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The Tax Benefit Rule, Claim of Right Restorations, and Annual Accounting: A Cure for the Inconsistencies

I. Introduction

The Internal Revenue Code is premised on an annual accounting concept which requires the taxpayer to count up his transactions at the end of the year and remit to the Government taxes based on the occurrences of that particular year. In theory this requires disregarding the factors of prior or subsequent taxable years, despite their relation to events of the tax year in question. In most instances, annual accounting poses no special problem. When applied to certain items whose tax impact transcends more than a single taxable year, however, inconsistencies and inequities may result. Two instances in which inconsistent tax treatment is occasioned by annual accounting are: (1) the restoration to another of items previously included in the taxpayer's gross income because he had held them under a claim of right; and (2) the recovery of items by the taxpayer which he had deducted from his income in a prior tax year. To require annual accounting with respect to these items makes the timing of the restoration or recovery determinative of the tax consequences. Variable factors such as fluctuation in the taxpayer's income and changes in tax rates determine whether the taxpayer ultimately pays more or less tax than if the original tax accounting were not erroneous in light of subsequent events. For example, if recovery of a previously deducted item occurs in a high income year for the taxpayer, the progressive rate structure is likely to exact a higher toll than if the taxpayer had foregone the original deduction so that the later recovery would be a return of capital, and therefore not taxable. It is the thesis of this note that the inconsistency is unnecessary and that the timing of a recovery or restoration need not determine the tax consequences. It is submitted that a transactional approach that would provide tax accounting for an item in light of events of prior years, as well as consideration of facts of the year of restoration or recovery, should be used.

Such an approach is not unprecedented. Section 1341 of the 1954 Code follows it substantially in regard to restoration of items held under a claim of right, and the Tax Benefit Rule views transactions as a whole when a previously deducted item which did not offset taxable income is recovered. But section 1341 stops short of the exact tax accounting which a purely transactional approach would provide, and the Tax Benefit Rule is inapplicable to recoveries of items if the prior

deduction was tax beneficial. This note proposes the adoption of a completely transactional approach under section 1341, and extension of the theory of the Tax Benefit Rule to encompass the recovery of deducted items which provided a tax benefit. Although this approach is inconsistent with the annual accounting concept, it does not go far beyond the departures already inherent in section 1341 and the Tax Benefit Rule, and it would eliminate inconsistencies and inequities under existing law.

II. The Problem: Annual Accounting for Transactional Items

Congress recognized at an early date that the revenue needs of the nation demanded that some period of time be established for computation of income forming the basis of tax liability.[1] This accounting period principle was embodied in the first income tax under the sixteenth amendment and has been adhered to in all subsequent income tax enactments.[2] Interpreting these statutory provisions, courts have acknowledged the necessity for a regular accounting period. Thus in the leading case of *Burnet v. Sanford & Brooks Co.* the Supreme Court observed:

> It is the essence of any system of taxation that it should produce revenue ascertainable, and payable to the government, *at regular intervals*.[3]

In *Healy v. Commissioner*, the Court explained:

> Congress has enacted an annual accounting system under which income is counted up at the end of each year. It would be disruptive of an orderly collection of the revenue to rule that the accounting must be done over again to reflect events occurring after the year for which the accounting is made.[4]

The problem with the annual accounting concept is that it often provides inconsistent tax accounting for items which have tax consequences in two or more tax years. For example, an item deducted as a bad debt in one year may be repaid in a later tax year. Assume that the applicable tax rate in the year of deduction is 25 percent, and is 50 percent in the year of recovery. Under current authority, if there was sufficient taxable income to allow deduction of the full amount of the debt, the recovery would be taxed in the year of recovery at the 50 percent rate, although the deduction offset income

1. *See* 36 Stat. 112 (1909), where Congress imposed a corporate business privilege tax measured by *annual* net income.
2. Rev. Act of 1913, § II(A) & (G)(c), 38 Stat. 166, 174 (1913); *see* Lassen, *The Tax Benefit Rule and Related Problems*, 20 Tax Mag. 473, 474 (1942).
3. 282 U.S. 359, 365 (1931) (emphasis added).
4. 345 U.S. 278, 284-85 (1953).

taxable at only 25 percent.[5] If the taxpayer had not taken the deduction in the earlier year, however, the later recovery would have been a nontaxable return of capital,[6] and the effective tax rate would remain only 25 percent; that is, by foregoing the deduction he would pay tax at 25 percent on the income which the bad debt deduction would have offset. Obviously, the timing of the deduction, if taken, determines the tax consequence. This result would be avoided if the transaction were viewed as a whole. However, when the annual accounting concept is applied strictly to the type of problem posed in the foregoing example, "each taxable year must be regarded as an independent unit . . . ."[7]

There are four situations in which strict annual accounting can make timing determinative of tax consequences:

1. *The Dry Deduction Problem.*—Suppose *A* wrote off a bad debt of 2000 dollars in 1960, a year in which he incurred a net operating loss of 3000 dollars, and he fortuitously recovered the debt in 1964. As seen above, had *A* not written off the debt in 1960 the recovery would not have been taxable. Yet because he took the 1960 deduction, he would be required to include the recovery in his gross income for 1964,[8] absent some doctrine to the contrary. In this situation, however, the Tax Benefit Rule would prevent taxation of the later recovery,[9] thereby eliminating timing as a tax determinative factor to the extent that it guards against a dry deduction.

2. *Change in Tax Rates.*—Suppose a taxpayer contributed property to charity in 1939 and 1940 on condition that his gift be used for educational or religious purposes and that he took charitable deductions in those years against applicable tax rates of 18 and 24 percent. In 1957 the property could no longer be used for the specified purposes and it was returned to him. The applicable tax rate for the year of return was 52 percent. If the transaction were viewed as a whole, the taxpayer would need only to remit the taxes saved by the 1939 and 1940 deductions to effect the status quo, since he did not have the use of the property and thus received no economic benefit from it in the intervening years. Restoration of the tax savings would account entirely for any benefit which he received from the transaction.

