

property by the amount of the obligations or liabilities with respect to such property in respect of which the recovery was received, if the taxpayer for any previous taxable year chose under section 127(b)(2) of the Internal Revenue Code of 1939 to treat such obligations or liabilities as discharged or satisfied out of such property but such obligations or liabilities were not so discharged or satisfied prior to the date of the recovery.

[T.D. 6500, 25 FR 12048, Nov. 26, 1960]

§ 1.1337-1 Determination of tax benefits from allowable deductions.

(a) That part of the aggregate of the deductions allowed a taxpayer for any taxable year on account of war losses under section 127(a) of the Internal Revenue Code of 1939 which, if disallowed, would not result in an increase in the normal tax, surtax (including the tax imposed by section 102 of the Internal Revenue Code of 1939), or victory tax of taxpayer, or of any tax imposed in lieu of such taxes or of any tax imposed by chapter 2 of the Internal Revenue Code of 1939, for the taxable year in which such deductions are allowed or in any other taxable year, such as a taxable year in which the taxpayer's income tax is computed by reference to a carryover or carryback of net operating losses from the taxable year in which such deductions are allowed, is considered, for the purposes of section 127(a) of the Internal Revenue Code of 1939 an allowable deduction for the taxable year which did not result in a reduction of any tax of the taxpayer under chapter 1 or 2 of the Internal Revenue Code of 1939. In the case of recoveries of war losses and other items to which the recovery exclusion provisions of section 111 apply, such as bad debts, the determination of the tax benefit should be made in accordance with section 111(b) and the regulations thereunder. The deductions allowed a taxpayer for any taxable year on account of war losses are all the deductions on account of war losses which were claimed by the taxpayer in a return, in a claim for credit or refund of an overpayment, or in a petition to The Tax Court of the United States with respect to such taxable year and which were not disallowed, and all de-

ductions on account of war losses which, although not so claimed by the taxpayer, were nevertheless allowed (for example, by the Commissioner, a court, or The Tax Court) in computing a tax of the taxpayer.

(b) Any deduction allowable for a taxable year on account of a war loss under section 127(a) of the Internal Revenue Code of 1939 which was not claimed by the taxpayer for such year in a return, a claim for credit or refund of an overpayment, or a petition to the Tax Court of the United States and was not allowed as a deduction (for example, by the Commissioner, a court, or the Tax Court) in computing his tax for such year or for any other year is considered a deduction which did not result in a reduction of any tax of the taxpayer under chapter 1 or 2 of the Internal Revenue Code of 1939, since it is an allowable deduction which was not allowed in computing any tax of the taxpayer. If the taxpayer claimed for any taxable year a deduction on account of a war loss, and if such deduction was disallowed, the taxpayer may not subsequently contend for the purposes of section 1331 that such deduction was an allowable deduction for such taxable year.

(c) If the taxpayer elected under section 127(b) of the Internal Revenue Code of 1939 to decrease the amount of a war loss by treating the obligations and liabilities described in that section as discharged or satisfied out of the property destroyed or seized, and if the taxpayer establishes that any of the obligations and liabilities were not so discharged or satisfied, then the amount by which such continuing obligations and liabilities decreased the war loss shall be considered an allowable deduction for the taxable year in which the war loss was sustained which did not result in a reduction of any tax of the taxpayer under chapter 1 or 2 of the Internal Revenue Code of 1939.

[T.D. 6500, 25 FR 12048, Nov. 26, 1960]

CLAIM OF RIGHT

§ 1.1341-1 Restoration of amounts received or accrued under claim of right.

(a) *In general.* (1) If, during the taxable year, the taxpayer is entitled

under other provisions of chapter 1 of the Internal Revenue Code of 1954 to a deduction of more than \$3,000 because of the restoration to another of an item which was included in the taxpayer's gross income for a prior taxable year (or years) under a claim of right, the tax imposed by chapter 1 of the Internal Revenue Code of 1954 for the taxable year shall be the tax provided in paragraph (b) of this section.

(2) For the purpose of this section *income included under a claim of right* means 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 such item, and *restoration to another* means a restoration resulting because it was established after the close of such prior taxable year (or years) that the taxpayer did not have an unrestricted right to such item (or portion thereof).

(3) For purposes of determining whether the amount of a deduction described in section 1341(a)(2) exceeds \$3,000 for the taxable year, there shall be taken into account the aggregate of all such deductions with respect to each item of income (described in section 1341(a)(1)) of the same class.

