Rev. Rul. 68-153⁸ the Service explains the word "appeared," which is used in both the Code and regulation, as taxpayer having a "semblance of an unrestricted right in the year received as distinguished from an un-

⁶ 26 U.S.C. § 1341(b)(5) (1994).

⁷ *Dominion Resources, Inc. v. United States*, 219 F.3d 359 (4th Cir. 2000).

⁸ Rev. Rul. 68-153, 1968-1 C.B. 371.

challengeable right . . . and from no right at all." Taxpayers are not eligible to use Section 1341 if they over-report income resulting from "mere errors" since in these cases all the facts are available to determine that taxpayer did not have any right to the income.⁹ Similarly taxpayer is not entitled to Section 1341 relief for income received under an employment contract when he is required to pay the employer a liquidated damage for breach of the employment contract.¹⁰ In this case, taxpayer had an actual right to the income in the year received. He paid a claim for breaching the contract, he did not return amounts he had not earned.

The Service has taken the consistent position that the income must have been included because it only appeared as if taxpayer had a unrestricted right to the item. The courts have interpreted this requirement, specifically the word "appeared", as denying the use of this Section if taxpayer had an actual right to the income when received (rather than an apparent right to the income) and if there was evidence that the repayment was voluntary and/or the repayment was the result of a subsequent event.¹¹

Two of the earliest cases that address the issue of "apparent unrestricted right" to the income are *Pike*¹² and *Blanton*.¹³ In 1955, Pike along with several other individuals incorporated an insurance company in Kentucky. In 1957, taxpayer hired an investment banker to sell some of his corporate stock and rights and purchase additional shares of the corporation's stock. He received the proceeds from the sale of the stock and rights and reported them as capital gain. In 1958 taxpayer's right to keep the proceeds was questioned and he returned the funds to the corporation. The Tax Court concluded that taxpayer was not entitled to the benefits of Section 1341 because he had an actual right to the income in the year of receipt. The Court stated: "Petitioner has not proved that he was not entitled to retain the profits from the sale of . . . stock. Accordingly, he does not meet the requirements for relief under Section 1341." In *Blanton*, taxpayer received salary and director's fees from a closely held corporation from 1959-1961. In 1962 he signed a contract that obligated him to return any amounts held non-deductible by IRS. In 1963 he returned some of the fees he previously had reported as income pursuant to the 1962 contract after an IRS finding that the fees were excessive. Again the Tax Court denied the use of Section 1341. They stated: ". . . the req-

⁹ *Id.*

¹⁰ Rev. Rul. 67-48, 1967-1 C.B. 50.

¹¹ In Revenue Ruling 58-456, the I.R.S. concluded that taxpayers were entitled to use Section 1341 for repayments of corporate distributions that were involuntary as a result of a court order. Rev. Rul. 58-546, 1958-2 C.B. 415.

¹² *Pike v. Commissioner*, 44 T.C. 787 (1965).

¹³ *Blanton v. Commissioner* 46 T.C. 527 (1966).

uisite lack of an unrestricted right to an income item . . . must arise out of the circumstances terms and conditions of the original payment . . . and not by reason of subsequent [event] . . .” Thus, the early cases mandated that taxpayers have an apparent rather than an actual right to the income with the added condition that the lack of an actual right to keep the funds cannot be the result of a subsequent event.

Following *Pike* and *Blanton*, other courts have adopted the actual right/subsequent event approach to deny the application of Section 1341. In *Kappel*¹⁴ taxpayer received distributions from four employee pension plans. He was advised that the distributions would not be subject to income, gift, or estate tax. The advice was wrong. Not only were the distributions subject to tax, they subjected the trusts to disqualification as tax exempt pension plans. After IRS notified taxpayer that they were going to assess deficiencies, taxpayer repaid the funds and claimed a deduction. The Third Circuit Court of Appeals agreed with the District Court that taxpayer was not legally required to return the funds. Consequently, he had an actual right to the money, not just an apparent right. This resulted in taxpayer not being entitled to use Section 1341.

In *Bailey*,¹⁵ taxpayer was an officer, shareholder, and director of Bestline Products, Inc. In 1971 he signed a consent decree with the Federal Trade Commission agreeing to stop the corporation’s deceptive and fraudulent business practices. In 1976, a district court found him guilty of continuing the practices and violating the consent decree. He paid a fine of \$1,036,000 which he deducted and to which he applied Section 1341. This time it was the Sixth Circuit Court of Appeals that denied Section 1341 treatment since taxpayer had an actual right to the prior reported income. The fine was the result of a separate, subsequent event rather than from the circumstances surrounding the original income inclusion.

These cases establish a strong line of precedent that taxpayer must have only an apparent right to the income. This effectively limits the benefits provided by Section 1341 to a very small group of taxpayers. It has also caused the courts to examine the voluntary versus involuntary nature of the reimbursement. This line of inquiry raises an interesting question about the voluntary nature of lawsuits and settlements that generated the repayment of the income.

