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“Claim of Right” Update: *Mihelick v. United States*

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When a taxpayer receives an amount as, for example, compensation for services or proceeds from the disposition of property, and it appears that the taxpayer has an unrestricted right to that amount, the “claim of right” doctrine generally requires that the amount must be included in the taxpayer’s gross income no later than the year of receipt. “Things” happen, however, and the taxpayer may be called upon to repay the amount received.

Even when overarching principles of tax accounting allow the taxpayer to claim a deduction in the year of repayment, the tax benefit of that deduction is often less than the tax cost of the income inclusion in the prior year. In order to mitigate this unfortunate situation, the special rule of section 1341 of the Internal Revenue Code (“Code”) is applicable when: a person receives an amount (“item”) included in gross income when received, because it appears that the person had an unrestricted right to the item; it is determined after the end of the year of receipt that the person did not have an unrestricted right to the item; and the person then relinquishes the item or portion thereof and is consequently entitled to a deduction.

Under section 1341, the person’s tax liability in the year of repayment is equal to the lesser of (i) the tax liability computed under ordinary rules, giving effect to the deduction in the year of repayment, or (ii) the person’s tax liability for that year, computed without regard to the deduction, *minus* the decrease in tax that would have resulted in the prior year if the item (or the portion repaid) had been excluded from income in that year. The application of section 1341 will generally result in a lower tax liability for the year of repayment if the person does not have sufficient income in the later year fully to benefit from the deduction, or was otherwise subject to a higher tax rate in the earlier year.

The application of section 1341 to particular circumstances is often uncertain and has resulted in numerous tax controversies, and the Internal Revenue Service seems predisposed (in the view of many practitioners) to dispute its applicability in circumstances where a cogent argument may be made to the contrary.

In *Mihelick v United States* (No. 17-14975, June 18, 2019), the Court of Appeals for the 11th Circuit reversed the decision of a U.S. District Court (120 AFTR 2d 2017-6146 (D. Fla.)) denying a refund claim premised on section 1341. In doing so, the Court of Appeals provided welcome guidance on the applicability of section 1341 in situations involving a change in marital status and where the repayment resulting in a deduction is not made to the initial payor of the item.

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Facts in *Mihelick*

During the marriage of the taxpayer (Mihelick) and her ex-husband (Bluso), both of them were employed by a closely held corporation owned by members of Bluso’s family. From 1999 to 2004, Bluso was the corporation’s CEO, and he eventually became the majority shareholder as well. Both spouses received compensation from the corporation, and that compensation was reported on their joint tax returns.

Mihelick filed for divorce in 2004. While the divorce proceedings were pending, a sibling of Bluso who was a minority shareholder of the corporation sued Bluso, the corporation, and others (though not Mihelick), asserting that Bluso had breached fiduciary duties by receiving excessive compensation.

In a “Separation Agreement” between Mihelick and Bluso that was incorporated in a divorce decree issued in 2005, the claim made by Bluso’s sibling against Bluso was classified as a marital liability for which Bluso and Mihelick would be jointly and severally liable. That claim was settled in 2007, with a payment of $600,000 being made by Bluso to the sibling. Bluso then sought to recoup $300,000 of the payment from Mihelick, while claiming a tax deduction for the $300,000 portion to be borne by him.

Mihelick initially resisted making any payment, but, in 2009, paid $300,000 to Bluso on account of the excess compensation claim. Mihelick took

the position in the controversy before the court that her payment of $300,000 was deductible under Code section 165 in 2009 as a loss attributable to her ex-spouse's employment during their marriage, and that section 1341 applied in determining the amount of benefit that she could derive from that deduction in computing her taxes for 2009. More specifically, according to a footnote in the District Court opinion, Mihelick claimed that she had paid $111,802 of federal income tax during the years 1999 through 2004 on her $300,000 share of $600,000 of income reported on joint tax returns with her ex-spouse.

The IRS disagreed with Mihelick's position, and she brought suit in the U.S. District Court.

Analysis

The District Court and Court of Appeals both agreed with the Government that section 1341 would apply only if, in the first instance, some provision of the Code other than section 1341 authorized a deduction for the 2009 payment by Mihelick to Bluso. Mihelick asserted before the District Court that she was entitled to a deduction under IRC section 165(c)(2), which provides, in substance, that a loss may be allowed to an individual if "incurred in any transaction entered into for profit, though not connected with a trade or business."