(b) *Determination of tax.* (1) Under the circumstances described in paragraph (a) of this section, the tax imposed by chapter 1 of the Internal Revenue Code of 1954 for the taxable year shall be the lesser of:

(i) The tax for the taxable year computed under section 1341(a)(4), that is, with the deduction taken into account, or

(ii) The tax for the taxable year computed under section 1341(a)(5), that is, without taking such deduction into account, minus the decrease in tax (net of any increase in tax imposed by section 56, relating to the minimum tax for tax preferences) (under chapter 1 of the Internal Revenue Code of 1954, under chapter 1 (other than subchapter E) and subchapter E of chapter 2 of the Internal Revenue Code of 1939, or under the corresponding provisions of prior revenue laws) for the prior taxable year (or years) which would result solely from the exclusion from gross income of all or that portion of the income included under a claim of right to which

the deduction is attributable. For the purpose of this subdivision, the amount of the decrease in tax is not limited to the amount of the tax for the taxable year. See paragraph (i) of this section where the decrease in tax for the prior taxable year (or years) exceeds the tax for the taxable year.

(iii) For purposes of computing, under section 1341(a)(4) and subdivision (i) of this subparagraph, the tax for a taxable year beginning after December 31, 1961, if the deduction of the amount of the restoration results in a net operating loss for the taxable year of restoration, such net operating loss shall, pursuant to section 1341(b)(4)(A), be carried back to the same extent and in the same manner as is provided under section 172 (relating to the net operating loss deduction) and the regulations thereunder. If the aggregate decrease in tax for the taxable year (or years) to which such net operating loss is carried back is greater than the excess of:

(a) The amount of decrease in tax for a prior taxable year (or years) computed under section 1341(a)(5)(B), over

(b) The tax for the taxable year computed under section 1341(a)(5)(A),

The tax imposed for the taxable year under chapter 1 shall be the tax determined under section 1341(a)(4) and subdivision (i) of this subparagraph. If the tax imposed for the taxable year is determined under section 1341(a)(4) and subdivision (i) of this subparagraph, the decrease in tax for the taxable year (or years) to which the net operating loss is carried back shall be an overpayment of tax for the taxable year (or years) to which the net operating loss is carried back and shall be refunded or credited as an overpayment for such taxable year (or years). See section 6511(d)(2), relating to special period of limitation with respect to net operating loss carrybacks.

(2) Except as otherwise provided in section 1341(b)(4)(B) and paragraph (d) (1)(ii) and (4)(ii) of this section, if the taxpayer computes his tax for the taxable year under the provisions of section 1341(a)(5) and subparagraph (1)(ii) of this paragraph, the amount of the restoration shall not be taken into account in computing taxable income or loss for the taxable year, including the

computation of any net operating loss carryback or carryover or any capital loss carryover. However, the amount of such restoration shall be taken into account in adjusting earnings and profits for the current taxable year.

(3) If the tax determined under subparagraph (1)(i) of this paragraph is the same as the tax determined under subparagraph (1)(ii) of this paragraph, the tax imposed for the taxable year under chapter 1 shall be the tax determined under subparagraph (1)(i) of this paragraph, and section 1341 and this section shall not otherwise apply.

(4) After it has been determined whether the tax imposed for a taxable year of restoration beginning after December 31, 1961, shall be computed under the provisions of section 1341(a)(4) or under the provisions of section 1341(a)(5), the net operating loss, if any, which remains after the application of section 1341(b)(4)(A) or the net operating loss or capital loss, if any, which remains after the application of section 1341(b)(4)(B) shall be taken into account in accordance with the following rules:

(i) If it is determined that section 1341(a)(4) and subparagraph (1)(i) of this paragraph apply, then that portion, if any, of the net operating loss for the taxable year which remains after the application of section 1341(b)(4)(A) and subparagraph (1)(iii) of this paragraph shall be taken into account under section 172 for taxable years subsequent to the taxable year of restoration to the same extent and in the same manner as a net operating loss sustained in such taxable year of restoration. Thus, if the net operating loss for the taxable year of restoration (computed with the deduction referred to in section 1341(a)(4)) exceeds the taxable income (computed with the modifications prescribed in section 172) for the taxable year (or years) to which it is carried back, such excess shall be available as a carryover to taxable years subsequent to the taxable year of restoration.

(ii) If it is determined that section 1341(a)(5) and subparagraph (1)(ii) of this paragraph apply, then that portion, if any, of a net operating loss or capital loss which remains after the application of section 1341(b)(4)(B) and

paragraph (d)(4) of this section shall be taken into account under section 172 or 1212, as the case may be, for taxable years subsequent to the taxable year of restoration to the same extent and in the same manner as a net operating loss or capital loss sustained in the prior taxable year (or years). For example, if the net operating loss for the prior taxable year (computed with the exclusion referred to in section 1341(a)(5)(B)) exceeds the taxable income (computed with the modifications prescribed in section 172) for prior taxable years to which such net operating loss is carried back or carried over (including for this purpose the taxable year of restoration), such excess shall be available as a carryover to taxable years subsequent to the taxable year of restoration in accordance with the rules prescribed in section 172 which are applicable to such prior taxable year (or years).

