

The Claim of Right Doctrine

Quick-Take: When reporting income, beware of the *claim of right doctrine* that requires reporting the income in the year of its receipt when there are no apparent restrictions as to the income's disposition, even if that income must later be repaid. If that erroneously received and reported income is repaid in a subsequent year, the repayment might not be deductible, creating a mismatch between reported income and the available deduction amount regarding the repayment.

Background: The Claim of Right Doctrine is a principle followed by the IRS and courts that requires a taxpayer to report income in the year that he/she has unrestricted control over it, even if that individual might have to repay the amount later. The doctrine was first announced by the Supreme Court in *North American Oil Consolidated v. Burnet*, 286 U.S. 417 (1932) which is intended to ensure tax compliance on received taxable income. The income must be received without restrictions on its use or its disposition. The income is taxed in the year that it is received, not when the legal right to the income is finalized, i.e., at a much later date.

Mitigation: However, if the taxpayer later repays that income in a subsequent year, and the repayment is more than \$3,000 in the subsequent tax year because it was determined that the taxpayer did not possess the right to the income, the taxpayer may be entitled to a tax deduction or credit in the year of the repayment. [IRC 1341.] For repayments over \$3,000 the taxpayer may compute his/her tax by either taking a deduction in the current year or, if more beneficial, reducing his/her tax liability paid in the earlier year.

Mismatch: Note the mismatch between the amount received and reported in income and the amount that is later repaid that can be deducted under IRC 1341. If the repaid amount is less than \$3,000, there is no later offsetting tax deductible amount.

IRS Scrutiny: Sometimes promoters of aggressive tax strategies will argue that the 'claim of right' can be used by a taxpayer to legitimately assert that income is not yet subject to tax, but the IRS takes the view that it is a frivolous position to avoid paying tax on income.

Examples: Some common examples of when this claim of right doctrine arises are: (i) a contractor receives payment for a project but is later forced to refund the retainer due to a customer dispute; (ii) a shareholder receives a dividend that is later deemed to have impaired corporate capital and the dividend must be returned; or (iii) an employee receives a signing bonus that he/she is required to repay, if he/she leaves the employer within a specific time period.

A recent example of where the claim of right doctrine was invoked was with regard to the payment of SSDI benefits that were subsequently determined to be erroneously paid.

Smith v. Commissioner, U.S. Tax Court Memo 2026-25

Facts: Mike Smith held jobs with two separate employers in 2022, for which he received wages of \$16,535, that he correctly reported on his income tax return. However, Mike claiming a disabling injury also applied for Social Security Disability Insurance benefits in early 2022. In November 2022 Mike was granted retroactive SSDI benefits from March 2022 through March 2023, in the amount of \$26,802 for the 2022 tax year. Mike was issued a Form SSA-1099, but Mike did not report any of these benefits on his 2022 tax return. In April 2023 Mike ceased to receive SSDI benefits and the Social Security Administration (SSA) advised him that “he should never be entitled to receive a Social Security disability benefit.” Accordingly, Mike was required to reimburse the SSA. Mike repaid \$31,116 in May of 2023 and he fulfilled the remaining balance via monthly payments over 2023 and 2024. When Mike’s 2022 Form 1040 was examined by the IRS it determined that 85% of the 2022 SSDI benefits (\$22,782) should have been included in Mike’s reported gross income for the year [IRC 86(a)] that resulted in a deficiency of \$5,454.

Dispute: Mike petitioned the Tax Court for a redetermination. Mike claims that the \$26,802 that he received in 2022 was an ‘accidental overpayment which was repaid...in full.’ Mike argued that the SSDI benefits should be completely excluded from his 2022 gross income due to his subsequent obligation to return the funds. Mike claimed that the SSDI benefits were ‘tantamount to loan proceeds that should be excluded from his income.’

Tax Court: The Court granted summary disposition in favor of the IRS and against Mike.

Annual Accounting Principal: The Tax Code requires a cash basis taxpayer to include items of gross income in the year that they are received. [IRC 451(a).]

IRC 86(d)(2)(A): This Tax Code section states that “the amount of Social Security benefits received during a taxable year is ‘reduced by any repayment made by the taxpayer *during the taxable year* of a social security benefit previously received by the taxpayer.”

Unfortunately, Mike sought to offset his 2022 SSDI income with repayments made in 2023 and 2024. Because Mike did not make the repayment in 2022, his 2022 tax liability could not be adjusted.

Loan Argument: The Court also rejected Mike’s ‘tantamount to a loan’ argument. Mike clearly received the 2022 benefits under the ‘claim of right’ doctrine because he applied for those benefits and the SSA issued to him a letter that affirmed his entitlement to the benefits. The ‘restriction’ on those SSDI funds only arose the following year when the SSA reversed its decision upon learning of Mike’s ongoing employment.

Conclusion: The claim of right doctrine can produce harsh results. The failure to repay the mistakenly received income in the same year produces a hardship, even when the funds are repaid shortly in the next calendar year. In addition, if the repayment amount is less than \$3,000, then there is no corresponding deduction available for the repaid amount, i.e., the recipient is ‘out’ the repaid amount but still paid income tax on the now-phantom income. Bottom line: if income must be repaid, repay that amount in the same tax year that it was received.

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