

## INTERNAL REVENUE SERVICE

March 20, 2001

Number: **200129001**  
Release Date: 7/20/2001  
CC:ITA:01  
TL-N-7313-00

UILC: 1341.00-00

### INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR BRADFORD A. JOHNSON, ASSOCIATE AREA COUNSEL  
AREA 1 CC:L:FSH:HAR  
ATTN Carmino J. Santaniella

FROM: HEATHER MALOY  
Associate Chief Counsel CC:ITA

SUBJECT:

This Field Service Advice responds to your memorandum dated December 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.

### DISCLOSURE STATEMENT

Field Service Advice is Chief Counsel Advice and is open to public inspection pursuant to the provisions of section 6110(i). The provisions of section 6110 require the Service to remove taxpayer identifying information and provide the taxpayer with notice of intention to disclose before it is made available for public inspection. Section 6110(c) and (i). Section 6110(i)(3)(B) also authorizes the Service to delete information from Field Service Advice that is protected from disclosure under 5 U.S.C. § 552(b) and (c) before the document is provided to the taxpayer with notice of intention to disclose. Only the National Office function issuing the Field Service Advice is authorized to make such deletions and to make the redacted document available for public inspection.

**Accordingly, the Examination, Appeals, or Counsel recipient of this document may not provide a copy of this unredacted document to the taxpayer or their representative.** The recipient of this document may share this unredacted document only with those persons whose official tax administration duties with respect to the case and the issues discussed in the document require inspection or disclosure of the Field Service Advice.

LEGEND:

X	=
Year 1	=
Year 2	=
Year 3	=
\$ A	=
\$ B	=
\$ C	=
\$ D	=
\$ E	=
\$ F	=
\$ G	=
\$ H	=
\$ J	=

ISSUE:

May the reduction in tax allowed by I.R.C. section 1341(a)(5)(B) be taken into account in determining the amount of alternative minimum tax (AMT) a taxpayer is required to pay.

CONCLUSION:

Yes. The reduction in tax provided for in section 1341(a)(5)(B), which is essentially treated as a payment of tax, may be taken into account in determining the total amount of chapter 1 tax that a taxpayer is required to pay. Because the AMT is a tax imposed by chapter 1 of the Code, the section 1341(a)(5)(B) reduction in tax may be taken into account in computing the amount of AMT payable.

FACTS:

For calendar years 1, 2 and 3 (restoration years), X filed consolidated income tax returns as the common parent of an affiliated group. In each restoration year X returned substantial funds previously included in gross income under the claim of right doctrine. These funds, which were reported as income in years (inclusion years) prior to years 1, 2 and 3, consist of access fees ordered to be refunded by local public utility commissions.

The refunded amounts were originally reported by X in years in which it was subject to regular income tax rates of 46% for some years and 39.95% for one year. X did not pay any other tax, such as the corporate minimum tax under former section 56, in any of those years. In the restoration years X was subject to a regular income tax rate of 34%.

In statements attached to its year 1, 2, and 3 returns, X notified the Service that it was claiming certain tax benefits under section 1341(a)(5) relating to the refunded access fees. X computed its income tax for each year by reducing its regular income tax by \$A, \$B, and \$C, respectively, as permitted under section 1341(a)(5). These amounts represent the repayment amounts multiplied by the income tax rate differential between the inclusion and restoration years (46% less 34%, or 39.95% less 34%).

In years 1 & 2, X's tentative minimum tax (TMT) exceeded its regular income tax by \$D and \$E. Consequently, X paid AMT in those years under section 55 equal to the excess of its TMT over its regular tax.. For year 3, X claimed a credit for prior year minimum tax of \$F under section 53(c).

According to the year 1, 2 and 3 Forms 4626, X also reduced its TMT for the years in question based on a similar application of section 1341(a)(5). Specifically, the taxpayer reduced its year 1, 2 and 3 TMT by \$G, \$H, and \$J. These amounts were computed by multiplying the repayment amounts for each year by 26% (46% less 20%). As a result the tax it actually paid for those years was less than an amount equal to 20% of the Alternative Minimum Taxable Income (AMTI).

The examination team does not disagree with the manner in which X applied section 1341(a)(5) in computing its year 1, 2 and 3 regular income tax. They do, though, disagree with taxpayer's reduction of the TMT for those same years under section 1341(a)(5). In the examiners' view, the maximum amount that the TMT may be reduced for a given restoration year is 20% of the repayment amount.

LAW:

The AMT is an alternative tax that is computed by applying an alternative rate to an alternative income base. In computing the AMT, a corporation determines its TMT for the taxable year. I.R.C. section 55(a)(1). TMT is calculated on the basis of the corporation's AMTI, a broader based calculation of income than that used in calculating the regular federal income tax due. Once the AMTI is determined, the corporation computes its TMT by multiplying by 20% the excess, if any, of AMTI over the AMT exemption amount and then subtracts from this amount the AMT foreign tax credit. Section 55(b)(1)(B). The regular tax liability is then subtracted from the TMT and the amount by which TMT exceeds the regular tax liability is the amount of the AMT. CSX Corp. v. United States, 124 F.3d 643,644 (4<sup>th</sup> Cir. 1997); Day v. Commissioner, 108 T.C. 11, 14 (1997) (The AMT is paid only if, and to the extent that, it exceeds the taxpayer's regular income tax.)

The corporate AMT provisions were enacted as part of the Tax Reform Act of 1986. Congress sought a more efficient means of collecting taxes from corporate taxpayers with significant financial profits who were escaping tax liability through tax preferences, deductions, and incentives. CSX Corp. 124 F.3d at 645. Congress determined that the existing minimum tax on corporations needed modification so that

corporations which were prospering but were able to structure their affairs to eliminate significant federal income tax, would incur some federal tax liability. The changes effectively created a separate, parallel tax system in addition to the ordinary corporate income tax. Doyon, Inc. v. United States, 214 F.2d 1309 (Fed. Cir. 2000).