5. *See* Alice Phelan Sullivan Corp. v. United States, 381 F.2d 399 (Ct. Cl. 1967), *noted in* 21 VAND. L. REV. 288 (1968).

6. *See* First Nat'l Bank, Fort Worth, P-H 1943 Tax Ct. Mem. para. 43,073; J. P. Bass Publishing Co., 12 B.T.A. 728 (1928). *See also* Plumb, *The Tax Benefit Rule Today*, 57 HARV. L. REV. 129, 131 n.11, 133 n.20 (1943).

7. Helvering v. State-Planters Bank & Trust Co., 130 F.2d 44, 46 (1942).

8. For a brief explanation of this result, see Note, *The Tax Benefit Rule and the Loss Carryover Provisions of the 1954 Code*, 67 YALE L.J. 1394, 1398 (1958).

9. *See* text accompanying notes 24-31 *infra*.

Yet, if he received a tax benefit from the 1939 and 1940 deductions, current authority requires inclusion of the later recovery at the 1957 rates.[10] If the property given in each of the two earlier years was worth 1,000 dollars, the timing of the return of the property, coupled with the intervening rate change, would cause the taxpayer to suffer a net tax loss of 620 dollars.[11]

3. *Fluctuation of Income Within a Constant Rate Structure.*—Assume the facts as set out in example (2), except that the applicable tax rate remained constant. Also, assume that the taxpayer recovered only one of the 1000-dollar contributions in 1957, but that his income in 1957 placed him in a higher tax bracket than in 1939 or 1940. Obviously, the recovery would be subject to taxation at a rate higher than that used when his income was offset by the contribution deduction. Again, timing of the return of the property and an intervening change of circumstances result in an overall tax loss.[12]

4. *Deduction Taken Over Several Years Recovered in One.*—Again assume the facts as set out in example (2), except that the applicable tax rate remained constant. Assuming also that the taxpayer's income remained constant in the years concerned, it is likely that the recovery of 2000 dollars in 1957 would place the taxpayer in a higher tax bracket than when he took the two 1,000-dollar deductions. In effect, this would subject the recovery to a higher tax rate. Timing of the recovery would again determine the tax consequence of the transaction.[13]

It should be obvious that in the latter three situations in which timing can determine tax consequences, the result could as easily be detrimental to the Government. Tax rates could go down, the taxpayer's recovery-year income could be less, or a large deduction in one year might be recovered over several years, thereby taxing the

10. The facts posed in this hypothetical are taken from Alice Phelan Sullivan Corp. v. United States, 381 F.2d 399 (Ct. Cl. 1967). The court held that recovery must be taxed at the 1957 rates, although it meant an out-of-pocket tax loss to the taxpayer as a result of his charitable contributions.

11. Under the facts posed, the 1939 gift would yield a $180 deduction and the 1940 gift would represent a $240 tax savings. Yet the tax on the recovery would be $1040 (52% of $2000). Thus, the taxpayer would suffer a net loss of $620. In the *Healy* case, quoted at note 4 *supra*, the Supreme Court said the effect of its decision would mean that "factors such as the tax rates in the years involved and the brackets in which the income of the taxpayer falls will be controlling" of tax consequence. 345 U.S. at 284. *See also* Webster, *The Claim of Right Doctrine: 1954 Version*, 10 TAX L. REV. 381 (1954).

12. *See* Plumb, *supra* note 6, at 176-77, noting this effect of fluctuation in taxpayers' income.

13. *See* Perry v. United States, 160 F. Supp. 270, 272 (Ct. Cl. 1958): "[i]nclusion in one year of all the deductions taken in several years would probably put the taxpayer in a higher tax bracket."

recovery in a lower tax bracket than that used when the income was offset by the single-year deduction.

III. The Tax Benefit Rule

A. Development of Tax Benefit Doctrine

1. *Judicial and Administrative Origin.*—The Tax Benefit Rule is a rule of administrative and judicial origin which was developed to deal with the dry deduction problem discussed above.[14] Its development was preceded by judicial concurrence in the Bureau of Internal Revenue's position[15] that the recovery within a taxable year of an item previously deducted should be accounted for as gross income:

> [It] would be inequitable for the taxpayer to reduce his taxes for prior years on account of the [deductions], and not to pay taxes on them when he got them back. This . . . is a rule enunciated by the courts, and not by Congress, and is based altogether on equitable considerations.[16]

Even if the taxpayer did not "reduce his taxes for prior years" by the deduction, the early Bureau position was that the recovery was nonetheless taxable.[17] Recognizing the inequity of this position, the Bureau,

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14. Plumb, *supra* note 6, at 131.

15. The Bureau early ruled that if a bad debt were charged off and allowable as a deduction, a subsequent recovery was taxable even if no deduction had been claimed. S.R. 2940, IV-1 Cum. Bull. 129 (1925). The Board of Tax Appeals sustained this ruling, at least where the bad debt had been claimed as a deduction. Lake View Trust and Sav. Bank, 27 B.T.A. 290 (1932). *See* Plumb, *supra* note 6, at 131-32.

16. Perry v. United States, 160 F. Supp. 270, 271 (Ct. Cl. 1958), *noted in* 8 Duke L.J. 151 (1959). Attempts by the Commissioner to invoke the tax benefit doctrine in situations not falling strictly within the tax beneficial deduction-later recovery mold have been of little avail. *See, e.g.,* B. D. Anders, 48 T.C. 815 (1967), where taxpayer had fully depreciated various corporate assets which were later sold and the proceeds distributed to stockholders in a 12-month liquidation under § 337. The Commissioner argued that since the assets had been deducted for the full tax benefit, the recovery by sale was income to the taxpayer. The Tax Court, however, noted that what was involved was a sale of assets which qualified under § 337. The fact that their cost had already been deducted in full was not considered a barrier to nonrecognition of gain under § 337. The tax tribunal said that Rev. Rul. 61-214, 1961-2 Cum. Bull. 60, which reached an opposite conclusion on similar facts, was not a valid interpretation of the statute.