The government takes the extreme position that taxpayer must prove that the payments are not voluntary unless the repayment is the result of a court suit. In other words, absent a court suit, repayments are assumed voluntarily unless proven otherwise. In *Pike* the court described the government’s argument as “. . . there must be a clear showing, under State statutes or decisions, of [taxpayer’s] liability . . . before section 1341

¹⁴ *Kappel v. United States*, 437 F.2d 1222 (3d Cir. 1971).

¹⁵ *Bailey v. Commissioner*, 756 F.2d 44 (6th Cir. 1985).

(a)(2) can be satisfied." In *Barrett*,¹⁶ a case involving a settlement of insider trading violations, the government's position was more direct. They argued that taxpayer was not entitled to Section 1341 relief because he did not "establish" that he did not have an unrestricted right to the income. It was not established according to IRS, because the civil suit was not litigated to judgement but rather taxpayer acquiesced to a settlement.

In both cases the courts rejected the government's attempt to require completed litigation. The courts held that the settlement was the equivalent of a negative judgement. In *Pike* the court stated that a judicial determination of liability is not necessary. In *Barrett* the court applied the *Lyeth v. Hoey* principle that an arm's length settlement has the same effect as a judgement.

The rejection of the government's position is not as complete as it should be if the principle from *Lyeth v. Hoey* is accepted. The court in *Pike* stated that taxpayer must prove the probable validity of the claim for repayment. The court then raised the bar even higher when it provided: "We are of the opinion that, to become entitled to relief under Section 1341, a taxpayer must prove by a preponderance of the evidence that he was not entitled to the unrestricted use of the amount received in prior years." The court concluded that since taxpayer did not prove he was not entitled to the income, he could not use Section 1341.

In *Barrett*, taxpayer was permitted to use Section 1341. The precedential value of its pro-taxpayer holding, however, is limited because of subsequent criticism and analysis. For example, in *Parks*,¹⁷ the court states that *Barrett* ". . . effectively reads the 'appeared that the taxpayer had an unrestricted right' language out of the statute." In *Wang*,¹⁸ the Tax Court stated that *Barrett* did not consider the apparent versus actual right controversy. Instead it addressed the limited question of whether the repayment was voluntary or not. Since the fact that the payment is not voluntary does not automatically mean that taxpayer had only an apparent right to the income, *Barrett* does not apply to the question of whether taxpayer had an apparent right to the income or not. The end result of these cases is to leave the applicability of Section 1341 to settlement payment in doubt in spite of the relatively direct statements in *Pike* and *Barrett*.

In *Parks*, the court attempted to establish an alternate approach to the question of litigation to resolve the uncertainty created by the prior decisions. Under their approach, Section 1341 can be used in situations that do not involve any contention of illegal activity if the repayment is the result of a settlement or trial. However if illegal activities are involved,

¹⁶ *Barrett v. Commissioner*, 96 T.C. 713 (1991).

¹⁷ *Parks v. United States*, 945 F. Supp. 865 (W.D. Pa. 1996).

¹⁸ *Stephen S. Wang, Jr. v. Comm.*, Tax Court Memo 1998-389, 76 TCM 753, Nov. 2, 1998.

taxpayer must prove, by a completed trial, if necessary, that he did not commit an illegal act. This approach has not been endorsed by subsequent litigation. Since it conflicts with the approach used by the courts in *Dominion Resources* that this article favors, it is hoped that the *Parks* approach is not adopted.

All the approaches used by the courts to establish that taxpayer had only an apparent right to the income and was required to repay it, including a requirement of completed litigation or a requirement that taxpayer prove by a preponderance of the evidence that no actual right existed, are overly restrictive. Section 1341 is a relief provision. As long as the taxpayer is neither convicted of a crime nor the repayment a nondeductible fine, taxpayer should only have to prove that the funds were repaid because of a claim that was not frivolous. This would encourage taxpayers to return funds they may have received inappropriately by neutralizing all negative tax impacts of the prior taxation. It should be remembered that Section 1341 is not a tax deduction provision. It does not grant taxpayers a tax benefit for amounts that are not otherwise deductible. It simply compensates for an overpayment of tax in a prior year. Allowing additional taxpayers to use the provision is not creating a loophole that will be exploited by knowledgeable taxpayers. Therefore, a less restrictive approach than the one used prior to *Dominion Resources* is warranted.

III. NEXUS

As previously discussed, the government has been successful in arguing its subsequent event theory in some of the early cases in which taxpayer agreed to return excess compensation where the agreement to return the funds was adopted after the salary was paid.¹⁹ In *Van Cleave*,²⁰ they tried to expand the subsequent event approach by arguing that repayments of excess salaries based on a preexisting contract were ineligible because the tax audit which generated the obligation to repay the funds was a subsequent event. In the prior cases, they simply had argued that the agreement to repay which was signed after the salary was received, was the subsequent event. They had not previously attempted to disallow amounts repaid from salaries received after the agreement was signed.

