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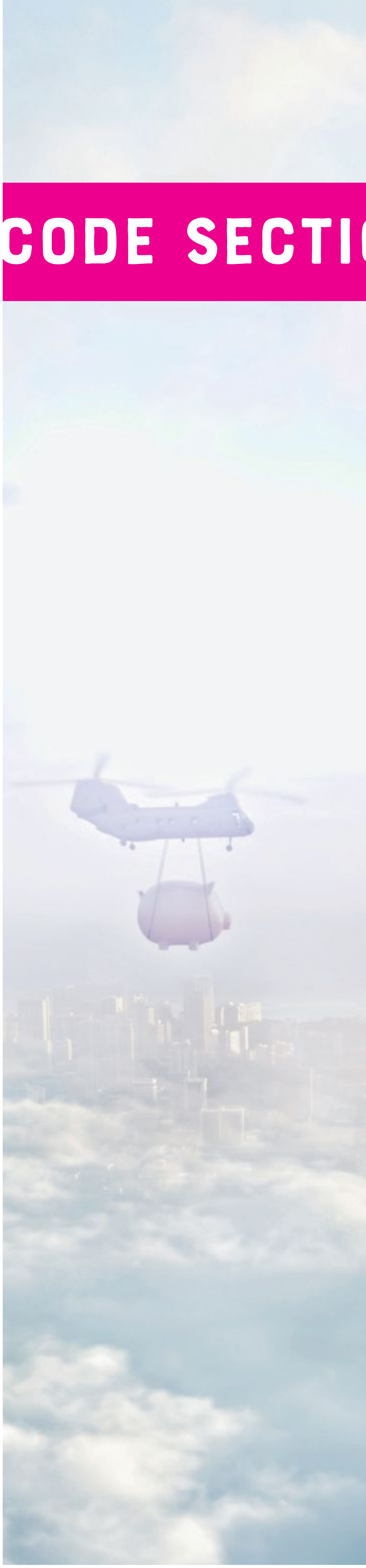
Code Section 1341 to the Rescue! / NAEA Winter Education Academy

FEATURES


CODE SECTION 1341 CODE SECTION 1341



CODE SECTION 1341 TO THE RESCUE!

How many times over the last few tax seasons have you found yourself having to tell your client: “Sorry, the 2017 tax cut doubled the amount of the standard deduction so your deductions are not enough to make a difference?”

Or “The 2017 Tax Cuts and Jobs Act (TCJA) eliminated most types of miscellaneous deductions, so that is no longer deductible.” We all know about the obvious ones, those formerly deducted on Form 2106: unreimbursed employee expenses immediately come to mind. But what about some of the more obscure deductions like repayment of different types of income (e.g., unemployment benefits, wages, retirement income, and other sources of income)? Is it fair that repayments of income are no longer deductible for many taxpayers?

Well, believe it or not, there is another option for relief. Payments over a certain threshold are still deductible and there is an alternate way to decrease the tax even without deducting these repayments. This available relief gives two methods for calculating the adjustment to the tax, and the taxpayer gets to use whichever method produces the better result.

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Claim of Right Relief
This relief is codified in Internal Revenue Code (IRC) §1341, *Computation of Tax Where Taxpayer Restores Substantial Amount Held Under Claim of Right*, also known as the claim-of-right doctrine. Let us take a look at how it works.

Essentially, the taxpayer is allowed to calculate either a deduction or a tax credit depending on which method gives the better result. If the taxpayer reported income in a prior year because it appeared he or she had an unrestricted right to receive it, but after the close of the prior year it became apparent that the taxpayer did not have an unrestricted right to such income and had to pay it back, then the taxpayer fulfilled the first couple of provisions.[i]

To be eligible for this relief, the amount repaid must be greater than $3,000.[ii] After such repayment, the taxpayer's tax is computed as the lesser of: 1) tax in the current year with a deduction for the amount repaid or 2) tax in the current year without the deduction minus the decrease in tax from the prior year if the amount had been excluded in the prior year.[iii] Once the decrease in tax has been calculated, the taxpayer uses either the deduction or the tax credit method on the current year return (assuming the taxpayer is on the cash method of accounting).

