DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR ASSOCIATE AREA COUNSEL, PHILADELPHIA
CC:LM:MCT:PHI

ATTN: JAMES C. FEE

FROM: Anne O'Connell Devereaux
Assistant to the Branch Chief, CC:INTL:3

SUBJECT:

This Field Service Advice responds to the first issue raised in your memorandum dated August 7, 2000. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be used or cited as precedent.

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LEGEND

Taxpayer =

B =
C =
X =
Y =
Year 1 =
Year 2 =
Month 1 =
Date 1 =
Date 2 =
Date 3 =
Date 4 =

ISSUES

1. To what extent is Taxpayer obligated to recognize in income a distribution paid to it by a foreign subsidiary when Taxpayer repays a portion of the distribution to the subsidiary during the same tax year?

2. What is the proper tax treatment of Taxpayer's repayment of a portion of the distribution to the subsidiary?

CONCLUSION

1. Taxpayer is required to recognize any portion of the distribution that Taxpayer was not obligated to repay to the foreign subsidiary. If Taxpayer was obligated to repay any portion of the distribution within the year of distribution, Taxpayer recognizes income under the claim of right doctrine in an amount equal only to the difference between the payment made by the British Utility, £X, and the amount refunded, £Y. However, Taxpayer has not established that it was obligated to repay the distribution. Accordingly, Taxpayer must recognize income under the claim of right doctrine in an amount equal to the distribution paid by the British Utility, £X.

2. Since Taxpayer is required to recognize the entire amount of the distribution because it has not established that it was obligated to repay the distribution, the repayment to the British Utility in the amount of £Y is treated as a contribution to capital rather than an offset against recognized income.

FACTS

Commencing in the 1980s, the United Kingdom Parliament enacted a series of statutory provisions "privatizing" certain government-owned public utilities by selling their shares to the public. A number of these utilities were acquired by U.S. utilities and, in Year 1, Taxpayer, a calendar-year domestic corporation, acquired B percent of the shares of one of these British utilities ("the British Utility") from an unrelated domestic corporation.

The British Utility declared and paid two distributions each in the amount of £X in Month 1. The first distribution is not in issue here. The Taxpayer returned £Y, 99% of the amount of the second distribution, to the British Utility on Date 2, 11 days after the distribution was made on Date 1. On Date 4, approximately five months after Date 1, Taxpayer and the British Utility executed a rescission agreement ("Rescission Agreement"). All of these events took place in Year 2.

The Rescission Agreement states that the British Utility distributed the sum of £X to its shareholders on Date 1 "even though it was not clear" whether the British Utility "would need the cash for its own projected purposes (including payment of the proposed UK windfall profits tax ["UKWT"[1]])." The Rescission Agreement further stated that the Date 1 distribution was made in the belief that it would constitute a nontaxable return of capital, that after the UK announced the UKWT, "it became clear" that the British Utility "would require" a return of the distribution, and that "shortly after the distribution," "it was also determined" that the distribution would be taxable "if not rescinded or treated as a stock dividend." Finally, the Rescission Agreement states that Taxpayer returned the £Y to the British Utility on Date 2. The Rescission Agreement purports to rescind the distribution in question "to the extent of the returned funds."

LAW AND ANALYSIS

Under section 61(a)(7) of the Code, taxpayers are required to include in gross income the amount of any dividends received. Furthermore, under the claim of right doctrine, if a taxpayer receives income under a claim of right and without restriction as to its disposition, the taxpayer must report the income in the year of receipt regardless of the taxpayer's method of accounting.

There are four basic elements to the claim of right doctrine: the taxpayer must receive cash or property; the cash or property must constitute income; the taxpayer must have unlimited control over the use and disposition of this income; and the taxpayer must hold the income under an asserted claim of right. *See* Stephen F. Gertzman, *Federal Tax Accounting* ¶12.03[2] (2d ed. 1993). Thus, the claim of right doctrine does not apply unless the item received is income and unless the taxpayer received the income without restriction as to its disposition. That is, if a restriction does not prevent the taxpayer from using the funds for its own benefit, the requisite control exists. *Nordberg v. Commissioner*, 79 T.C. 655 (1982),*aff'd*, 720 F.2d 658 (1st Cir. 1983) (control present even though receipt conditioned on a contractual provision). The taxpayer must also treat the funds as its own.