The Sixth Circuit rejected the subsequent event theory in this case and allowed taxpayer to use Section 1341. They based their conclusion on

¹⁹ See, e.g., *Pahl v. Commissioner*, 67 T.C. 286 (1976). The court allowed the taxpayer to use Section 1341 for repayments for salary received after the repayment agreement was in force without addressing the subsequent event theory.

²⁰ *Van Cleave v. United States*, 718 F.2d 193 (6th Cir. 1983).

the Fifth Circuit's decision in *Prince*.²¹ In *Prince* taxpayer was a beneficiary of a trust who had to return part of the distributed income when an Alabama court held that the distribution should have been reduced by the trustee's commission. The Sixth Circuit quoted the Fifth Circuit's opinion which states:

The Alabama judgement established . . . that the deduction . . . had been miscalculated. As a result, [taxpayer] had received more income from the trust than she was entitled to receive. This income had to be returned. The requirements of Section 1341 were thus clearly satisfied. [Taxpayer] appeared to have an unrestricted right to the income when she received it; it was established in a taxable year after she received it that she did not have such a right.

Although the last sentence can be read as a rejection of the subsequent event theory, it can also be read as holding that the determination that the income was overstated was decided in a subsequent year based on a contract that was in force in the year of the distribution (income inclusion.) Under this reading, the lawsuit was not a subsequent event. Instead, the time that the provision of the existing contract was interpreted occurred in a subsequent year. Under this reading of the opinion, *Prince* does not reject the subsequent event approach since the court was not confronted with a subsequent event.

Van Cleave can be distinguished from *Prince* based on differences in the subsequent activity. The lawsuit in *Prince* can be distinguished from the IRS audit in *Van Cleave* which arose in a year after a salary was paid and which concluded that the salary payment was excessive. One subsequent event (*Prince*) is a determination of the correct amount of a prior distribution and the other subsequent event (*Van Cleave*) is an IRS audit that holds salary payments to be nondeductible. Regardless of whether *Prince* actually rejected the subsequent event approach and the difference in the type of subsequent activities in the two cases, *Van Cleave* and other subsequent cases cite it as the initial case that rejected the subsequent event approach.

At the end of the *Van Cleave* opinion the court stated that accepting the IRS subsequent event theory would “. . . thwart the ameliorative purpose intended by congress in enacting the section.” Equity might have been the real reason for the decision that court reached in *Van Cleave* and it's interpretation of *Prince*.

The government's interpretation of Section 1341 was rejected

²¹ *Prince v. United States*, 610 F.2d 350, (5th Cir. 1980).

most recently in *Dominion Resources, Inc.*²² Dominion Resources owns Virginia Power. The regulatory authorities allow Virginia Power to bill customers at a rate that covers the costs of generating the electric power including estimated federal income taxes. From 1975-1987 the estimate of federal income tax was based on an assumed rate of 46 percent. The Tax Act of 1986 reduced this rate. Therefore when Virginia Power paid tax on this income it paid tax at a rate less than the 46 percent it used to bill customers. The regulatory agencies ordered Virginia Power to refund the difference between the amount collected based on the prior tax estimate and the actual tax paid. The utility refunded approximately \$10 million to its customers which it deducted and to which it applied Section 1341. The IRS denied the corporation the right to use Section 1341 on the basis that the refund was the result of a subsequent event. The Service cited *Blanton* and its progeny as authority.

The district court stated that the IRS interprets *Blanton*, and the subsequent cases that cite it as denying Section 1341 treatment if taxpayer has an actual right to the income rather than just an apparent right to the income. This interpretation is wrong according to the court. The prior cases denied taxpayer the right to use Section 1341 because in each case taxpayer voluntarily returned the funds not because they had an actual right to the income. As for the IRS argument that Section 1341 should be denied based on the subsequent event approach, the court found that this theory has been rejected in *Prince* and *Van Cleave* and was rejected by the district court in the current case.

Section 1341 applies if taxpayer reports income in one year and in a subsequent year it is determined that taxpayer is not entitled to keep the income based on the facts and circumstances surrounding the receipt. According to the district court, the appropriate way to apply this requirement is to limit Section 1341 to cases in which there is a "substantive nexus" between the right to the income and the circumstances requiring the refund. Voluntary subsequent actions by taxpayer will not have the required nexus. However, in *Dominion Resources* the nexus exists. Customers were billed based on the estimate of taxes to be paid on the income. Part of the amount collected was ordered refunded because of a tax rate change. Thus, there is the required nexus between the amount of income reported and the mandated refund. Taxpayer meets the Code requirement of having reported income because it appeared that it had an unrestricted right to the income and later it was determined that it did not have a right to the income. Applying a nexus standard avoids

²² *Dominion Resources, Inc. v. United States*, 48 F. Supp. 2d 527 (E.D. Va. 1999), *aff'd by*, *Dominion Resources, Inc. v. United States*, 219 F.3d 359, 369 (4th Cir. 2000).

and eliminates the added requirements and restrictions that IRS' actual versus apparent and subsequent event theories added to the law.