In Henry C. Beck Builders, Inc., 41 T.C. 616 (1964), affiliated corporations had eliminated intercompany profits from a consolidated return filed for 1953. On termination of affiliation in 1957, the Commissioner asserted a deficiency based on failure of the parent corporation to include the 1953 profit from the intercompany transactions with its now-departed subsidiary. The Commissioner relied on his authority to compel a change of accounting methods under § 446(b) if the taxpayer's method does not properly reflect income, but his argument was analagous to that advanced where the taxpayer recovers a beneficially deducted item; *i.e.,* that the 1953 noninclusion was equivalent to a deduction recovered upon the 1957 termination of affiliation. The court rejected the argument and said that § 481(a) prohibited a change in accounting method by the Commissioner since taxpayer "initiated" no change. *Id.* at 623.

17. Note 15 *supra.*

in a series of rulings by the General Counsel, indicated it would disregard the later recovery if the prior deduction had not led to tax savings.[18] Although the Bureau later revoked these favorable rulings,[19] the fundamental principles of the Tax Benefit Rule were established. The Board of Tax Appeals, notably, continued to apply the Rule after Bureau revocation.[20] Several federal courts, however, followed the Bureau position in taxing recoveries, regardless of prior tax benefit.[21]

2. *Statutory Enactment and Dobson Extension.*—Congress stepped into the confusion in 1942 and statutorily applied the Tax Benefit Rule to recoveries of bad debts, prior taxes and delinquency amounts.[22] It is not entirely clear why Congress limited the legislation to the enumerated situations, since witnesses at congressional hearings had urged broader terminology.[23] In any event, *Dobson v. Commissioner* foreclosed this question in 1943 when the Supreme Court applied the Tax Benefit Rule to a recovery under a Blue Sky statute.[24] The Court said the new code section was intended only to correct errors committed by the federal courts which refused to apply the Tax Benefit Rule, and that it did not intend to precipitate further errors by narrow construction of the legislation. Instead, the Court spoke in broad terms:

> The question of whether a recovery is properly accounted for as income in the year received or should be related to a previous reported deduction without tax benefit is one with a long history and much conflict. It arises not only in case of recoveries . . . of the type we have here [loss on sale of stock later recovered under Blue Sky law]. It is also present in case of refund of taxes or cancellation of expenses or interest previously re-

18. G.C.M. 18525, 1937-1 CUM. BULL. 80, applied to banks and other corporations subject to federal supervision. The memorandum stated, "the deductions for bad debts contemplated by the clause 'allowed as a deduction for income tax purposes' . . . refer to deductions for bad debts which accomplished a reduction in tax liability and do not refer to deductions for bad debts in cases in which the taxpayer, on account of other allowable deductions, had no net income irrespective of the deductions for bad debts." *Id.* at 83. G.C.M. 20854, 1939-1 CUM. BULL. 102 extended the tax benefit principle to cover debts voluntarily deducted by banks or other corporations subject to state or federal supervision, and to recoveries of debts deducted by other taxpayers.

19. G.C.M. 22163, 1940-2 CUM. BULL. 76.

20. *See, e.g.,* Motor Prods. Corp., 47 B.T.A. 983 (1942); Citizens State Bank, 46 B.T.A. 964 (1942).

21. The Second Circuit said, "There is nothing in the regulation or in any statute which makes the inclusion in gross income of collections on bad debts, previously charged off as worthless, dependent upon whether or not the charge off has resulted in a tax benefit to the taxpayer." Helvering v. State-Planters Bank & Trust Co., 130 F.2d 44, 46 (2d Cir. 1942).

22. INT. REV. CODE of 1939, § 22(b)(12) (now INT. REV. CODE of 1954, § 111).

23. *E.g., Hearings Before the House Comm. on Ways & Means on Revenue Revision of 1942,* 77th Cong., 2d Sess. 10, 88 (1942) [hereinafter cited as *1942 House Hearings*].

24. 320 U.S. 489 (1943).

> ported as accrued, adjustments of depreciation and depletion or amortization, and other similar situations.[25]

The Treasury Regulations were quickly amended to reflect the *Dobson* decision. The Tax Benefit Rule was declared to cover "all other losses, expenditures, and accruals," as well as bad debts, prior taxes and delinquency amounts.[26]

3. *Current Broad Application.*—Subsequent decisions indicate the broad application of the tax benefit doctrine as extended by *Dobson*. The Court of Claims has held the rule applicable to charitable contributions returned to the grantor because conditions of the gifts were no longer possible to fulfill.[27] The Internal Revenue Service has ruled that where bondholders surrendered claims for past due interest which had previously been deducted by the issuing corporation, there was no increase in the corporation's income if the earlier deduction resulted in no tax benefit.[28] In *Tuttle v. United States*,[29] the Court of Claims applied the doctrine to repayments to bank stockholders of assessments on their bank stock. The court held that the repayments could be recovered tax-free to the extent prior deductions reflecting worthless stock had not been of tax benefit. The rule has even been applied to income resulting from cancellation of indebtedness. In *Helvering v. Jane Holding Corp.*,[30] the taxpayer incurred a debt in a loss year for which he took a non-beneficial deduction. The debt was cancelled in a profit year and the Eighth Circuit held the cancellation not to be income, because the indebtedness was incurred in a year in which deduction was of no tax benefit.[31]

The current tax treatment, then, of an item deducted in one year but subsequently recovered in another is determined by section 111 of the Internal Revenue Code if the item is a bad debt, a prior tax, or a delinquency amount, and by judicial decision and administrative ruling if some other item. Generally, the recovery will be taxed only

25. *Id.* at 506 n.36.

26. T.D. 5454, 1945 CUM. BULL. 68.

27. Alice Phelan Sullivan Corp. v. United States, 381 F.2d 399 (Ct. Cl. 1967); Perry v. United States, 160 F. Supp. 270 (Ct. Cl. 1958).

28. Rev. Rul. 58-546, 1958-2 CUM. BULL. 143.

29. 101 F. Supp. 532 (Ct. Cl. 1951).

30. 109 F.2d 933 (8th Cir. 1940).

