INTERNAL REVENUE SERVICE

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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE
May 23, 2000

MEMORANDUM FOR

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

SUBJECT: Entitlement to Use Section 1341

This Field Service Advice responds to your memorandum dated February 16, 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 =
Year 4 =
Year 5 =
X =
Product A =
Product B =
Product C. =
Product D =

ISSUES:

1. Whether I.R.C. § 1341(a) applies to payments made by A to settle various actions brought on behalf of the United States Government for alleged overcharges and violations of federal statutes including the False Claims Act.
2. Whether I.R.C. § 1341(b)(2) precludes A’s use of section 1341 with respect to items included in gross income in prior years attributable to the sale of property held by A primarily for sale to customers in the ordinary course of its business.

CONCLUSIONS:

1. Section 1341 requires an appearance of an unrestricted right to income. This requirement is not met where repayment of the income item is necessitated by fraud or intentional wrongdoing, which is apparantly the case with each settlement discussed infra.

2. If A were not otherwise precluded from using section 1341, the inventory exception would bar its use for settlements 1, 2 and 3.

FACTS:

A has submitted claims for refund for some of the taxable years between Year 2 and Year 5, claiming tax benefits under section 1341 relating to payments made to settle various lawsuits filed by or on behalf of the United States Government and to settle claims in which A made voluntary disclosures of wrongdoing. Former employees and the Government alleged that A engaged in various deceptive practices regarding contracts for manufactured goods. A subsequently entered into numerous settlement agreements with the U.S. both to settle the various allegations of wrongdoing as well as allegations of wrongdoing voluntarily disclosed by A and not related to a lawsuit. There were approximately X settlement agreements between A and the U.S. We will discuss five of the settlement agreements, which are a fair representation of all of them. All of the lawsuits and voluntary disclosures to be discussed occurred between Year 2 and Year 4. The prohibited practices at issue took place between Year 1 and Year 3.

Settlement 1

A lawsuit was filed against A under the provisions of the False Claims Act. A manufactured and sold Product A and was required to comply with a rigorous testing program to ensure product reliability. The complaint alleged A knowingly falsified testing information and submitted fabricated test results to the Government to cover up the routine failures under the mandatory testing. An amended complaint alleged A's misuse of marks owned by the U.S. and protected by the Lanham Act. Specifically, A sold a number of Product A bearing a registered mark owned by the U.S., and the use of the mark by entities such as A represents that the goods were manufactured in accordance with standard Government specifications. Thus, A sold Product A representing that it was appropriately tested. In addition, A knowingly falsified testing information and submitted fabricated test results and, of course, failed to report the occurrence of many failures, and such failures were required to be reported to the U.S.

Under the terms of a settlement agreement, A paid a sum of money, and in exchange the U.S. released A from all claims and causes of action under the False Claims Act, the Lanham Act and any other statutes or common law theories. The agreement did not constitute an admission by either party.

Settlement 2

This involved another lawsuit filed against A under the provisions of the False Claims Act. The Complaint alleged that A in its capacity as either a prime or subcontractor, failed to negotiate procurement contracts in good faith, specifically violating the Truth in Negotiations Act. The Act requires a contractor to submit cost and pricing data to the U.S. with its contract proposal and to update that information throughout the negotiating process. A "Contract Pricing Proposal" must be submitted and state that the party is providing the Government with its best estimate and/or its actual costs for work to be performed and certifies that all cost and pricing data is accurate, complete and current.

The complaint alleged that A schemed to defraud the Government by falsely representing that the cost estimates were true costs of the work to be done. A's practice was to add to estimated costs various undisclosed amounts termed "reserve" or "negotiation loss factor". These added on costs were concealed under the labor cost estimate, deemed to be the least likely factor to be questioned by the Government. Thus, cost estimates were inflated by substantial amounts. A withheld original documentation prepared for developing the true labor cost estimates.

An amended complaint alleged false estimates of cost and price in all fixed price contracts, negotiation of contracts based on false estimates and making claims and receiving payments at inflated prices. The cost estimates were alleged to be inflated by 10-40%.

The settlement agreement required A to pay a fixed amount to the U.S., and A was released from liability under various federal statutes and the common law.

Settlement 3

A, in its capacity as either a prime or a subcontractor, notified B of certain testing practices for Product B sold to the Government that did not satisfy applicable specifications. A's own investigation, subsequent to an employee's report, determined that A failed to comply with all testing requirements in accordance with specifications for its sales of Product B. In addition, testing reports were falsified and thus A had overcharged for products which failed to meet requirements.

The parties entered into a settlement agreement whereby A paid the U.S. a fixed amount and in return the U.S. compromised any and all statutory or common law claims. The settlement amount was apparently a reimbursement for the overcharges on sales of Product B.

Settlement 4

A sought admission into the Voluntary Disclosure Program administered by B. The Voluntary Disclosure Report revealed a discrepancy in material handling procedures involving

Product C. Product C had been approved by A's engineers for installation even though it did not satisfy all of the Product C specifications, and this practice violated requirements of the Government contracts.

In a settlement agreement A agreed to pay the U.S. a fixed amount and to conduct a recall, screening and repair of all units alleged to be not in conformity with contract requirements. Accordingly, the Government released A from all claims and causes of action under either statutory or common law.