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 amounts. 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 is to place a taxpayer in no worse tax position than he would have been in 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 chapter 1 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 chapter 1 tax 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(a)(5)(B)).

In computing the decrease in chapter 1 tax referred to in (ii) above, the exclusion of such item shall be given effect not only in the taxable year in which it was included in

gross income but also for any other taxable year up to and including the restoration year to the extent the exclusion affects the chapter 1 tax for those years. Treas. Reg. § 1.1341-1(d)(4)(ii).<sup>1</sup>

Section 1341(b)(1) provides that if the decrease in tax computed under (ii) above exceeds the tax computed under (i), the excess shall be considered to be a payment of tax on the last day prescribed by law for payment of the tax for the taxable year, and shall be refunded or credited in the same manner as if it were an overpayment for the taxable year.

#### ANALYSIS:

Based on the facts recited above, which were taken from the request for Field Service advice, we have been unable to definitively determine the positions of both the examining agents and X with regard to the proper application of section 1341. However, this does not prevent us from addressing the fundamental issue.

To compute the decrease in tax under section 1341(a)(5)(B) a taxpayer must recalculate its chapter 1 tax for the taxable year in which the item subject to section 1341 treatment was originally included in gross income by excluding that item from gross income. Any chapter 1 tax affected by this exclusion must be recomputed both for the inclusion year and any other taxable year prior to or including the restoration year that is affected by the exclusion. This includes regular tax, AMT, add-on minimum tax<sup>2</sup>, or any other tax imposed by chapter 1 of the Code. There is no authority to exclude the AMT from the benefit of section 1341.

For example, assume a taxpayer has the following chapter 1 tax liabilities:

	<u>Year 1</u>	<u>Year 2</u>
TMT	\$ 90X	\$ 80X
Regular Tax	<u>90X</u>	<u>90X</u>

---

<sup>1</sup> Although this regulatory provision literally only applies to the extent that the exclusion results in a net operating loss or capital loss carryover/carryback for the inclusion year, to serve the purpose of section 1341 the rule should also apply to take into account the effect of other tax attributes, such as credits that are freed-up or generated as a result of the exclusion.

<sup>2</sup> Treas. Reg. § 1.1341-1(b)(1)(ii) makes clear that any increase in add-on minimum tax that would have resulted from excluding an item from gross income in an inclusion year (because of the reduction in the regular tax deduction taken for add-on minimum tax purposes) must be taken into account in determining the section 1341(a)(5)(B) decrease in chapter 1 tax for the inclusion year.

AMT	0X	0X
Regular Tax	<u>90X</u>	<u>90X</u>
Total Chapter 1 Tax	\$ 90X	\$ 90X

In Year 3 it is determined that the taxpayer did not have a right to \$50X of gross income reported for Year 1. The taxpayer restores this income to its rightful owner and properly claims a \$50X deduction for that restoration in Year 3. Assume the deduction qualifies for section 1341 treatment.

If the taxpayer had excluded the \$50X from gross income in Year 1, its Year 1 and Year 2 chapter 1 taxes would have been as follows:

	<u>Year 1</u>	<u>Year 2</u>
TMT	\$ 80X	\$ 80X
Regular Tax	<u>73X</u>	<u>90X</u>
AMT	7X	0X
Regular Tax	<u>73X</u>	<u>90X</u>
Subtotal	80X	90X
Minimum Tax Credit	<u>0X</u>	<u>7X</u>
Total Recomputed Chapter 1 Tax	80X	83X
Chapter 1 Tax as Originally Reported	<u>90X</u>	<u>90X</u>
Section 1341(a)(5)(B) Decrease in Chapter 1 Tax	\$10X	\$ 7X

A comparison of the taxpayer's chapter 1 tax liability for Year 3 both with and without the \$50X deduction follows:

	<u>With</u>	<u>Without</u>
TMT	\$110X	\$ 120X
Regular Tax	<u>73X</u>	<u>90X</u>
AMT	37X	30X
Regular Tax	<u>73X</u>	<u>90X</u>
Total Chapter 1 Tax	\$ 110X	\$ 120X

Because excluding the \$50X from gross income in Year 1 results in a greater chapter 1 tax reduction than taking the \$50X deduction for Year 3 (\$17X versus \$10X) the taxpayer computes its total chapter 1 tax liability under section 1341(a)(5) for Year 3.

It appears that in the instant case the only chapter 1 tax liability that X may have been subject to in some of the inclusion years may have been the regular tax. However, the analysis remains the same. Under section 1341(a)(5) X is entitled to take the net decrease in chapter 1 tax, no matter what the components thereof, into account in determining how much chapter 1 tax it is required to pay for the restoration years.

Section 1341(b)(1) makes clear that the section 1341(a)(5)(B) reduction in tax is treated as a payment made on the last day of the taxable year to the extent it exceeds the chapter 1 tax computed for the restoration year without taking the deduction into account. However, to serve the intent behind section 1341, that is, to put the taxpayer in no worse position than if the taxpayer had never included the item in gross income, the entire section 1341(a)(5)(B) reduction in tax must be treated as a payment of tax for the restoration year. The section 1341(a)(5)(B) reduction in tax does not affect the computation of TMT, regular tax, or any other chapter 1 tax reported for the restoration year. It only affects the total amount of chapter 1 tax payable for the restoration year.

HEATHER MALOY

By: \_\_\_\_\_  
GERALD M. HORAN  
Senior Technician Reviewer  
Income Tax & Accounting  
Branch 1