31. *See also* Quincy Mining Co. v. United States, 156 F. Supp. 913 (Ct. Cl. 1957), where the taxpayer took a deduction in 1920, a loss year, for costs of used copper ore thrown away. In 1943, the value of the ore was recovered via a new process and the taxpayer was permitted to apportion the 1920 costs to the recovered ore. In Birmingham Terminal Co. v. Commissioner, 17 T.C. 1011 (1951), a railroad incurred retirement losses with regard to its terminal facilities, but deduction of the losses produced no tax savings. Later recovery of a portion of the losses, when the facilities were used by other railroads, was held nontaxable to the extent of the prior nonbeneficial deductions.

to the extent of prior tax benefit. The Internal Revenue Code expresses this in terms of a "recovery exclusion"—that portion of section 111 items initially deducted without affecting tax liability, determined by taking away from the total sum of section 111 items in the original year the amount of those items which reduced taxes.[32]

B. *Tax Benefit Theory*

1. *Legislative Expression.*—Unfortunately, the legislative history of Section 111 is not particularly enlightening. The section was originally enacted during World War II when the overriding congressional concern was financing the war effort,[33] and therefore, little attention was given in committee reports to the inclusion of the Tax Benefit Rule in the legislation. The House Ways and Means Committee, in recommending adoption of the Rule, said only:

> The bill makes substantial changes in the treatment of bad debts. These changes are designed to remove existing inequities. . . .
>
> There is at present considerable confusion as to the state of the law regarding the recovery of bad debts or taxes which have been taken as deductions in previous years. The confusion has arisen as to whether the taxation of the amount of the bad debt or tax recovered in the year of such recovery depends upon the tax benefit which the taxpayer derived from the deduction of these items in a prior year.
>
> The bill settled this question by excluding from the gross income of the taxpayer in the year of recovery the amounts recovered to the extent that the debt or tax did not in any prior taxable year reduce his income tax liability. Securities which become worthless and which result in a capital loss are allowed the same treatment as bad debts and taxes.[34]

The most extensive statement in committee hearings on the Revenue Act of 1942 in regard to enactment of the Tax Benefit Rule came from Mr. Randolph Paul, tax advisor to the Secretary of the Treasury, who emphasized the equitable nature of the tax benefit doctrine and said it would eliminate hardship in many cases.[35]

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32. Treas. Reg. § 1.111-1(b)(2) (1956).

33. *1942 House Hearings* 1-3. The Revenue Act of 1942 was designed to raise American tax revenue by 6 billion dollars. *Id.* at 2.

34. H.R. Rep. No. 2333, 77th Cong., 2d Sess. 44, 45 (1942).

35. Mr. Paul noted that the Secretary of the Treasury had "pointed out that wartime rates make it imperative to eliminate as far as possible existing inequities which distort the tax burden of certain taxpayers." Listed among existing inequities was the following example: "If a taxpayer who has taken a bad debt deduction later receives payment of such debt, such payment must be included in his income even though he obtained no tax benefit from the deduction in the prior year. While this result is theoretically proper under our annual system of taxation, it may produce severe hardship in certain cases through a distortion of the taxpayer's real income. At the same time, any departure from our annual system of taxation always produces administrative difficulties which serve to impede the collection of taxes. It is believed that the hardships can be removed and the administrative difficulties kept to a minimum by excluding from income amounts received in payment of the debt to the extent that

Although there are few legislative materials regarding the original enactment of section 111, the subsequent congressional adoption of the tax benefit principles for basis adjustment[36] clearly demonstrates the equitable purpose of the tax benefit doctrine. The Revenue Act of 1932 had explicitly required basis to be adjusted downward to the extent basis deductions had been allowed, although in excess of the deduction properly "allowable."[37] Previous revenue acts had referred only to the latter amount as a reduction of basis.[38] The purpose of the change in terminology was to ensure that taxpayers who were allowed excessive basis reductions did not receive a double deduction on later disposition of the property involved,[39] that is, if deductions in excess of the amount properly allowable were taken, and did not reduce basis, the taxpayer would retain a correspondingly higher basis for his property, although he benefited from the excessive basis reduction. The question arose whether basis should be reduced in the amount of excessive deductions claimed though not properly allowable, if the reductions resulted in no tax benefit to the taxpayer. Although presented in a different context, the question was essentially the same as that encountered when a taxpayer recovered an item previously deducted without tax benefit. Since the express congres-

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the deduction on account of the debt in the prior year did not produce a tax benefit." *1942 House Hearings* 87-88.

36. INT. REV. CODE of 1954, § 1016(a)(2), *formerly* INT. REV. CODE of 1939, § 113(b)(1)(B).

37. Rev. Act of 1932, § 113(b)(1)(B): "Proper adjustment in respect of the property shall in all cases be made . . . in respect of any period since February 28, 1913, for exhaustion, wear and tear, obsolescence, amortization, and depletion, to the extent allowed . . . ."

38. *See, e.g.*, Rev. Act of 1928, § 111(b)(2); Rev. Act of 1926, § 202(b)(2): "The basis shall be diminished by the amount of the deductions for exhaustion, wear and tear, obsolescence, amortization, and depletion which have since the acquisition of the property been allowable in respect of such property . . . ."