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[1] The UKWT, enacted on July 2, 1997, was a one-time tax imposed on certain UK utilities that were privatized in the 1980's, including the British Utility. Since the British Utility paid the UKWT after the close of its tax year that ended on Date 3, its earnings and profits for that tax year were not reduced by the tax payment. The unreduced earnings and profits exceeded the sum of the distributions made in Month 1.

If in the same taxable year of receipt a taxpayer realizes that a payment was received in error, an acknowledgment of an obligation to repay prevents the need for recognition.[2] In *United States v. Merrill*, 211 F.2d 297 (9th Cir. 1954), a taxpayer received an executor's fee and later in the year discovered that this was an error. The Court did not apply the claim of right doctrine as the taxpayer had made appropriate book entries to account for the error. The Court decided that these actions demonstrated a recognition of a repayment obligation in the year of receipt. *See*, *e.g*., *Bates Motor Transport Lines, Inc. v. Commissioner*, 200 F.2d 20 (7th Cir. 1952) (contractual obligation for taxpayer to refund excessive freight tariffs and an acknowledgment of overpayments); *Gaddy v. Commissioner*, 38 T.C. 943 (1962), *rev'd in part on other grounds*, 344 F.2d 460 (5th Cir. 1965) (contractual obligation to refund excessive freight tariffs, a firm renunciation of any right to the excess payments and a contractual undertaking as to a method of repayment, all in the same year). However, a dividend once legally declared by the corporation's board of directors cannot be revoked. *See*, *Crellin's Estate v. Commissioner*, 203 F.2d. 812 (9th Cir. 1953) (the corporation declared and paid a dividend based on erroneous advice of a certified public accountant that unless distributed, the corporation would be subject to tax. Later in the same year, the corporation recalled the dividends upon learning of the error and demanded that the shareholders return the amounts paid. The shareholders complied. The court determined that in this case state law did not compel the repayment and therefore it was not an offset against the distribution) and *Staats v. Biograph Co*., 236 F. 454 (2nd Cir. 1916)(the corporation's board of directors declared a dividend on December 28, 1914, and issued a rescission on August 10, 1915. The court determined that since the dividend had been legally declared that it could not be rescinded. The shareholders had a legal claim against the company).

In this case, when Taxpayer received the payment in Year 2 the four claim of right elements were met with respect to that payment. Accordingly, the payment is income in Year 2 to Taxpayer. However, the amount of the distribution that Taxpayer must recognize is reduced by the amount, if any, that Taxpayer was legally obligated to refund to the British Utility in Year 2. Accordingly, the amount of the payment that must be recognized under the claim of right doctrine and treated as a dividend under section 301(c) of the Code is dependent directly upon whether Taxpayer had a legal obligation to return all or part of the Date 1 payment.

Under *Crellin's Estate* and *Staats*, Taxpayer has failed to establish that it was legally obligated to refund the payment. Accordingly, Taxpayer must recognize income under the claim of right doctrine in Year 2 in an amount equal to £X, the full

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[2] A taxpayer that is not obligated to repay the amounts received until a year later than the year of receipt is required to recognize income under the claim of right doctrine in the year of receipt and claim a deduction in the year of repayment. *North American Oil Consol. v. Burnet*, 286 U.S. 417, 424 (1932); *United States v. Lewis*, 340 U.S. 590 (1951).

amount of the distribution paid by the British Utility.[3] The amount returned by Taxpayer to the British Utility in the amount of £Y is treated as a contribution to capital. Had Taxpayer established that it was legally obligated to refund the Date 1 payment Taxpayer would have recognized income in Year 2 equal to only the difference between the dividend paid by the British Utility, £X, and the amount refunded, £Y.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

[redacted]

Please call (202) 622-3850 if you have any further questions.

ANNE O'CONNELL DEVEREAUX
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[3] Pursuant to section 301(c) of the Code, to the extent that British Utility had earnings and profits for its year ending on Date 3, the distribution, if income under the claim of right, would be a dividend as defined in section 316. To the extent it is not a dividend, the distribution would be applied against and reduce Taxpayer's adjusted basis in its stock of the British Utility, and to the extent that the distribution exceeded its adjusted basis in that stock, it would be treated as gain from the sale or exchange of property. Section 301(c)(2) and (3).

[4] Convention Between the Government of the United States of America and the Government of the United Kingdom of Great Britain and Northern Ireland for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital Gains, TIAS 9682, 1980-1 C.B. 394.