(c) *Application to deductions which are capital in nature.* Section 1341 and this section shall also apply to a deduction which is capital in nature otherwise allowable in the taxable year. If the deduction otherwise allowable is capital in nature, the determination of whether the taxpayer is entitled to the benefits of section 1341 and this section shall be made without regard to the net capital loss limitation imposed by section 1211. For example, if a taxpayer restores \$4,000 in the taxable year and such amount is a long-term capital loss, the taxpayer will, nevertheless, be considered to have met the \$3,000 deduction requirement for purposes of applying this section, although the full amount of the loss might not be allowable as a deduction for the taxable year. However, if the tax for the taxable year is computed with the deduction taken into account, the deduction allowable will be subject to the limitation on capital losses provided in section 1211, and the capital loss carryover provided in section 1212.

(d) *Determination of decrease in tax for prior taxable years—(1) Prior taxable years.* (i) Except as otherwise provided in subdivision (ii) of this subparagraph, the prior taxable year (or years) referred to in paragraph (b) of this section is the year (or years) in which the

item to which the deduction is attributable was included in gross income under a claim of right and, in addition, any other prior taxable year (or years) the tax for which will be affected by the exclusion from gross income in such prior taxable year (or years) of such income.

(ii) For purposes of applying section 1341(b)(4)(B) in computing the amount of the decrease referred to in paragraph (b)(1)(ii) of this section for any taxable year beginning after December 31, 1961, the term *prior taxable year (or years)* includes the taxable year of restoration. Under section 1341(b)(4)(B), for taxable years of restoration beginning after December 31, 1961, in any case where the exclusion referred to in section 1341(a)(5)(B) and paragraph (b)(1)(ii) of this section results in a net operating loss or capital loss for the prior taxable year (or years), such loss shall, for purposes of computing the decrease in tax for the prior taxable year (or years) under such section 1341(a)(5)(B) and such paragraph (b)(1)(ii) of this section, be carried back and carried over to the same extent and in the same manner as is provided under section 172 (relating to the net operating loss deduction) or section 1212 (relating to capital loss carryover), except that no carryover beyond the taxable year shall be taken into account. See subparagraph (4) of this paragraph for rules relating to the computation of the amount of decrease in tax.

(2) *Amount of exclusion from gross income in prior taxable years.* (i) The amount to be excluded from gross income for the prior taxable year (or years) in determining the decrease in tax under section 1341(a)(5)(B) and paragraph (b)(1)(ii) of this section shall be the amount restored in the taxable year, but shall not exceed the amount included in gross income in the prior taxable year (or years) under the claim of right to which the deduction for the restoration is attributable, and shall be adjusted as provided in subdivision (ii) of this subparagraph.

(ii) If the amount included in gross income for the prior taxable year (or years) under the claim of right in question was reduced in such year (or years) by a deduction allowed under section 1202 (or section 117 (b) of the In-

ternal Revenue Code of 1939 or corresponding provisions of prior revenue laws), then the amount determined under subdivision (i) of this subparagraph to be excluded from gross income for such year (or years) shall be reduced in the same proportion that the amount included in gross income under a claim of right was reduced.

(iii) The determination of the amount of the exclusion from gross income of the prior taxable year shall be made without regard to the capital loss limitation contained in section 1211 applicable in computing taxable income for the current taxable year. The amount of the exclusion from gross income in a prior taxable year (or years) shall not exceed the amount which would, but for the application of section 1211, be allowable as a deduction in the taxable year of restoration.

(iv) The rule provided in subdivision (iii) of this subparagraph may be illustrated as follows:

Example: For the taxable year 1952, an individual taxpayer had long-term capital gains of \$50,000 and long-term capital losses of \$10,000, a net long-term gain of \$40,000. He also had other income of \$5,000. In 1956, taxpayer restored the \$50,000 of long-term gain. He had no capital gains or losses in 1956 but had other income of \$5,000. If his tax liability for 1956, the taxable year of restoration, is computed by taking the deduction into account, the taxpayer would be entitled to a deduction under section 1211 of only \$1,000 on account of the capital loss. However, if the taxpayer computes his tax under section 1341(a)(5) and paragraph (b)(1)(ii) of this section, it is necessary to determine the decrease in tax for 1952. In such a determination, \$50,000 is to be excluded from gross income for that year, resulting in a net capital loss for that year of \$10,000, and a capital loss deduction of \$1,000 under section 117(d) of the Internal Revenue Code of 1939 (corresponding to section 1211 of the Internal Revenue Code of 1954) with carryover privileges. The difference between the tax previously determined and the tax as recomputed after such exclusion for the years affected will be the amount of the decrease.

(3) *Determination of amount of deduction attributable to prior taxable years.* (i) If the deduction otherwise allowable for the taxable year relates to income included in gross income under a claim of right in more than one prior taxable year and the amount attributable to each such prior taxable year cannot be

readily identified, then the portion attributable to each such prior taxable year shall be that proportion of the deduction otherwise allowable for the taxable year which the amount of the income included under the claim of right in question for the prior taxable year bears to the total of all such income included under the claim of right for all such prior taxable years.

