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The Section 1341 "Claim of Right"

-by Robert P. Achenbach, Jr., J.D.

Although taxpayers have the option to file an amended return, I.R.C. § 1341 provides an additional method of obtaining a refund of taxes paid on income in prior years where the taxpayer is required to return income received in a prior year and for which the taxpayer paid taxes. A recent Eleventh Circuit Court of Appeals[1] case provides a review of the "claim of right" under Section 1341. This option has gained importance after 2017 because the TCJA 2017 removed the miscellaneous expenses deduction for individual taxpayers; therefore, the option of claiming a deduction for restored taxed income under the claim of right as a miscellaneous deduction is currently not available.

The "Claim of Right" Credit

I.R.C. § 1341 (Section 1341) was enacted in 1954 to overturn a 1951 U.S. Supreme Court ruling[2] which held that a taxpayer had to deduct in the current tax year a repayment of income taxed in a prior year. Instead, Section 1341 allows a taxpayer to recalculate the tax in the prior year as if the repaid taxable income was never received in that prior year and then claim the excess tax as a deduction in the current year.[3]

To obtain relief under Section 1341, a taxpayer must satisfy four requirements: (1) an item of income must have been included in a prior year's gross income "because it appeared that the taxpayer had an unrestricted right to such item;"[4] (2) the taxpayer must have later learned that the taxpayer "did not have an unrestricted right" to that income;[5] (3) the amount the taxpayer did not have an unrestricted right to must have exceeded $3,000;[6] and (4) the amount must be otherwise deductible.[7]

The *Mihelick v, United States*[8] Case

Facts of the Case. Although the facts of the case fit well with the remedy provided by Section 1341, the application of the requirements of Section 1341 were complicated by a divorce decree and the joint and several liability of the taxpayer for the tax year involved.

From 1999 to 2004, the taxpayer and former spouse were married and both worked for a family corporation. In 2004, the taxpayer filed for divorce and during that year another family member sued the former spouse and the corporation, alleging that the former spouse had breached the fiduciary duty by receiving excessive compensation.

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As part of the divorce decree, the taxpayer agreed to liability for half of any award required to be paid by the former spouse, but only after the former spouse threatened to withhold alimony and other divorce payments. The taxpayer's divorce became final in August 2005 and the former spouse settled the fiduciary lawsuit in 2007, agreeing to a payment of $600,000 in excess compensation. The former spouse paid the settlement and the taxpayer reimbursed the former spouse half of the payment. Although the former spouse was allowed a deduction for $300,000, the IRS disallowed the taxpayer's similar deduction. The trial court agreed with the IRS and the taxpayer appealed.

Did the Amount of Restored Taxed Income Exceed $3000? The parties agreed that the amount in question exceeded $3,000.

Did Taxpayer Have Unrestricted Right to the Income? The IRS argued that the former spouse did not have an unrestricted right to the original income because the former spouse misappropriated the money. However, the court found that the IRS presented no evidence of the former spouse knowingly misappropriating the money and the spouse expressly denied any wrongdoing in the settlement agreement; therefore, the former spouse had an unrestricted right to the income during the tax year it was reported.

As to the taxpayer, the court looked to the filing of the joint return and Ohio law to find that the taxpayer reasonably believed that the taxpayer had a right to a one-half share of the former spouses income (and was liable for one-half of any tax due) in the tax year involved. The court thus held that the taxpayer had the same unrestricted right to at least half of the income during the tax year it was reported as the former spouse.

Did the Taxpayer Later Not Have an Unrestricted Right to the Income? The court stated that to meet this requirement, the taxpayer must demonstrate that the taxpayer involuntarily gave away the relevant income because of some obligation, and the obligation had a substantive nexus to the original receipt of the income. Here the court found that the taxpayer involuntarily agreed to liability for the settlement payment under the divorce decree under pressure from the former spouse who threatened to withhold alimony and other divorce payments unless the taxpayer agreed to be liable. That divorce agreement also provided the substantive nexus needed to connect the taxpayer's $300,000 payment to the marital income which was the subject of the fiduciary lawsuit settlement.

Was the Restored Taxed Income Eligible for a Deduction? Although this requirement is not separately stated in Section 1341, Section 1341 states that once the income becomes restricted and repaid, a deduction must be allowable for the amount claimed.[9] Here the court held that the taxpayer could claim the $300,000 as a loss from a trade or business under I.R.C. § 165(c)(1).[10]

In Conclusion

Thus, the court held that the taxpayer was entitled to deduct the $300,000 repayment of the original compensation under Section 1341. The court was able to look through the indirect nature of the source of the compensation as marital property, the taxpayer's divorce agreement, and the taxpayer's reimbursement of the former spouse to focus on the taxpayer's actual liability for the settlement payment and actual payment of the $300,000 as part of the settlement and divorce agreement. The court noted that the taxpayer and former spouse were jointly liable for the original taxes on the income and thus should receive the joint benefit of Section 1341.

ENDNOTES

[1] Mihelick v. United States, 2019 U.S. App. LEXIS 18205 (11th Cir. 2019), *rev'g* 2017 U.S. Dist. LEXIS 167897 (M.D. Fla. 2017).

[2] United States v. Lewis, 340 U.S. 590 (1951).

[3] A claim for relief under Section 1341 is to be made on Form 1045, *Application for Tentative Refund*.

[4] I.R.C. § 1341(a)(1).

[5] I.R.C. § 1341(a)(2).

[6] I.R.C. § 1341(a)(3).

[7] I.R.C. § 1341(a)(2).

[8] 2019 U.S. App. LEXIS 18205 (11th Cir. 2019), *rev'g* 2017 U.S. Dist. LEXIS 167897 (M.D. Fla. 2017).

[9] I.R.C. § 1341(a)(2).

[10] See Butler v. Comm'r, 17 T.C. 679 (1951) (corporate officer may deduct amount to settle *bona fide* suit alleging mismanagement of corporate affairs, where allegations directly connected with business activity).

CASES, RULINGS, REGULATIONS AND STATUTES

BANKRUPTCY

GENERAL

AUTOMATIC STAY. The debtors, husband and wife, filed for Chapter 13 bankruptcy protection in November 2012. Under Section 362(a), the automatic stay blocks creditors from collection attempts outside of court-supervised reorganization proceedings. The parties agreed that the IRS violated the automatic stay four times: (1) in December 2013, the IRS sent the first of four notices to the debtors demanding payment for back taxes. The notice bore the headlines "Final Notice" and "Notice Of Intent to Levy And Notice Of Your Right To A Hearing." The IRS sent three similar notices in February 2014, September 2014, and December 2014. Each notice violated the automatic stay. After each notice, the debtors contacted their attorney and the attorney contacted the IRS notifying it of the automatic stay. The debtors alleged the violations caused them significant emotional harm. The Bankruptcy Court awarded the debtors monetary damages for emotional distress. On appeal, the District Court reversed on the grounds that the damage award was barred by sovereign immunity of the IRS. On further appeal the Ninth Circuit Court of Appeals reversed and remanded the case, holding that the claim