39. The House Ways and Means Committee said: "The Treasury Department has frequently encountered cases where a taxpayer, who has taken and been allowed depreciation deductions at a certain rate consistently over a period of years, later finds it to his advantage to claim that the allowances so made to him were excessive and that the amounts which were in fact 'allowable' were much less. By this time the Government may be barred from collecting the additional taxes which would be due for the prior years upon the strength of the taxpayer's present contentions . . . the Treasury should not be penalized for having approved the taxpayer's deductions. While the committee does not regard the existing law as countenancing any such inequitable results, it believes the new bill should specifically preclude any such possibility." The language of the section was accordingly changed from "allowable" to "allowed." H.R. REP. No. 708, 72d Cong., 1st Sess. 21 (1932). Commenting on the 1932 amendment, the Senate Finance Committee said, "The purpose of the amendment was to provide that, where taxes had been reduced by excessive depreciation erroneously claimed and the statute of limitations had barred the collection of the correct tax, the taxpayer could not then claim that he could restore to basis the amount of the excess depreciation. If this latter result had been permitted, the taxpayer in effect would have been allowed a double deduction." S. REP. No. 1160, 82d Cong., 2d Sess. 2 (1952).

sional purpose in the 1932 enactment was to prevent double deductions,[40] it would seem that the tax benefit theory would have applied to allow the taxpayer's disclaimer of the excessive adjustment previously allowed. The excessive deduction was of no tax benefit to him and thus later disposition with a higher basis would not result in a double deduction. This was the view of the Third Circuit in *Pittsburgh Brewing Co. v. Commissioner.*[41] But the Supreme Court, in *Virginian Hotel Corp. v. Helvering,*[42] took the contrary view and required the taxpayer to reduce his basis by the amount allowed in excess of the amount allowable.

Chief Justice Stone, in dissent,[43] viewed the result as "incongruous" and contrary to the statute. Congress agreed and enacted what is now section 1016(a)(2).[44] In its report, the Senate Finance Committee said, "this legislation is intended to correct the inequitable tax effects . . . from the application of the rule of the Virginian Hotel case."[45] The report also stated that the taxpayer should not

> be penalized because of his error in claiming excessive depreciation in an earlier year, even though for that year he had a net loss . . . even without the deduction of the excessive depreciation. Under those conditions the excess depreciation claimed by the taxpayer could have resulted in no tax advantage to him and in no tax prejudice to the Government.[46]

Thus, the statutory enactments of the Tax Benefit Rule, sections 111 and 1016(a)(2), were intended by Congress to reverse erroneous

40. Note 39 *supra.*

41. 107 F.2d 155 (3d Cir. 1939). The court held that basis was not to be reduced by an amount greater than the amount allowable if any claimed excess over that amount was not tax beneficial.

42. 319 U.S. 523 (1943). In this case the taxpayer had taken depreciation deductions for the years 1927 to 1937 on hotel furnishings and fixtures, although the years 1931 to 1936 were net loss years. In 1938, the Commissioner disagreed with taxpayer's claimed depreciation, asserting a longer useful life for some assets and reducing the depreciation rates accordingly. The taxpayer did not contest the lower rates but contested the Commissioner's basis determination, which had taken account of the depreciation claimed by taxpayer during the net loss years. He argued that the 1931-36 deductions were of no tax benefit and thus should not be used to decrease basis. The Supreme Court did not agree "with the contention that such a reduction [of basis] must be made only to the extent that the deduction for depreciation has resulted in a tax benefit . . . . 'Allowed' connotes a grant. Under our federal tax system there is no machinery for formal allowances of deductions from gross income. Deductions stand if the Commissioner takes no steps to challenge them." *Id.* at 526-27.

43. 319 U.S. at 528 (dissenting opinion).

44. The section reads: "Proper adjustment in respect of the property shall in all cases be made . . . for exhaustion, wear and tear, obsolescence, amortization, and depletion, to the extent of the amount . . . allowed as deductions in computing taxable income under this subtitle or prior income tax laws, and (B) resulting (by reason of the deductions so allowed) in a reduction for any taxable year of the taxpayer's taxes . . . ."

45. S. Rep. No. 1160, 82d Cong., 2d Sess. 2 (1952).

46. *Id.*

court decisions. By implication, at least, judicial decisions could have fully implemented these tax benefit principles without transgressing the congressional prerogative.

2. *Judicial Explanation.*—The decision in *Dobson v. Commissioner* also supports a view that the judiciary has wide discretion in applying the tax benefit doctrine. The Supreme Court there indicated that the Tax Benefit Rule involves a question of proper tax accounting. Answering the Government's contention that the enactment of legislation covering only bad debts, prior taxes and delinquency amounts evidenced an intent to exclude other items from the Tax Benefit Rule, the Court said:

> [I]nstead of affording a reason for overruling the Tax Court, the history of the bad debt recovery question illustrates the mischief of overruling the Tax Court *in matters of tax accounting.* Courts were persuaded to rule as matter of law that bad debt recoveries constitute taxable income, regardless of tax benefit from the charge-off. The Tax Court had first made a similar holding, but had come to hold to the contrary. Substitution of the courts' rule for that of the Tax Court led to such *hardship and inequities* that the Treasury appealed to Congress to extend relief.[47]

The idea of equity and prevention of hardship, while not articulated in the early judicial decisions applying the Tax Benefit Rule, clearly underlay the opinions. In what may be the first case applying the tax benefit principle,[48] a taxpayer received in the taxable year in question an award under the Minerals Relief Act of 20,000 dollars. The award was to compensate for a 38,700-dollar loss suffered when the end of World War I rendered the taxpayer's chrome plant obsolete. He had received 5,500 dollars for the plant at salvage, so that his total out-of-pocket loss was 13,200 dollars. In declining to tax the Minerals Relief award in the year of receipt, the Board of Tax Appeals said, "Under these facts, we do not see how partial reimbursement for losses sustained can be construed to be income."[49] Obviously, it would have been inequitable to do so. Had the annual accounting concept been strictly applied, however, the taxpayer would have been liable for tax on the full amount of the award: he would not have been permitted to point to his losses in prior years to determine taxability of an amount received during the current tax year.

