

# Recouping tax on lost income

Using a claim of right to reduce income tax **By Larry D. Friedman**

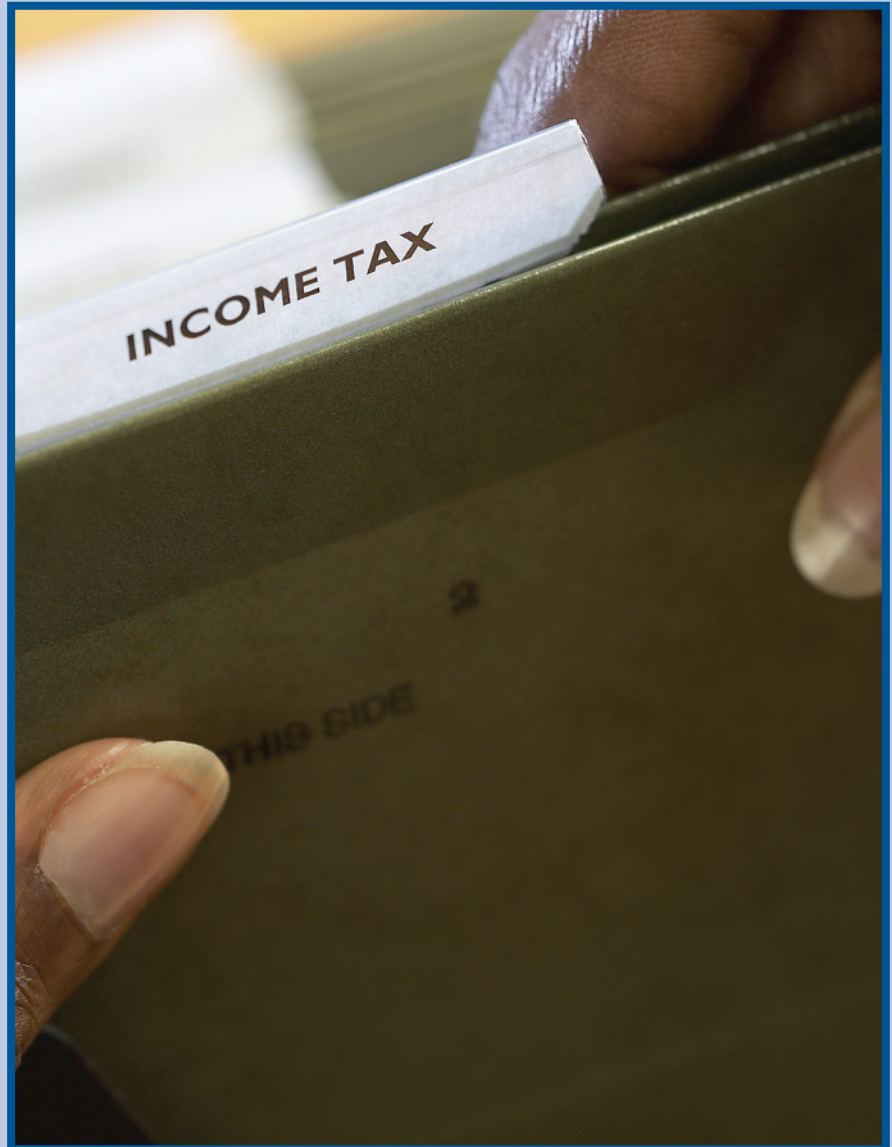
**T**he concept of taxation is a difficult one for most. The problems individuals encounter generally revolve around how laws, rules and regulations affect their tax liabilities. Often, taxes are overpaid and your corresponding net worth reduced if unusual circumstances arise. This article describes one such topic called the claim of right.

In the normal course of events, you pay tax when income is received. For most of us, the receipt of cash corresponds with the recognition of income. There are situations called constructive receipt where income is recognized without the receipt of cash, but they are fairly infrequent. This article will discuss situations where you received cash and paid tax in a prior year, but in a later year had to repay the income due to somebody making a claim against the receipt. A familiar example would be what recently happened with a player from our hometown football organization.

The tax laws say that when you receive any income under a claim of right that is free from restrictions, it is taxable in the year of receipt. The taxation in the year of receipt is definite, even if you might be obligated to return it. If in a later year you are required to return the income, you may be able to use the claim of right doctrine. A common example of its use is when you receive compensation from employment, such as a bonus, that is later found to be incorrect and you are required to repay the amount. The claim of right doctrine could prove to be a large reduction to your tax.

In order to qualify for the claim of right, you must pass three tests. First, you must have actually or constructively received the income. Second, you must have received the income under a claim of right – there must be some dispute as to whether you are entitled to retain the income. Third, there cannot be any restrictions on the use of the money.

The claim of right doctrine effectively permits you to reverse out the tax cost of originally reporting the income. If you fall within the rather complex rules of the section, you must perform two calculations. First, your originally reported tax is recalculated without the income you repaid. Second, you calculate your current year tax by deducting the repaid amount. The



second calculation can become very cumbersome, especially where the deduction causes your current year income to be negative. If the prior year recalculated tax produces a smaller liability, you must use that calculation to report your current year tax. There are no amended tax returns filed when using the claim of right doctrine. The set of calculations are included with your current year filing and you receive a credit similar to tax withholding.

Tax laws can be difficult to understand even for those who work full-time in the area. The claim of right doctrine is one of the more difficult areas to comprehend, but can prove to be very beneficial if your

facts fit the pattern. We highly recommend that you consult with your tax professional about this or your other tax questions and issues.



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