(ii) The rule provided in subdivision (i) of this subparagraph may be illustrated as follows:

Example: Under a claim of right, A included in his gross income over a period of three taxable years an aggregate of \$9,000 for services to a certain employer, in amounts as follows: \$2,000 for taxable year 1952, \$4,000 for taxable year 1953, and \$3,000 for taxable year 1954. In 1955 it is established that A must restore \$6,750 of these amounts to his employer, and that A is entitled to a deduction of this amount in the taxable year 1955. The amount of the deduction attributable to each of the prior taxable years cannot be identified. Accordingly, the amount of the deduction attributable to each prior taxable year is:

1952— $\$6,750 \times \$2,000 \div \$9,000 = \$1,500$
 1953— $\$6,750 \times \$4,000 \div \$9,000 = \$3,000$
 1954— $\$6,750 \times \$3,000 \div \$9,000 = \$2,250$

(4) *Computation of amount of decrease in tax.* (i) In computing the amount of decrease in tax for a prior taxable year (or years) resulting from the exclusion from gross income of the income included under a claim of right, there must first be ascertained the amount of tax previously determined for the taxpayer for such prior taxable year (or years). The tax previously determined shall be the sum of the amounts shown by the taxpayer on his return or returns, plus any amounts which have been previously assessed (or collected without assessment) as deficiencies or which appropriately should be assessed or collected, reduced by the amount of any refunds or credits which have previously been made or which appropriately should be made. For taxable years beginning after December 31, 1961, if the provisions of section 1341(b)(4)(B) are applicable, the tax previously determined shall include the tax for the taxable year of restoration computed without taking the deduction for the amount of the restoration into account. After the tax previously determined has been ascertained, a re-

computation must then be made to determine the decrease in tax, if any, resulting from the exclusion from gross income of all or that portion of the income included under a claim of right to which the deduction otherwise allowable in the taxable year is attributable.

(ii) No item other than the exclusion of the income previously included under a claim of right shall be considered in computing the amount of decrease in tax if reconsideration of such other item is prevented by the operation of any provision of the internal revenue laws or any other rule of law. However, if the amounts of other items in the return are dependent upon the amount of adjusted gross income, taxable income, or net income (such as charitable contributions, foreign tax credit, deductions for depletion, and net operating loss), appropriate adjustment shall be made as part of the computation of the decrease in tax. For the purpose of determining the decrease in tax for the prior taxable year (or years) which would result from the exclusion from gross income of the item included under a claim of right, the exclusion of such item shall be given effect not only in the prior taxable year in which it was included in gross income but in all other prior taxable years (including the taxable year of restoration if such year begins after December 31, 1961, and section 1341(b)(4)(B) applies, see subparagraph (1)(ii) of this paragraph) affected by the inclusion of the item (for example, prior taxable years affected by a net operating loss carryback or carryover or capital loss carryover).

(iii) The rules provided in this subparagraph may be illustrated as follows:

Example 1. For the taxable year 1954, a corporation had taxable income of \$35,000, on which it paid a tax of \$12,700. Included in gross income for the year was \$20,000 received under a claim of right as royalties. In 1957, the corporation is required to return \$10,000 of the royalties. It otherwise has taxable income in 1957 of \$5,000, so that without the application of section 1341 it has a net operating loss of \$5,000 in that year. Facts also come to light in 1957 which entitle the corporation to an additional deduction of \$5,000 for 1954. When a computation is made under paragraph (b)(1)(i) of this section, the corporation has no tax for the taxable year 1957. When a computation is made under paragraph (b)(1)(ii) of this section, the tax

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for 1957, without taking the restoration into account, is \$1,500, based on a taxable income of \$5,000. The decrease in tax for 1954 is computed as follows:

| | |
|---|----------|
| Tax shown on return for 1954 | \$12,700 |
| <hr/> | |
| Taxable income for 1954 upon which tax shown on return was based | 35,000 |
| Less: Additional deduction (on account of which credit or refund could be made) | 5,000 |
| <hr/> | |
| Total | 30,000 |
| Tax on \$30,000 (adjusted taxable income for 1954) | 10,100 |
| <hr/> | |
| Tax on \$30,000 (adjusted taxable income for 1954) | 10,100 |
| Taxable income for 1954, as adjusted | \$30,000 |
| Less exclusion of amount restored | 10,000 |
| <hr/> | |
| Taxable income for 1954 by applying paragraph (b)(1)(ii) of this section | 20,000 |
| Tax on \$20,000 | 6,000 |
| <hr/> | |
| Decrease in tax for 1954 by applying paragraph (b)(1)(ii) of this section | \$4,100 |
| Tax for 1957 without taking the restoration into account | 1,500 |

Amount by which decrease exceeds the tax for 1957 computed without taking restoration into account

(The \$2,600 is treated as having been paid on the last day prescribed by law for the payment of the tax for 1957 and is available as a refund. In addition the taxpayer has made an overpayment of \$2,600 (\$12,700 less \$10,000) for 1954 because of the additional deduction of \$5,000.)