The Court of Appeals affirmed the district court's conclusion as well as its rejection of the IRS theories. The Court of Appeals rejected the actual versus apparent theory based on a simple reading of the Code. The law requires that taxpayer report income ". . . because it appeared that the taxpayer had an unrestricted right to the income." According to the court:

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. [Emphases in original]

The court also rejected the subsequent event theory based on the prior courts' rejection of it in *Prince* and *Van Cleave*. The court adopted the rule from *Blanton* and *Pahl*: "the requisite lack of an unrestricted right to an income item permitting deduction must arise out of the circumstances, items and conditions of the original payment of such item to the taxpayer." Without actually referring to the district court's formulation, the Court of Appeals accepted the use of Section 1341 when there is a substantial nexus between the reporting of the income and the payment of the refund.

With the decision in *Dominion Resources* we have a much more equitable approach to Section 1341. No longer will taxpayer have to prove that they did not have an actual right to the income nor that a subsequent event forced repayment. Taxpayers will need to show that as a result of an involuntary event that is significantly related to the original inclusion decision, they refunded the prior taxed income and they are currently entitled to a deduction. This is in keeping with the intent of Congress when it enacted Section 1341 and is unlikely to result in tax abuse or avoidance schemes.

In spite of the Fourth, Fifth and Sixth Circuits' rejection of the government's position, IRS has continued to argue actual versus apparent right to income. Unfortunately, the courts have not consistently rejected the government's position. For example, in *Wicor, Inc.*,²³ a case that was factually similar to *Dominion Resources*, the District Court stated that they would apply the result from *Dominion* without specifically rejecting the apparent versus actual dichotomy argued by the government. The fact that the court concluded that taxpayer was ineligible to use Section 1341 for other reasons decreases the value of this decision as a re-

²³ *Wicor, Inc. v. United States*, 116 F. Supp. 2d 1028 (E.D. Wis. 2000).

jection of the government's arguments. In *Midamerican Energy Co.*,²⁴ the Tax Court chose not to rule on the issue since, again, taxpayer failed to meet one of the other requirements to use Section 1341.²⁵ It would have been preferable if both courts had unequivocally stated that the correct test is nexus, not apparent right to income so that taxpayers in the future could be more certain of obtaining the relief benefits Congress enacted.

IV. ILLEGAL INCOME

As previously discussed, it is the government's position that to use Section 1341 there must be the appearance of an unrestricted right to the income. If taxpayer has an actual right to the income, then Section 1341 is not available. The government also argues the reverse. If there is absolutely no right to the income then Section 1341 is again not available. This part of the argument has led IRS to state that money obtained illegally, even through fully taxable and even if deductible when repaid, is not eligible for Section 1341 treatment.

Traditionally the courts have agreed with the government. In a long line of cases the courts have denied Section 1341 treatment to embezzled income, kickbacks, and insider trading profits.²⁶

There has been a slight retrenchment from this hard and fast rule. In *Wang*,²⁷ the Tax Court considered the availability of Section 1341 for amounts obtained from insider information. After stating that embezzled income does not qualify for Section 1341, the court stated:

It does not necessarily follow, however, that taxpayers with illegal income, per se, are not entitled to use Section 1341. With respect to each taxpayer it would be necessary to decide whether his circumstances meet the requirement of Section 1341.

The court goes on to state that Section 1341 will apply only if taxpayer appeared to have an unrestricted right to the income. They con-

²⁴ *Midamerican Energy Co. v. Commissioner*, 114 T.C. 570, (2000).

²⁵ In *Florida Progress Corporation v. Commissioner*, 114 T.C. 587 (June 2000), the Tax Court was confronted with a similar issue and ruled that the same result as in *Midamerican Energy* should be reached.

²⁶ See, e.g., *Yerkie v. Commissioner*, 67 T.C. 388 (1976); *McKinney v. United States*, 574 F.2d 1240 (5th Cir. 1978); *Zadoff v. United States*, 638 F. Supp. 1240 (S.D.N.Y. 1986); *Wood v. United States*, 863 F.2d 417 (5th Cir. 1989); and *Kraft v. United States*, 991 F.2d 292 (6th Cir. 1993).

²⁷ *Wang v. Commissioner*, Tax Court Memo 1998-389 (Nov. 2, 1998).

cluded that *Wang* did not, and therefore, could not use the relief provision.