Subsequent decisions by the Board of Tax Appeals often referred to the Tax Benefit Rule as "well settled," and rarely explained the basis of the doctrine.[50] However, recent judicial opinions point ex-

47. Dobson v. Commissioner, 320 U.S. 489, 505 (1943).
48. Edward E. Marshall, 10 B.T.A. 1140 (1928).
49. *Id.* at 1143.
50. *See, e.g.,* National Bank of Commerce of Seattle, 40 B.T.A. 72, 75, *aff'd,* 115 F.2d 875 (9th Cir. 1940): "It is now well settled . . . that if such amounts deducted

plicitly to its equitable foundation. In *Perry v. United States*, the Court of Claims said: "the so-called tax benefit rule . . . is a rule enunciated by the courts, and not by Congress, and is *based altogether on equitable considerations*."[51] And in *Alice Phelan Sullivan Corp. v. United States*, the court reiterated that "the tax-benefit concept is an equitable doctrine . . . ."[52]

3. *Administrative Rulings*.—The administrative explanations of the basis for the Tax Benefit Rule took a different tack. A 1939 General Counsel Memorandum which fully discussed the concept[53] stated that:

> [i]n any case in which a bad debt has been allowed as a deduction and has had the effect of offsetting income . . . the taxpayer has, to that extent, in effect had the benefit of a recovery of capital for income tax purposes . . . . To the extent that a deduction does not result in such a benefit to the taxpayer, the deduction can not be said to have accomplished a return of capital. Until the taxpayer has had the income tax equivalent of a full return of the capital represented by his debt, there is no valid ground for treating as income any amount received in recovery of the debt.[54]

It is submitted that this explanation of the rule is a resort to fiction: recovery of a deducted item is not a return of capital, regardless of whether the deduction produced a tax benefit. The true basis for the ruling is the decision that a taxpayer need only make one tax accounting for an item. When a non-beneficial deduction is taken and the deducted item is subsequently recovered, inclusion of the item in the later year in effect forces the taxpayer to account for the item a second time. Thus, when the memorandum states "there is no valid ground," it means there is no equitable ground, on which to require the double tax accounting which results when a non-beneficially deducted item is included in gross income upon subsequent recovery.

The Bureau continued to ignore the equitable basis of the tax benefit concept when it revoked the favorable 1939 ruling one year later in General Counsel Memorandum 22163. Relying on the Treasury

[in a prior year] did not effect an offset of taxable income for the year in which deducted, then recoveries in subsequent years should not be included in gross income in the years of recovery." The court cited G.C.M. 18525 and 20854, discussed in note 18 *supra*, and Central Loan & Investment Co., 39 B.T.A. 981 (1939), where the court held a tax refund was not includable in gross income because the deduction at time of payment had not been tax beneficial. Referring to the existence of the Tax Benefit Rule, the court there said: "While the question of actual benefit may not heretofore have been made a prerequisite to the inclusion in gross income of the amount recovered, inferentially it has been a controlling factor." *Id.* at 984.

51. 160 F. Supp. 270, 271 (Ct. Cl. 1958).

52. 381 F.2d 399, 403 n.5 (Ct. Cl. 1967).

53. G.C.M. 20854, 1939-1 CUM. BULL. 102.

54. *Id.* at 103-04.

Regulations[55] under section 22(b)(12) of the 1939 Code[56] and *Burnet v. Sanford & Brooks Co.*,[57] the Bureau concluded that "amounts recovered in any taxable year upon debts previously charged off and allowed as a deduction should be treated as taxable income regardless of whether the prior allowance of the deduction resulted in a tax benefit to the taxpayer."[58]

4. *Conclusion.*—The decision that bad debts may not be properly considered capital investments does not compel the conclusion that any later recovery on a deducted bad debt must be accounted for as income whether or not the deduction was tax beneficial. The true basis for exclusion when the deduction did not produce tax benefit is that it would be inequitable to do otherwise. Congress premised its adoption of the tax benefit concept on prevention of hardship and apparently considered the question of taxability of recovery as one of tax accounting.[59] At no point did it indicate the excluded recoveries represented a return of capital.

Both the judicially-created doctrine[60] which taxes recovery of items previously deducted and its exception—the Tax Benefit Rule—are based on equitable considerations. Furthermore, the existence of the rule does not depend upon its statutory embodiment in section 111; rather, as the Supreme Court said in *Dobson*, the rule merely represents proper tax accounting procedure,[61] enacted into law by Congress to prevent the hardship occasioned by courts which refused to accept the tax benefit principle.[62]

C. *Inconsistencies in Current Application of the Tax Benefit Doctrine*

Although the only justification for the Tax Benefit Rule is an attempt to achieve equity, one commentator has observed that the rule "is inherently incapable of producing exact justice."[63] The commentator might better have said that the Tax Benefit Rule as presently applied is inherently incapable of producing exact justice. The current application of the rule is inconsistent with its underlying bases.

55. Treas. Reg. 103, § 19.23(k)-1, providing that amounts received on account of bad debts previously allowed as deductions must be included in gross income in the year in which received.

56. Now INT. REV. CODE of 1954, § 111.

57. 282 U.S. 359 (1931). The memorandum cited the case as establishing that bad debt expenditures were not capital investments.

58. G.C.M. 22163, 1940-2 CUM. BULL. 76, 79.

59. *See* text accompanying notes 34-35, 47 *supra*.

60. Text accompanying note 16 *supra*.

61. Text accompanying note 47 *supra*.

62. Text accompanying notes 34-35, 47 *supra*.

63. Plumb, *supra* note 6, at 176.

A case in point is *Alice Phelan Sullivan Corp. v. United States.*[64] The taxpayer in that case had taken deductions which had been fully offset against income which would have been taxed at rates of 18 and 24 percent; his recovery of the deducted items came in a year in which the applicable tax rate was 52 percent. The taxpayer argued that "exact justice" required him to account only for the tax savings which the prior deductions had provided and cited a previous case in the same court, *Perry v. United States,*[65] which ruled for the taxpayer in an identical factual situation. The Government argued for full taxation of the recovery at current rates and urged that *Perry* be overruled. It viewed the *Perry* decision as out of line with other judicial authority and "contrary to the statutory scheme."[66] The Court of Claims, although admitting the equity of the taxpayer's argument, nevertheless overruled *Perry.* It said that "*Perry* achieved a result which was more equitably just than legally correct,"[67] and cited the *Sanford & Brooks's* emphasis on the integrity of the annual accounting period as a basis for its decision:

> To insure the vitality of the single-year concept, it is essential not only that annual income be ascertained without reference to losses experienced in an earlier accounting period, but also that income be taxed without reference to earlier tax rates. And absent specific statutory authority sanctioning a departure from this principle, it may only be said of *Perry* that it achieved a result which was more equitably just than legally correct.[68]

In fact, however, the annual accounting concept does not demand the *Sullivan* result: the later recovery of items previously deducted is not technically income; rather, such items are taxed because it would be inequitable to allow the taxpayer to take a deduction and also retain the use of the subject-matter of the deduction by means of the later recovery.[69] This doctrine is judicially created and itself departs from the annual accounting concept by referring to prior years to determine whether amounts recovered had previously been deducted.[70] Furthermore, the Tax Benefit Rule as applied in *Sullivan*

64. 381 F.2d 399 (Ct. Cl. 1967). The Sullivan facts were posed hypothetically in Part II (2). *See* text accompanying notes 10-12 *supra.*

65. 160 F. Supp. 270 (Ct. Cl. 1958), *non acq.,* Rev. Rul. 59-141, 1959-1 Cum. Bull. 17.