Example 2. Assume the same facts as in example (1) except that, instead of the corporation being entitled to an additional deduction of \$5,000 for 1954, it is determined that the corporation failed to include an item of \$5,000 in gross income for that year. The decrease in tax for 1954 is computed as follows:

| | |
|---|----------|
| Tax shown on return for 1954 | \$12,700 |
| <hr/> | |
| Taxable income for 1954 upon which tax shown on return was based | 35,000 |
| Plus: Additional income (on account of which deficiency assessment could be made) | 5,000 |
| <hr/> | |
| Total | 40,000 |
| Tax on \$40,000 (adjusted taxable income for 1954) | 15,300 |
| <hr/> | |
| Tax on \$40,000 (adjusted taxable income for 1954) | 15,300 |
| Taxable income for 1954 as adjusted | \$40,000 |
| Less exclusion of amount restored | 10,000 |
| <hr/> | |
| Taxable income for 1954 by applying paragraph (b)(1)(ii) of this section | 30,000 |
| Tax on \$30,000 | 10,100 |
| <hr/> | |
| Decrease in tax for 1954 by applying paragraph (b)(1)(ii) of this section | 5,200 |

Tax for 1957 without taking the restoration into account

Amount by which decrease exceeds the tax for 1957 computed without taking the restoration into account

(The \$3,700 is treated as having been paid on the last day prescribed by law for the payment of the tax for 1957 and is available as a refund. In addition the taxpayer has a deficiency of \$2,600 (\$15,300 less \$12,700) for 1954 because of the additional income of \$5,000.)

Example 3. For the taxable year 1954, a corporation had taxable income of \$25,000, on which it paid a tax of \$7,500. Included in gross income for the year was \$10,000 received under a claim of right as commissions. In 1956, the corporation is required to return \$5,000 of the commissions. The corporation has a net operating loss of \$10,000 for 1956, excluding the deduction for the \$5,000 restored. When a computation is made under either paragraph (b)(1)(i) or paragraph (b)(1)(ii) of this section, the corporation has no tax for the taxable year 1956. The decrease in tax for 1954 is computed as follows:

| | |
|---|----------|
| Tax shown on return for 1954 | \$7,500 |
| <hr/> | |
| Taxable income for 1954 upon which tax shown on return was based | 25,000 |
| Less: Additional deduction (on account of net operating loss carryback from 1956) | 10,000 |
| <hr/> | |
| Net income as adjusted | 15,000 |
| Tax on \$15,000 (adjusted taxable income for 1954) | 4,500 |
| <hr/> | |
| Tax on \$15,000 (adjusted taxable income for 1954) | 4,500 |
| Taxable income for 1954, as adjusted | \$15,000 |
| Less: exclusion of amount restored | 5,000 |
| <hr/> | |
| Taxable income for 1954 by applying paragraph (b)(1)(ii) of this section | 10,000 |
| Tax on \$10,000 | 3,000 |
| <hr/> | |
| Decrease in tax for 1954 by applying paragraph (b)(1)(ii) of this section | 1,500 |
| Tax for 1956 without taking the restoration into account | None |

Amount by which decrease exceeds the tax for 1956 computed without taking the restoration into account

(The \$1,500 is treated as having been paid on the last day prescribed by law for the payment of the tax for 1956 and is available as a refund. In addition, the taxpayer has an overpayment of \$3,000 (\$7,500 less \$4,500) for 1954 because of the net operating loss deduction of \$10,000.)

Example 4. For the taxable year 1946 a married man with no dependents, who kept his books on the cash receipts and disbursements basis, filed a return (claiming two exemptions) disclosing adjusted gross income of \$42,000, deductions amounting to \$12,000,

and a net income of \$30,000. Gross income included among other items, salary in the amount of \$15,000 and rental income in the amount of \$5,000. During the taxable year he donated \$10,000 to the American Red Cross and in his return claimed a deduction of \$6,300 on account thereof, representing the maximum deduction allowable under the 15-percent limitation imposed by section 23(o) of the Internal Revenue Code of 1939 for the year 1946. In computing his net income he omitted interest income amounting to \$6,000 and neglected to take a deduction for interest paid in the amount of \$4,500. The return disclosed a tax liability of \$11,970, which was assessed and paid. In 1955, after the expiration of the period of limitations upon the assessment of a deficiency or the allowance of a refund for 1946, the taxpayer had to restore the \$5,000 included in his gross income in 1946 as rental income. The amount of the decrease in tax for 1946 is \$2,467.62, computed as follows:

| | |
|--|-------------|
| Tax previously determined for 1946 | \$11,970.00 |
| <hr/> | |
| Net income for 1946 upon which tax previously determined was based | 30,000.00 |
| Less: Rents included under claim of right | 5,000.00 |
| Balance | 25,000.00 |
| Adjustment for contributions (add 15 percent of \$5,000) | 750.00 |
| Net income as adjusted | 25,750.00 |
| Tax on \$25,750 | 9,502.38 |
| <hr/> | |
| Amount of decrease in tax for 1946: | |
| Tax previously determined | \$11,970.00 |
| Tax as recomputed | 9,502.38 |
| Decrease in tax | \$2,467.62 |