In *Culley*,²⁸ the Court of Appeals for the Federal Circuit expressed similar thoughts. They stated:

Mr. Culley urges that there should be no per se rule that taxpayers with illegal income cannot obtain the benefits of Section 1341 We agree that the issue presented by Section 1341 is not simply whether Mr. Culley obtained funds unlawfully, but whether it appeared to him that he had an unrestricted right to those funds.

The court concluded that the money obtained by Culley through fraud and kickbacks did not meet the requirement of an appearance of a right to the income. In both *Wang* and *Culley* taxpayer was denied Section 1341 treatment because he could not prove that he had only an apparent right to the income. It would have been interesting to see what decision the courts would have reached if they had adopted the substantial nexus approach of *Dominion Resources* rather than the apparent right to income approach.

Although two courts have stated that illegal income may qualify for Section 1341, they did not find the income in question to qualify. They also did not give any examples of illegal income that would qualify, effectively denying Section 1341 to illegal income.

The government's theory on qualification is best evaluated based on the extreme approach taken in FSA 200036006. Taxpayer had underpaid oil royalties and claimed Section 1341 treatment on the restoration of the underpaid amounts. There was no question of fraud or illegal activities, still the government was not willing to allow the use of Section 1341 unless taxpayer could prove that the facts that caused the underpayment were not known or *knowable* by taxpayer. Having to prove that you could not have known that the income belonged to someone else appears overly restrictive. The approach taken by the courts in *Dominion Resources* appears to be the better approach.

Instead of trying to separate income into three groups, appeared to have unrestricted right, actually had unrestricted right, and had no right, it is better to ask: was the income included on a return and was it repaid; was there sufficient nexus between these two items; and do you meet the other condition of Section 1341? Using this approach will give more rational and more equitable results. For example, applying the rule to illegal income will result in the following decisions. Taxpayers who have illegal income and pay fines, etc. will be denied Section 1341 treatment since fines are nondeductible and the repayment must be deducti-

²⁸ *Culley v. United States*, 222 F.3d 1331 (Fed. Cir. 2000).

ble to qualify under Section 1341. Taxpayers who reported illegal income and are entitled to a deduction because they repaid the injured party would be able to use Section 1341. In these cases the courts can deny the guilty taxpayer undue enrichment by increasing the ordered repayment to include the future tax refund. This would actually increase equity by returning the funds to the injured party rather than allowing the government to keep the funds to punish the taxpayer who obtained the money illegally. This would also prevent the Service from forcing taxpayer to prove not only that the funds were not obtained illegally but also that they could not possibly have known that the money belonged to someone else when the funds were obtained because of errors or confusion about the appropriate amount or computation such as the royalty due a third party. This approach might also cause the courts to reexamine whether embezzled funds could ever come under Section 1341. The benefit of this approach is that a simple rule would be used in all cases rather than the multiple rules that now exist. In addition, the proposed rule better coincides with the Congressional intent in enacting this relief provision.

V. OTHER REQUIREMENTS

Applying the approach from *Dominion Resources* should make it easier for taxpayers by eliminating the need to prove apparent right and absence of a subsequent event. It will not eliminate the need to meet the other conditions outlined in Section 1341.

The first requirement that must be met is that taxpayer has included an amount in income. The government's position is that to be included in income an amount must have increased gross receipts.²⁹ They do not adopt the more customary definition which would be that the amount was included in taxable gross income. Applying the government's approach to "inclusion" means that items that affect the cost of goods sold and thereby reduce gross receipts to arrive at taxable gross income are not eligible for consideration under Section 1341. This approach to "inclusion" also means that taxpayers will not be able to use Section 1341 for payment of any item that would, if it had occurred in a previous year, increase an expense.³⁰

Given this approach it is a little puzzling that the Service treated the underpayment of oil and gas royalties as resulting in an inclusion in

²⁹ See Field Service Advice 200036017 (June 1, 2000); Gen. Couns. Mem. 35,403 (July 16, 1973); Rev. Rul. 72-28, 1972-1 C.B. 269.

³⁰ See *Cal-Farm Ins. Co. v. United States*, 647 F. Supp. 1083 (E.D. Cal. 1986).

income.³¹ It would appear that the government should have argued that taxpayer understated a deduction rather than included an item in income and was therefore ineligible for Section 1341 relief. They explain their treatment of the item as having been included in income on the theory that royalty owners have an economic interest in the property and therefore taxpayer included in income an item that belonged to the recipient of the royalty. A more likely explanation is that the early claim of right cases involved underpaid royalties and the Service did not want their approach to be rejected based on the obvious intent of Congress when it enacted Section 1341 as evidenced by the committee reports which cite these early royalty cases. If the government were to use the more accepted definition of income as taxable gross income, as previously discussed, the underpaid royalties would definitely be considered an inclusion in income without having to rely on a strict interpretation of property rights.