66. Brief for Government at 10, Alice Phelan Sullivan Corp. v. United States, 381 F.2d 399 (Ct. Cl. 1967). The Treasury Regulations indicate in passing that recoveries of beneficially deducted items are to be taxed at recovery-year rates, although the point is not discussed. Treas. Reg. § 1.111-1(b)(3) (1956).

67. 381 F.2d at 403.

68. *Id.*

69. Text accompanying notes 15 & 16 *supra.*

70. Strict annual accounting would probably require the taxpayer to take a deduction every time he charged off a bad debt; otherwise a later recovery would automatically be taxed as income since reference to the prior year to determine whether a deduction had been taken would be precluded.

requires reference to the prior year to determine whether the deductions were tax beneficial. It does no more violence to the annual accounting concept to calculate tax savings attributable to prior deductions than it does to examine returns of earlier years to compute a "recovery exclusion."

Sullivan clearly makes timing tax determinative. Had the contributed property been returned within a few years of the original transactions, tax rates would likely have varied little; in the 18 years which did elapse, however, tax rates shot up 34 percent. This intervening rate change meant a sizable out-of-pocket tax loss for the taxpayer—an inequitable result for having contributed the use of his property to charity for 18 years. Indeed, the writer of the majority opinion in *Sullivan* noted the injustice:

> This opinion represents the views of the majority and complies with existing law and decisions. However, in the writer's personal opinion, it produces a harsh and inequitable result. Perhaps, it exemplifies a situation 'where the letter of the law killeth; the spirit giveth life.' The tax-benefit concept is an equitable doctrine which should be carried to an equitable conclusion.[71]

While the inequity of *Sullivan* results from the intervening rise in tax rates, other factors could have led to similar out-of-pocket tax losses.[72] For example, the taxpayer's deductions were taken over two years, but recovery was bunched in one year, which could easily have boosted the taxpayer into a higher tax bracket in the recovery year. The taxpayer might also have substantially increased his income since taking the deductions; under the progressive rate structure the recovery would thus be taxed at a higher rate than the income which the deductions offset. But it is not always the taxpayer who suffers when timing is tax determinative. If a deduction taken in one year is recovered over several years, or a deduction taken when income was high is recovered in a low income year, or tax rates declined between deduction and recovery, the Government would suffer tax loss.[73]

71. 381 F.2d at 403 n.5.

72. *See* text accompanying notes 10-13 *supra*.

73. The Government's brief in *Sullivan* noted the possibility of such a result: "The Court's tax adjustment in the *Perry* case, though justified on the basis of equity, is not necessarily any more equitable than inclusion of the recovery in income. The deduction may have been taken during a period of higher taxes or when the taxpayer was in a higher surtax bracket than at the time of recovery. In such an instance the effect of the involuntary retroactive tax adjustment required by *Perry* would be to impose upon the taxpayer who has not been at fault a higher tax in the later year than if the recovery were in fact income." Brief for Government at 17, Alice Phelan Sullivan Corp. v. United States, 381 F.2d 399 (Ct. Cl. 1967). The fallacy in the Government's "equitable" argument is that when the transaction is viewed as a whole, the earlier, more valuable deduction was not warranted. To properly reflect the transaction the taxpayer

This uncertainty could be avoided by requiring the taxpayer to account exactly for the amount of tax savings occasioned by his prior deductions. In this way rates could change, income fluctuate, and recovery or deduction be spread over any number of years without increasing or decreasing the liability of the taxpayer. Such a rule, said the writer of the majority opinion in *Sullivan*, "would avoid a penalty to the taxpayer and an unjust enrichment to the government."[74]

IV. RESTORATION OF CLAIM OF RIGHT ITEMS

A. *Introduction*

Analagous to the problems presented when an item which has been deducted is later recovered are those created when an item required to be included in income under the so-called "claim of right doctrine" must be restored in a later year. The question in both cases is whether the tax consequences of the later event should be determined by reference to the tax treatment of the item in the earlier year. Thus, assume that *A* recovered a judgment against *B* for 2,000 dollars in 1960 and was paid that amount. The claim of right doctrine would require *A* to include the 2,000 dollars in his 1960 gross income.[75] If, however, the judgment were reversed on appeal in 1964 and *A* required to return the 2,000 dollars to *B*, should he take a deduction against his 1964 income on repayment, or should his 1960 tax liability be adjusted to restore the additional taxes occasioned by the inclusion of the item in that year? Strict annual accounting requires the former alternative. But, as demonstrated with problems involving the Tax Benefit Rule,[76] adherence to the annual accounting concept could make timing tax determinative and increase the taxpayer's liability.[77] And, as noted earlier, the difference is as likely to work to the detriment of the Government as to the taxpayer.[78] Thus, while the taxpayer faces an inclusion problem in the tax benefit situation

should remit the tax savings to which later events show he was not entitled. That is, there is no reason why the taxpayer should be subject to a greater tax burden, as in *Sullivan*, or receive a windfall, as in the hypothetical posed in the Government's brief, when the later events show a prior deduction was unwarranted. The equitable solution for the taxpayer and the Government is to adjust tax liability to reflect the transaction as it actually occurred, not to segregate events in one year from those in another as if they were unrelated.