The recomputation to determine the amount of the decrease in tax for 1946 does not take into consideration the barred item of \$6,000 representing interest received, which was omitted from gross income, or the barred item of \$4,500 representing interest paid for which no deduction was allowed. See subdivision (ii) of this subparagraph.

Example 5. (a) Facts. For the taxable year 1959, a corporation reporting income on the calendar year basis had taxable income of \$20,000 on which it paid a tax of \$6,000. Included in gross income for such year was \$100,000 received under a claim of right as royalties. For each of its taxable years 1956, 1957, 1958, 1960, 1961, and 1962, the corporation had taxable income of \$10,000 on which it paid tax of \$3,000 for each year. In 1963, the corporation returns the entire amount of \$100,000 of the royalties. In such taxable year the corporation has taxable income of \$25,000 (without taking the deduction of \$100,000 into account), and has a net operating loss of \$75,000 (taking the deduction of \$100,000 into account). In determining whether section 1341(a)(4) or section 1341(a)(5) applies, the corporation will compute the lesser amount

of tax referred to in section 1341(a) by applying the rules provided in section 1341(b)(4).

(b) *Tax under section 1341 (a)(4) and (b)(4)(A).* The net operating loss of \$75,000 for 1963 (taking into account the deduction of \$100,000) is carried back to the three taxable years (1960, 1961, and 1962) in the manner provided under section 172. For purposes of this example it is assumed that no modifications under section 172 are necessary. Since the aggregate taxable income for such three taxable years is only \$30,000 the entire taxable income for such years is eliminated by the carryback, and the corporation would be entitled to a refund of the tax for such years in the aggregate amount of \$9,000. (In addition, the remaining \$45,000 of the net operating loss for 1963 would be available as a carryover to taxable years after the taxable year (1963) to the extent and in the manner provided by section 172.)

(c) *Tax under section 1341 (a)(5) and (b)(4)(B).* The tax for the taxable year (1963) on \$25,000 of taxable income (computed without the deduction of \$100,000) is \$7,500. The exclusion of \$100,000 from gross income for the taxable year 1959 (the year in which the item was included) results in a net operating loss of \$80,000 for such year (\$20,000 taxable income minus the \$100,000 exclusion, no adjustments under section 172 being necessary), thus decreasing the tax for such year by the entire amount of \$6,000 paid. The resulting net operating loss of \$80,000 for 1959 is available as a carryback to 1956, 1957, and 1958, and as a carryover to 1960, 1961, 1962, and 1963. For purposes of this example it is assumed that no modifications under section 172 are necessary. Since the aggregate taxable income for such taxable years is \$85,000, all except \$5,000 of the 1963 taxable income is eliminated by such carryback and carryover. The tax on such remaining \$5,000 of taxable income for 1963 is \$1,500, thus decreasing the tax determined for such year by \$6,000 (\$7,500 minus \$1,500). Under section 1341 (a)(5) and (b)(4)(B), the decrease in tax for the prior taxable years exceeds the tax for the taxable year of restoration computed without the deduction of the amount of the restoration by \$22,500, computed as follows:

| | |
|---|---------|
| Tax for taxable year 1963 (on taxable income of \$25,000 without the deduction) | \$7,500 |
| Decrease in tax for prior taxable years: | |
| Due to exclusion (1959) | \$6,000 |
| Due to net operating loss carryback: | |
| 1956 | 3,000 |
| 1957 | 3,000 |
| 1958 | 3,000 |
| | 9,000 |
| Due to net operating loss carryover: | |
| 1960 | 3,000 |
| 1961 | 3,000 |
| 1962 | 3,000 |

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| 1963 | 6,000 | | |
| | | 15,000 | |
| | | 30,000 | |
| | | | |
| Excess of the decrease in tax for the prior tax- able years over the tax for taxable year 1963 (\$30,000 less \$7,500 tax for the taxable year) | | | 22,500 |

(d) *Application of section 1341(a)(4) or section 1341(a)(5).* Since the computation under section 1341 (a)(4) and (b)(4)(A) results in an available refund of only \$9,000 tax for the taxable years to which the net operating loss for 1963 is carried back, and since the computation under section 1341 (a)(5) and (b)(4)(B) results in an overpayment of \$22,500, it is determined that section 1341(a)(5) applies. Accordingly, the \$22,500 is treated as having been paid on the last day prescribed by law for the payment of tax for 1963 and is available as a refund.