Another important requirement for the use of Section 1341 is that taxpayer must restore the income and be entitled to a deduction for the restoration. Restoration means to repay the funds to the appropriate party. In *Chenin*³² the Eighth Circuit Court of Appeals denied Section 1341 treatment when taxpayer transferred the funds to an escrow account because the Section requires restoration to the affected taxpayer. Likewise, taxpayer must restore the funds included in income. In PLR 199923003 taxpayer was denied Section 1341 treatment for settlement of a patent infringement suit since the damages paid were based on the patent holder's lost profit rather than the amount of profit that taxpayer had reported.

This requirement of a repayment was also considered in *Dominion Resources*. Previously, the government had been successful in arguing that a utility that reduced future rates had not restored the reported income.³³ The courts were able to distinguish *Dominion Resources* from prior cases by pointing out that taxpayer was required to reduce current bills and refund some money rather than simply reducing future power bills. The court held that issuance of a credit to be used by the customers on their current bill and certainly the issuance of a cash refund was a repayment. Having lost this argument about repayment, the government attempted to impose an additional requirement that the restoration be to the same persons who had paid the excessive charges. The Court of Appeals upheld the lower court's decision that restoration to as many of the actual payors as was reasonably feasible was sufficient to qualify as a repayment. There did not need to be complete agreement between the customers who overpaid their bills and the one who received the refund.

³¹ Field Service Advice 200036006 (March 31, 2000).

³² *Chenin v. United States*, 149 F.3d 805 (8th Cir. 1998).

³³ See, e.g., *Roanoke Gas Co. v. United States*, 977 F.2d 131 (4th Cir. 1992).

The final part of the restoration requirement is that taxpayers must be entitled to deduct the payment. As previously mentioned, the payment of a fine or penalty is not deductible under Section 162(f) and would not qualify under Section 1341. Again *Dominion Resources* examined the government's extreme interpretation of this requirement. The government tried to argue that since taxpayer booked the refunds as returns rather than as an expense they did not qualify as having paid an amount which was deducted on the return. The court pointed out that accounting rules do not dictate tax results. Therefore the account used on the books will not prevent qualification under Section 1341. If the repayment is an ordinary and necessary expenditure under Section 162 or deductible under any other Code section it has met this part of the requirement. The refunds granted to the customers were deductible and *Dominion Resources* qualified for Section 1341.

VI. TRANSFEREES

A final issue has arisen recently on which the courts should extend Section 1341 to provide the relief intended by Congress. Their failure to apply the Section broadly is inconsistent with the approach taken in *Dominion Resources* and the conclusions reached in other related cases.

The availability of Section 1341 for a transferee who is required to restore funds has been considered in several different contexts. In Rev. Rul. 78-25,³⁴ a shareholder who received a liquidating distribution from a corporation was required to restore funds to a third party following a judgement against the liquidated corporation. The ruling holds that the shareholder, as transferee, was entitled to use Section 1341. The ruling cites the committee report as its authority, specifically the report's statement that Section 1341 would apply to an *Arrowsmith*³⁵ situation which also involved a corporate liquidation with transferee liability. Since the original income in Rev. Rul. 78-25 was reported as a capital gain, the repayment is a capital loss and the Section 1341 relief calculated appropriately.

Another transferee that has been allowed the benefits of Section 1341 is a decedent's estate. The Service's original position was that an estate may not use Section 1341.³⁶ This position conflicted with the earlier decision in *Estate of Charles Good*.³⁷ Following another pro-taxpayer deci-

³⁴ Rev. Rul. 78-25, 1978-1 C.B. 270.

³⁵ *Arrowsmith v. Commissioner*, 344 U.S. 6 (1952).

³⁶ Rev. Rul. 67-355, 1967-2 C.B. 296.

³⁷ *Good's Estate v. United States*, 208 F. Supp. 521 (E.D. Mich. 1962).

sion,³⁸ IRS reconsidered its position. It decided to revoke the earlier ruling and in Rev. Rul. 77-322,³⁹ ruled that a decedent's estate can use Section 1341 when it restores income a decedent had reported.

*Estate of Smith*⁴⁰ addressed an interesting collateral issue that arose from Rev. Rul. 77-322 conclusion that an estate may use Section 1341. In this case, the question was the effect of the repayment and potential tax refund on the estate's value for estate tax purposes. The Court of Appeals concluded that the repayment was a deductible liability and the refund an includible asset and that these two should be netted generating a net deduction on the estate tax return. Appropriate adjustment should be made to the amount of the liability to allow for the possibility that the estate may not be required to refund the prior inclusion.

Given that other transferees are permitted the benefit of Section 1341, it is surprising that a bankruptcy estate was held ineligible to use this provision. In *Langdon Cooper*,⁴¹ the court ruled against the estate. The court reasoned that since Section 1341 is not included in Section 1398 (g)(1)–(7) which lists the attributes that carry over to a bankruptcy estate, it does not apply. The court rejected the use of Section 1398 (g)(8) which provides for other attributes to qualify based on regulations since no regulations have been issued.