Settlement 5

Suit was filed against A alleging that A failed to properly establish and maintain a property management system over government furnished property thereby misappropriating Product D, which it was hired to repair. A's contract required it to establish and maintain a property administration system to fully account for and trace all Government parts sent to A for repairs. A invoiced the Government for the full contract fee knowing that it had not provided all of the work and services required under the contracts, namely properly establishing and maintaining a property administration system. A was supposed to accurately track parts from receipt, through repair, and ultimate return of the repaired part. A was simultaneously involved in repair work for commercial customers.

When parts were shipped to A, they were accompanied by forms specifying the quantity and type of parts being shipped. When Government parts were used to make commercial repairs, procedures existed to document the "borrowing" so that they were properly replaced and accounted for. A used Government parts for commercial repairs without replacing them, and in addition, A's employees stole Government parts and sold them to private companies or distributors of such parts. A was aware that there were shortages in the parts on hand, and A concealed such shortages from the Government by destroying and altering Government forms.

The settlement agreement released A from all statutory or common law claims, provided that A expressly denied all allegations and provided for the payment of a fixed amount of money to the Government.

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 under a claim of right; Did A appear to have an unrestricted right to the item ?

Treas. Reg. § 1.1341-1(a)(2) defines "income included under a claim of right" to mean an item included in gross income because it appeared from all the facts available in the year of inclusion that the taxpayer had an unrestricted right to the 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.

By requiring that it be established that the taxpayer 'did not have an unrestricted right,' the statutory language indicates that the lack of the right to the item of income must be a condition in existence in the taxable year of inclusion. It is only a determination, or establishment, that the taxpayer lacks an unrestricted right that occurs after the close of the taxable year.

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. Nor does it apply if 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 as we understand them, in each instance, A entered the settlement due to knowing misconduct. Reports and tests were falsified, cost estimates were inflated, products were approved that did not satisfy contract specifications, and shortages of parts were concealed from the Government.

Fraudulent misconduct by A, either willfully or with knowledge of wrongdoing precludes A's use of section 1341. Rev. Rul. 68-153, 1968-1 C.B. 371. Section 1341 requires income inclusion under a claim of right because it appeared from all the facts available in the year of inclusion that the taxpayer had an unrestricted right to the income. Therefore, A's knowledge that it was violating federal statutes and regulations and/or various provisions of its Government contracts, fails to meet the unrestricted right test and section 1341 does not apply to any of the settlement payments.

Was the settlement payment deductible because it was established after the year of the item's inclusion in income that A 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. In general, a payment is considered involuntary for purposes of section 1341 if the repayment is based on a potential claim that if pursued would be resolved adversely to the taxpayer. Pike v. Commissioner, 44 T.C. 787 (1965), acq., 1968-2 C.B. 2.

Nevertheless as discussed, supra, the facts indicate that A cannot use section 1341 because the settlement payments are due to A's intentional wrongdoing.

Was the payment in Settlement 5 a restoration of the same income item?

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).

We agree with your view that A's payment in settlement 5 is factually related to parts shortages and, therefore, is not a repayment of the income that A received for repairing Product D.

Section 1341(b)(2) inventory exception

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

A argues that the inventory exception applies only to matters involving sales returns and allowances. The argument is not supported by the language of the statute. The first sentence of

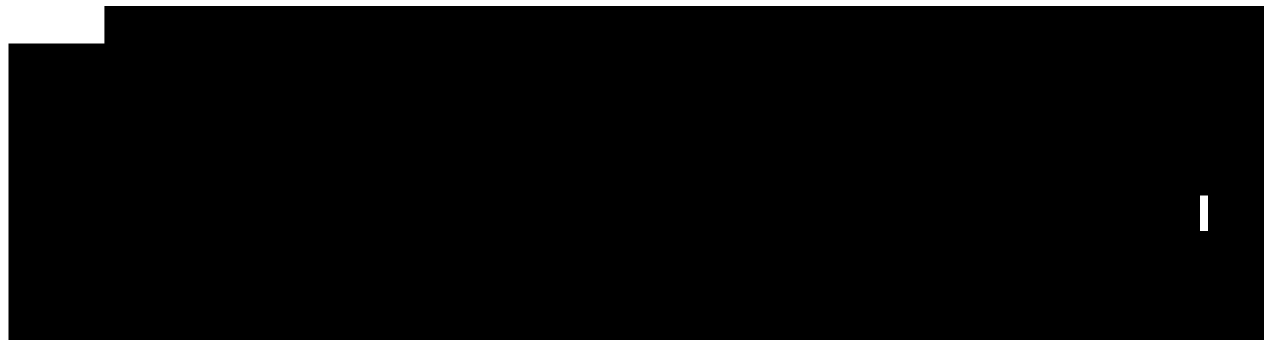
section 1341(b)(2) provides that section 1341 does not apply where a deduction is allowable with respect to an item that was included in gross income by reason of the sale or other disposition of inventory. However, the second sentence in section 1341(b)(2) provides that "this paragraph shall not apply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

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

The relief provided by section 1341(a) should be denied where the deduction arises out of an adjustment made to the stock in trade or similar items within the limiting provisions of Treas. Reg. § 1.1341-1(f) (inventory items, stock in trade).

Accordingly, we believe that if A were not otherwise precluded from using section 1341, the inventory exception would bar its use for settlements 1, 2 and 3. Each settlement involves products manufactured by A and sold either to the Government or, in its capacity as a subcontractor, to a prime contractor who in turn sold to the Government.

CASE DEVELOPMENT HAZARDS AND OTHER CONSIDERATIONS



DEBORAH A. BUTLER

By: ___________________________