(e) *Method of accounting.* The provisions of section 1341 and this section shall be applicable in the case of a taxpayer on the cash receipts and disbursements method of accounting only to the taxable year in which the item of income included in a prior year (or years) under a claim of right is actually repaid. However, in the case of a taxpayer on the cash receipts and disbursements method of accounting who constructively received an item of income under a claim of right and included such item of income in gross income in a prior year (or years), the provisions of section 1341 and this section shall be applicable to the taxable year in which the taxpayer is required to relinquish his right to receive such item of income. Such provisions shall be applicable in the case of other taxpayers only to the taxable year which is the proper taxable year (under the method of accounting used by the taxpayer in computing taxable income) for taking into account the deduction resulting from the restoration of the item of income included in a prior year (or years) under a claim of right. For example, if the taxpayer is on an accrual method of accounting, the provisions of this section shall apply to the year in which the obligation properly accrues for the repayment of the item included under a claim of right.

(f) *Inventory items, stock in trade, and property held primarily for sale in the or-*

dinary course of trade or business. (1) Except for amounts specified in subparagraphs (2) and (3) of this paragraph, the provisions of section 1341 and this section do not apply to deductions attributable to items which were 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 the taxpayer's trade or business. This section is, therefore, not applicable to sales returns and allowances and similar items.

(2)(i) In the case of taxable years beginning after December 31, 1957, the provisions of section 1341 and this section apply to deductions which arise out of refunds or repayments with respect to rates made by a regulated public utility, as defined in section 7701(a)(33) without regard to the limitation contained in the last two sentences thereof (for taxable years beginning before January 1, 1964, as defined in section 1503(c) (1) or (3) and paragraph (g) of §1.1502-2A (as contained in the 26 CFR edition revised as of April 1, 1996)), if such refunds or repayments are required to be made by the Government, political subdivision, agency, or instrumentality referred to in such section, or are required to be made by an order of a court, or are made in settlement of litigation or under threat or imminence of litigation. Thus, deductions attributable to refunds of charges for the sale of natural gas under rates approved temporarily by a proper governmental authority are, in the case of taxable years beginning after December 31, 1957, eligible for the benefits of section 1341 and this section, if such refunds are required by the governmental authority, or by an order of a court, or are made in settlement of litigation or under threat or imminence of litigation.

(ii) In the case of taxable years beginning before January 1, 1958, the provisions of section 1341 and this section apply to deductions which arise out of refunds or repayments (whether or not

with respect to rates) made by a regulated public utility, as defined in section 7701(a)(33) without regard to the limitation contained in the last two sentences thereof (for taxable years beginning before January 1, 1964, as defined in section 1503(c) (1) or (3) and paragraph (g) of §1.1502-2A), if such refunds or repayments are required to be made by the Government, political subdivision, agency, or instrumentality referred to in such section. Thus, in the case of taxable years beginning before January 1, 1958, deductions attributable to refunds or repayments may be eligible for the benefits of section 1341 and this section, even though such refunds or repayments are not with respect to rates. On the other hand, in the case of such taxable years, section 1341 and this section do not apply to any deduction which arises out of a refund or repayment (whether or not with respect to rates) which is required to be made by an order of a court, or which is made in settlement of litigation or under threat or imminence of litigation.

(3) The provisions of section 1341 and this section apply to a deduction which arises out of a payment or repayment made pursuant to a price redetermination provision in a subcontract:

(i) If such subcontract was entered into before January 1, 1958, between persons other than those bearing a relationship set forth in section 267(b);

(ii) If such subcontract is subject to statutory renegotiation; and

(iii) If section 1481 (relating to mitigation of effect of renegotiation of Government contracts) does not apply to such payment or repayment solely because such payment or repayment is not paid or repaid to the United States or any agency thereof.

Thus, a taxpayer who enters into a subcontract to furnish items to a prime contractor with the United States may, pursuant to a price redetermination provision in the subcontract, be required to refund an amount to the prime contractor or to another subcontractor. Since the refund would be made directly to the prime contractor or to another subcontractor, and not directly to the United States, the taxpayer would be unable to avail himself of the benefits of section 1481. However,

the provisions of section 1341 and this section will apply in such a case, if the conditions set forth in subdivisions (i), (ii), and (iii) of this subparagraph are met. For provisions relating to the mitigation of the effect of a redetermination of price with respect to subcontracts entered into after December 31, 1957, when repayment is made to a party other than the United States or any agency thereof, see section 1482.

(g) *Bad debts.* The provisions of sections 1341 and this section do not apply to deductions attributable to bad debts.