The fact that regulations have not been issued should have been ignored. The Service applied Section 707(a)(2)(B) to a disguised sale even though regulations have not been issued.⁴² Likewise the Tax Court allowed passive income netting in the absence of regulations.⁴³ They stated:

. . . We have held that the . . . Treasury's failure to provide the needed guidance should not deprive taxpayers of the benefits or relief Congress intended.

Following this reasoning, bankruptcy estates should be allowed the benefit of Section 1341 if Congress intended them to use the provision. Consequently, the court should have examined Congressional intent. If it had, it would have discovered that in the Senate Report on the Bankruptcy Act of 1980, it states that bankruptcy estates could be allowed the benefit of Section 1341.⁴⁴ Given this statement and the overall knowl-

³⁸ *Nalty v. United States*, Civ. No. 73-1574, 1975WL577 (E.D. La. Apr. 16, 1975).

³⁹ Rev. Rul. 77-322, 1977-2 C.B. 314.

⁴⁰ *In re Estate of Algerene Allen Smith*, 110 T.C. 12 (1998), *rev'd and vacated*, 198 F.3d 515 (5th Cir. 1999).

⁴¹ *Cooper v. United States*, No. 3:97CV502-V, 2000 U.S. Dist. LEXIS 8988 (W.D.N.C. May 17, 2000).

⁴² Tech. Adv. Mem. 2000-37-005 (May 18, 2000).

⁴³ *Hillman v. Commissioner*, 114 T.C. 103 (2000).

⁴⁴ *Reprinted at* 1980-2 C.B. 635.

edge that Section 1341 was intended to ameliorate a harsh result, the court should have allowed the bankruptcy estate the requested benefit.

Even if the courts did not want to ignore the absence of regulations, they could have allowed the bankruptcy estate to use Section 1341 by following the reasoning in *In re Bradley*.⁴⁵ The question before the court in *Bradley* was the ability of a bankruptcy estate to exclude the gain from the sale of a residence under Section 121. The government had argued that the estate was ineligible since Section 121 is not listed in Section 1398. The court rejected this argument. They pointed out that the phrase tax attribute is not defined in the Code.⁴⁶ It generally refers to items that have continuing tax consequences such as NOL carryovers, earning and profits, etc. Therefore they concluded that Section 121 is not an attribute. The holding period and classification of the property sold are the attributes. Following this logic, Section 1341 is not an attribute. The type of repayment and its deductibility are the attributes. If the estate is allowed to deduct the repayment based on its attributes then Section 1341 can be used to calculate the tax consequences.

This reasoning is bolstered by the Government's position on Section 1341 following a corporate reorganization. In most tax-free reorganizations, the corporate transferor's tax attributes carryover to the acquiring corporation pursuant to Section 381 which contains a very detailed list of attributes. Therefore the use of Section 1341 following a transaction governed by Section 381 is similar to a bankruptcy estate using Section 1341 under Section 1398. The interaction between Sections 1341 and 381 is considered in Rev. Rul. 71-496.⁴⁷

In this ruling, M Corporation merged into P Corporation in a tax-free "A" reorganization. Following the merger, P Corporation had to repay a government subsidiary that M Corporation had included in income before the merger. The ruling holds that P Corporation is entitled to a deduction under Section 381(c)(16) that allows the acquirer a deduction for payments that would have been deductible if paid by the acquired corporation before the reorganization. The ruling goes on to state:

If a taxpayer is entitled, under Section 381(c)(16). . . , to a deduction because it paid or accrued an obligation of the transferor corporation which gave rise to a liability after the date of distribution, and such obligation is the restoration to another of an item which was included in the

⁴⁵ *In re Bradley*, 222 B. R. 313 (Bankr. M.D. Tenn. 1998).

⁴⁶ See Matthew A. Melone, *Taxable Corporate Acquisition: A Primer for Business and the Non-Specialist*, 25 U. TOL. L. REV. 673. (1994), cited in *Bradley*.

⁴⁷ Rev. Rul. 71-496, 1971-2 C.B. 315.

transferor's gross income for a year prior to the distribution under a claim of right, as defined in Section 1341 of the Code . . . , there is nothing in the provisions of Section 381 or 1341 of the Code which would preclude a taxpayer from computing its tax under the provisions of Section 1341(a) . . .

Therefore P Corporation was entitled to use Section 1341 when it repaid income Corporation M had included on a prior return.

If the Government had considered Section 1341 to be a tax attribute it would have discussed its absence from the list in Section 381(c). Instead, they discussed only the deductibility of the repayment under Section 381. Having found the repayment to be deductible they allowed the use of Section 1341. Applying this reasoning to bankruptcy estates, you again only consider whether the repayment is deductible under Section 1398. If it is, then the bankruptcy estate should be entitled to use the relief provisions of Section 1341. This would treat bankruptcy estates consistent with decedent's estates and successor corporations.