In response to a motion for summary judgment by the Government, the District Court concluded that no deduction was allowable under section 165(c)(2) because Mihelick's loss did not arise from any business venture or investment of Mihelick, or from any personal obligation of Mihelick resulting from the excess compensation claim against Bluso. The court did not disagree that Mihelick was compelled under the Settlement Agreement incorporated in the divorce decree to make the payment, but reasoned that she did not enter into the Settlement Agreement as part of a business or investment. The lower court also concluded that Mihelick had not identified any other provision of the Code under which her payment was deductible, and granted summary judgment to the Government.

Upon appeal by Mihelick, the Court of Appeals reversed. The Government did not appear to dispute that the payment by *Bluso* was deductible under section 165(c)(1), but it asserted that *Mihelick* did not earn or have any right to the income that resulted in the payment, and therefore had no deduction allowable under that provision.

More specifically, the Government argued that, prior to the initiation of divorce proceedings in 2004, Mihelick had no presumptive right under Ohio statutory provisions and case law to any share of Bluso's income. That argument, if accepted, could have undercut Mihelick's assertion (necessary to relief under section 1341) that the amount ultimately repaid had previously been included in her income subject to tax "because it appeared that the taxpayer had an unrestricted right" to such item. It would also undermine the argument (necessary for her to claim a deduction under section 165) that the earlier inclusion and subsequent repayment were incurred in a trade or business of Mihelick.

The Court of Appeals disagreed and found that Mihelick's payment was deductible under IRC section 165(c)(1) as a loss incurred in a trade or business. The court reasoned that Bluso, as CEO and majority shareholder, was in the trade or business of acting as a fiduciary, officer, and employee, and that the $600,000 paid to Bluso's sibling should be viewed as a loss incurred in that business.

The Court's reasoning in response to the Government's argument was, in part, that it was sufficient for purposes of the "unrestricted right" requirement of section 1341 if Mihelick sincerely believed that she had a contemporaneous right to the wages paid to Bluso during each year of their marriage; that is, that a subjective belief of entitlement was sufficient for this purpose even if some might consider that belief to be unreasonable. The Court of Appeals further concluded that, under Ohio law, there was a presumption that each spouse had the same unrestricted right as the other to wages earned by either during the marriage, and that the liability Mihelick ultimately paid in 2009 should be viewed as a liability she helped to create during the marriage.

Under this view, the Settlement Agreement, in characterizing the claims made by Bluso's sibling as a marital liability, was not the origin of the liability that Mihelick ultimately paid in 2009, but rather a crystallization of a liability arising in each year in which Bluso allegedly received excessive compensation.

The Court of Appeals decision also notes that the Government, in denying Mihelick's claim, had asserted that no deduction was allowable because she made the payment to Bluso, rather than to the Bluso sibling who initiated the excess compensation litigation and who was paid by Bluso. Although section 1341(a) does not on its face require that the deduction in the later year be attributable to a payment made to restore an amount to another person, Reg. section 1.1341-1(a)(1) provides that the tax computation described in section 1341 will apply when a deduction arises "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 Court of Appeals characterized the Government's argument that section 1341 should apply only if the person seeking its benefits "returned the income to the 'actual owner'" as an effort to add a new requirement to section 1341 that was not based on the text of the provision, and declined to add such a requirement. The court concluded that it was sufficient (i) that the Bluso sibling who initiated the litigation made a claim that Bluso was not entitled to an item of income, (ii) that such claim was ultimately settled through payment of an amount, and (iii) that the payments made by Bluso to the sibling and by Mihelick to Bluso were all made in effectuation of that settlement.

Observations

The opinions of the District Court and the Court of Appeals noted, but did not dwell, on the circumstance that, during each of the years in which the wages at issue in the excess compensation litigation were received, Mihelick and

Bluso filed a joint return—in respect of which "the tax shall be computed on the aggregate income and the liability with respect to the tax shall be joint and several" (IRC § 6013(d)(3)).

The precise scope of this "aggregation" is uncertain, and questions about its meaning arise under many provisions of the Code. Some commentators have argued that it should be implicit in the filing of a joint return for a year that, if one of the parties to that return incurs an expense in a later year that is attributable to a liability arising by reason of events in the earlier year relating to a business then conducted by the other spouse, the paying spouse should be considered to "stand in the shoes" of the other for purposes of determining the tax consequences of the payment, for example, whether the expense was incurred in a trade or business, and that this conclusion should follow even if the parties do not file on a joint basis in the later year. *Mihelick* may provide some support for that common-sense proposition.

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