(h) *Legal fees and other expenses.* Section 1341 and this section do not apply to legal fees or other expenses incurred by a taxpayer in contesting the restoration of an item previously included in income. This rule may be illustrated by the following example:

Example: A sold his personal residence to B in a prior taxable year and realized a capital gain on the sale. C claimed that under an agreement with A he was entitled to a 5-percent share of the purchase price since he brought the parties together and was instrumental in closing the sale. A rejected C's demand and included the entire amount of the capital gain in gross income for the year of sale. C instituted action and in the taxable year judgment is rendered against A who pays C the amount involved. In addition, A pays legal fees in the taxable year which were incurred in the defense of the action. Section 1341 applies to the payment of the 5-percent share of the purchase price to C. However, the payment of the legal fees, whether or not otherwise deductible, does not constitute an item restored for purposes of section 1341(a) and paragraph (a) of this section.

(i) *Refunds.* If the decrease in tax for the prior taxable year (or years) determined under section 1341(a)(5)(B) and paragraph (b)(1)(ii) of this section exceeds the tax imposed by chapter 1 of the Code for the taxable year computed without the deduction, and for taxable years beginning after December 31, 1961, if such excess is greater than the decrease in tax for the taxable year (or years) to which the net operating loss described in section 1341(b)(4)(A) and paragraph (b)(1)(iii) of this section is carried back, such excess shall be considered to be a payment of tax for the taxable year of restoration. Such payment is deemed to have been made on the last day prescribed by law for the

payment of tax for the taxable year and shall be refunded or credited in the same manner as if it were an overpayment of tax for such taxable year. However, no interest shall be allowed or paid if such an excess results from the application of section 1341(a)(5)(B) in the case of a deduction described in paragraph (f)(3) of this section (relating to payments or repayments pursuant to price redetermination). If the tax for the taxable year of restoration is computed under section 1341(a)(4) and results in a decrease in tax for the taxable year (or years) to which a net operating loss described in section 1341(b)(4)(A) is carried back, see paragraph (b)(1)(iii) of this section.

[T.D. 6500, 25 FR 12049, Nov. 26, 1960, as amended by T.D. 6617, 27 FR 10824, Nov. 7, 1962; T.D. 6747, 29 FR 9790, July 21, 1964; T.D. 7244, 37 FR 28897, Dec. 30, 1972; T.D. 7564, 43 FR 40496, Sept. 12, 1978; T.D. 8677, 61 FR 33323, June 27, 1996]

§ 1.1342-1 Computation of tax where taxpayer recovers substantial amount held by another under claim of right; effective date.

Section 1342 shall apply with respect to taxable years beginning after December 31, 1954.

[T.D. 6500, 25 FR 12052, Nov. 26, 1960]

OTHER LIMITATIONS

§ 1.1346-1 Recovery of unconstitutional taxes.

(a) *In general.* (1) A taxpayer who recovers unconstitutional Federal taxes which were paid or accrued and for which a deduction was allowed in a prior taxable year may elect, as provided in paragraph (b) of this section, to exclude the income (exclusive of interest) attributable to such recovery from his gross income in the taxable year of recovery. Any such exclusion of income is subject to the requirements of section 1346 and this section.

(2) If a taxpayer elects to receive the benefits of section 1346, the income (exclusive of interest) attributable to the recovery of the unconstitutional Federal tax will be treated as an offset to the deduction allowed therefor in a prior taxable year (or years). The taxpayer's return for the prior taxable year (or years) with respect to which

the statutory period for the assessment of a deficiency has expired will be opened only for the purpose of reducing the deduction allowed for the unconstitutional Federal tax and assessing the resulting deficiency or deficiencies, if any. (An election under section 1346 may be made only if the taxpayer consents in writing to such assessment. See paragraph (b) of this section.) No other adjustment will be allowed.

(3) If the disallowance of the deduction allowed in respect of a prior taxable year results in a deficiency for that year, the deficiency will be assessed against the taxpayer within the period agreed upon between the taxpayer and the district director with respect to the taxable year of the prior deduction, even though the statutory period for the assessment may have expired prior to the filing of the consent.

(4) If a taxpayer does not elect under the provisions of section 1346 and this section to exclude the tax recovered from gross income in the taxable year of recovery, the tax recovered shall, from the standpoint of its inclusion in or exclusion from gross income, be governed by the provisions of section 111.

(b) *Manner of making election.* (1) The election provided for in paragraph (a) of this section shall be made by the taxpayer filing a statement in writing that he elects to treat the deduction allowed in a prior taxable year for the unconstitutional tax as not having been allowable for such taxable year. Such a statement must be filed with the taxpayer's return for the taxable year in which the recovery of the unconstitutional tax or taxes occurs. No other method of making the election is permitted. The statement of election must contain a description of the tax recovered, the date of recovery, the taxable year in which paid or accrued, and the taxable year for which the deduction was allowed. The statement of election must also contain a statement signifying the taxpayer's consent (i) to treat the deduction or portion thereof allowed in a prior year with respect to the unconstitutional tax as not allowable for that year and (ii) to the assessment, in respect of the taxable year for which the deduction was allowed, of any deficiency, together with interest thereon as provided by law, resulting