Besides getting to calculate the decrease in tax with the method which yields the better result, the taxpayer also takes the tax credit in the year of repayment without having to amend prior year returns. If the tax credit method is used and the amount of the credit is greater than the current year's tax, the excess is treated like an overpayment and is refundable much like wage withholding or any other overpayments of tax.[iv]

Section 1341 is a relief provision designed to place taxpayers in the same position as if they did not include the income in the first place. This provision has been in the IRC since 1954.

This computation is especially significant for corporations, as their tax rates were decreased from 35 percent to 21 percent with the passage of the Tax Cuts and Jobs Act (TCJA) in 2017.

When Does Section 1341 Relief Apply?
Section 1341 does not apply to deductions for bad debts, deductions for returns and allowances, or other items included in gross income from the sale of inventory or other property held primarily for sale to customers in the ordinary course of a trade business.[v]

Determining whether relief is available under §1341 can sometimes be more complicated than the simplified fact patterns mentioned above. In §1341(a)(1), the phrase "it appeared that the taxpayer had an unrestricted right to such item" can be difficult to apply after considering what the term "appeared" means in this context. For instance, amounts included in income due to fraud or embezzlement presumably would fall outside the provisions of the Code section since it would be difficult to claim a taxpayer appeared to have unrestricted rights to amounts obtained under such methods.[vi]

Deductions for legal expenses of contesting the repayment also do not apply.[vii] There are other provisions for certain refunds or repayments made by or to regulated utilities which is beyond the scope of this article.[viii]

Example
The following example is from Internal Revenue Service (IRS) Publication 525:[ix]

For 2019, the taxpayer filed a return and reported income on the cash method. In 2020, the taxpayer repaid $5,000 included in the 2019 income under a claim of right. The taxpayer's filing status in 2020 and 2019 is single. The income and tax for both years are as follows:

2019

	With Income	Without Income
Taxable Income	$15,000	$10,000
Tax	$1,609	$1,009

2020

	Without Deduction	With Deduction
Taxable Income	$49,950	$44,950
Tax	$6,785	$5,685

The taxpayer's tax under method one is $5,685. The taxpayer's tax under method two is $6,185, figured as follows:

Tax previously determined for 2019	$1,609
Less: Tax as refigured	($1,009)
Decrease in 2019 tax	$600
Regular tax liability for 2020	$6,785
Less: Decrease in 2019 tax	($600)
Refigured tax for 2020	$6,185

The taxpayer pays less tax using method one, so he or she should take a deduction for the repayment in 2020.

In the above example, why was it better to refigure the tax with a deduction for 2020? It is because the taxpayer's marginal tax rate was higher in 2020 than in 2019. If the reverse had been true (the taxpayer's marginal tax rate higher in 2019 than in

2020), then the credit would be figured on the decrease in tax for 2019 and the credit still taken on the 2020 return. Other factors such as filing status, other tax credits, net operating losses, etc., may also impact which method yields the better result.

As the Tax Cuts and Jobs Act of 2017 recedes further into the past, the chances of the marginal rate being higher in the previous year will decrease, assuming no future law changes. Indeed, it will become more a function of the taxpayer's overall income, deductions, and credits than of tax rates themselves.

Reporting

Once determined which method produces the better result, the taxpayer either reports a deduction on Schedule A, line 16 with an explanation on the blank line or a tax credit on Schedule 3, line 12d, and write "IRC 1341" on the blank line. The credit amount also carries to Form 1040, line 31.

Summary

Section 1341 defines the rules for a tax credit when a taxpayer can recalculate his or her tax when he or she must repay over $3,000 of income that was received in a prior year. Because two different methods may be used to calculate the adjustment to the tax, it restores a taxpayer to the same economic position as if the income had never been received in the first place. This IRC section has been in place since 1954 and, in some cases, allows a taxpayer to take a tax credit at the higher marginal tax rates of prior tax years.

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[i] *IRC §1341(a)*

[ii] *IRC §1341(a)(3)*

[iii] *IRC §1341(a)(4), (5)*

[iv] *IRC §1341(b)(1)*

[v] *IRC §1341(b)(2)*

[vi] *The Tax Adviser, Adam Hales, CPA, Dennis Tingey, CPA, Washington, D.C., July 1, 2019*

[vii] *2020 IRS Publication 525, p. 36*

[viii] *IRC §1341(b)(2)*

[ix] *2020 IRS Publication 525, p. 36*