Failure to apply Section 1341 to bankruptcy estates results in actual losses by the creditors of the bankrupt taxpayer not the taxpayer. The estate will contain fewer assets that are available for payment of creditor claims. The estate is reduced because the taxpayer has previously overpaid its tax liability as a result of the arbitrary annual accounting period and the estate is not allowed to recover this excess expenditure. Consequently, the creditors will receive less. The debtor, on the other hand, will be able to retain the same amount of assets whether Section 1341 is allowed or not. The party that suffers the loss will be the creditors. Following the lead provided by *Dominion Resources*, Section 1341 should be allowed where it will promote equity. Allowing bankruptcy estates to use the provision will result in greater equity. Failure to allow Section 1341 harms only the creditors. If the courts had permitted the use of Section 1341 under either theory, they would be able to quote *Bradley* (as modified):

Finally to allow a bankruptcy estate to [use Section 1341] promotes the public interest in a responsible bankruptcy system and does not frustrate any clearly defined federal policy.

VII. INVENTORY

Section 1341(b)(2) denies the benefits contained in subsection (a) for deductions related to the sale of inventory except refunds by regulated utilities. This exclusion was originally included in the law because taxpay-

ers were permitted an allowance for bad debts under Section 462.⁴⁸ This provision nullified the detriment of the annual accounting cycle by permitting taxpayers to estimate and deduct amounts equal to future sales returns against income in the year that the sale was reported. Therefore allowing a special tax computation in the year that the estimated bad debt was actually written off was unnecessary.⁴⁹ Since Section 462 has been repealed, this exclusion of sales return from Section 1341 treatment is not necessary. However given the large number of taxpayers that currently deduct bad debts, it is probably reasonable to maintain this limitation even though these deductions occur in a year following the year the income was reported.

From the beginning the Service has taken a restricted view of this inventory limitation. For example, in Rev. Rul 68-153 they state that the limitation applies to deductions related to the sale of inventory and not service income.⁵⁰

The courts have likewise limited this exception. In *Killian*⁵¹ they allowed taxpayer to use Section 1341. Taxpayer had paid a third party an amount equal to the underpayment due this party under a contract to split the income from the sale of inventory. The court distinguished this payment from a sales return. Although not specified, the court seems to adopt as a definition of a sales return, an amount that would be paid to a purchaser of the inventory for a return or adjustment. Therefore a revenue splitting contract does not involve payments for sales returns. In addition to using a strict definition of a sales return, the court ignored the fact that taxpayer had listed these payments to the third party as commissions under the general heading of selling expenses. The conclusion was that the payment was a deductible expenditure because taxpayer had incorrectly reported an income item. It was not a sales return and therefore taxpayer was eligible to use Section 1341.

Recently Treasury has followed *Killian* and allowed Section 1341 for payments relating to underpaid oil and gas royalties.⁵² They concluded

⁴⁸ H.R. REP. NO. 83-1337, at A294-A295 (1954).

⁴⁹ Under the old method of accruing bad debts, the actual write-off is against the reserve and not to a deductible account. Therefore, Section 1341 would not apply even in the absence of this exception. Section 1341 would only apply to those companies that did not follow generally-accepted accounting principles, and wrote off bad debts in the year of worthlessness rather than accruing them in the year of sale.

⁵⁰ Rev. Rul. 68-153, 1968-1 C.B. 371.

⁵¹ *Killeen v. United States*, Nos. 1202-60 WB Civil, 1204-60 WB Civil (S.D. Cal. February 27, 1963).

⁵² Field Service Advice 200028029 (July 14, 2000) and Field Service Advice 200036006 (March 31, 2000).

that the payments were not refunds of amounts from sales of inventory. However Treasury did apply this inventory exception in FSA 2000 36011 for payments made to settle claims that a purchased product was improperly tested. Again, the distinction that Treasury seems to be making is between payment to customers and all other payments. Only payments to customers that result from the purchase of inventory are ineligible for Section 1341 treatment. This limited definition of deductions related to inventory is very reasonable and in keeping with the recommended approach to the rest of the section.

VIII. CONCLUSION

Section 1341 was designed as a relief provision. From its inception, IRS has attempted to limit the use of the Section. They have attempted to deny transferees the right to use it as well as other taxpayers by insisting on a very strict interpretation of the phrase "appeared to have an unrestricted right to the income." In *Dominion Resources* the courts have opened up the provision to provide the relief Congress intended. This decision should be adopted and expanded. Illegal income should no longer be automatically excluded, nor should bankruptcy estates be denied the benefit. These expansions could actually benefit innocent third parties, persons from whom the cash was embezzled, and creditors who loaned taxpayer money. Although there is significant precedent for the restrictions, adopting and expanding *Dominion Resources* would provide a reasonable way to achieve Congressional intent and a more equitable tax system.