74. 381 F.2d at 403 n.5.

75. North Am. Oil Consol. v. Burnet, 286 U.S. 417 (1932).

76. *See* text accompanying notes 8-13 *supra*.

77. For example, if a taxpayer were in a 50% bracket during the year of receipt and a 25% bracket at restoration, deduction in the latter year would in effect restore only half the amount of taxes which subsequent events show the taxpayer did not owe.

78. Text accompanying notes 13 & 14 *supra*.

and a deduction problem upon restoration of a claim of right item, the basic question is the same—whether to apply strict annual accounting and consider the later event on the basis of facts as they appear in that year alone, or whether to view the later event in relation to facts occuring in the earlier year which are directly connected to the later event.

B. *Development and Theory of Taxation for Claim of Right Restorations*

1. *The North American Oil Decision.*—At the outset, the initial taxation of items held under a claim of right should be clearly distinguished from tax consequences attendant upon restoration of those items. It is only the latter with which this paper deals. Unfortunately, the Supreme Court did not explicitly analyze the tax concepts involved in regard to these two problem areas in the case which became the leading authority on tax treatment of both. In *North American Oil Consolidated v. Burnet*,[79] the Supreme Court clearly spelled out the claim of right doctrine, but it also added dicta regarding the taxation of claim of right items which later had to be restored. The case involved oil property in the hands of a receiver appointed to hold the property pending litigation between the Government and the owner. The receiver collected income from the property in 1916, which was paid to the owner in 1917 when a judgment was rendered in his favor. An appeal was taken which ultimately resulted in affirmance of the lower court decision for the owner. The problem in *North American Oil* was to determine the proper year for inclusion of the income in the owner's tax return. The Court held the receipt in 1917 was under a claim of right and therefore required inclusion for that year, but said further:

> If in 1922 the Government had prevailed and the company had been obliged to refund the profits received in 1917, it would have been entitled to a deduction from the profits of 1922, not from those of any earlier year.[80]

Although this statement was dictum, it fathered a doctrine which some commentators indicate ultimately directed the course of congressional legislation dealing with taxation of claim of right restorations.[81]

The Supreme Court was presented an opportunity to disavow its *North American Oil* dictum in *United States v. Lewis*.[82] There the

79. 286 U.S. 417 (1932).
80. *Id.* at 424.
81. Casey & Craig, *Restoration of Claim-of-Right Income and Percentage Depletion*, 68 DICK. L. REV. 381, 384 (1964); Webster, *The Claim of Right Doctrine: 1954 Version*, 10 TAX L. REV. 381, 384 (1955).
82. 340 U.S. 590 (1951).

taxpayer had received 22,000 dollars as a bonus in 1944, but due to incorrect computation he was forced to restore 11,000 dollars to his employer in 1946. After making the restoration, the taxpayer sued in the Court of Claims for a refund of his 1944 tax attributable to the restored sum. The Court of Claims allowed recovery, stating that:

> We observe that the language [from *North American Oil*] relied on by the Government was *obiter* . . . . [I]n the instant case . . . the taxpayer, having received the income, paid his tax, and did not ask the Government to wait for its revenue until he had completed his litigation or resolved his question otherwise . . . the naked question [is] whether the Government should keep the money paid to it upon the mistaken assumption that the citizen had taxable income, when in truth he did not have the income, since he was under a legal obligation to return the money to his employer.[83]

Nonetheless, on appeal the Supreme Court relied on the *North American Oil* dictum, strictly applied the annual accounting concept, and denied the taxpayer recovery of the taxes paid in 1944:

> Income taxes must be paid on income received (or accrued) during an annual accounting period . . . . The "claim of right" interpretation of the tax laws has long been used to give finality to that period, and is now deeply rooted in the federal tax system. . . . We see no reason why the Court should depart from this well-settled interpretation merely because it results in an advantage or disadvantage to a taxpayer.[84]

Mr. Justice Douglas dissented:

> Many inequities are inherent in the income tax. We multiply them needlessly by nice distinctions which have no place in the practical administration of the law. If the refund were allowed, the integrity of the taxable year would not be violated. The tax would be paid when due; but the Government would not be permitted to maintain the unconscionable position that it can keep the tax after it is shown that payment was made on money which was not income to the taxpayer.[85]

Congress took cognizance of the "inequities" occasioned by the *Lewis* holding, and overturned it by enacting section 1341 into the 1954 Code.[86] Committee reports recommending the legislation specifically repudiated the *Lewis* decision,[87] and the House Ways and Means Committee noted that "in many instances . . . the deduction

2. *Section 1341.*—The statutory solution provided by section 1341 is

83. 91 F. Supp. 1017, 1020-22 (Ct. Cl. 1950).
84. 340 U.S. at 592. Subsequent to this decision the courts were nearly unanimous in following this pronouncement to restrict the taxpayer's relief to deduction in the repayment year. Casey & Craig, *supra* note 81, at 381.
85. 340 U.S. at 592.
86. INT. REV. CODE of 1954, § 1341.
87. H.R. REP. No. 1337, 83d Cong., 2d Sess. A294 (1954); S. REP. No. 1622, 83d Cong., 2d Sess. 451 (1954).

allowable in the later year does not compensate the taxpayer adequately for the tax paid in the earlier year."[88]
in the form of an election to the taxpayer: he may take a deduction in the year he is forced to restore the item, or he may calculate the tax attributable to inclusion of the item in the year he received it and treat that figure as an overpayment of tax for the year of restoration, whichever yields the greater tax savings.[89]

One writer asserts that section 1341's basic policy "is to adopt a transactional approach for these situations under which in effect the taxpayer foregoes his deduction for the year of repayment in return for exclusion of the item from income."[90] Yet, while the approach is basically transactional, some commentators have correctly noted that vestiges of the annual accounting concept remain.[91] Thus, when the taxpayer foregoes deduction in the repayment year and seeks credit for the tax attributable to the restored item in the year of receipt, the credit "is treated as a payment of tax on the last day prescribed by law for payment for the taxable year and will be refunded or credited as an overpayment for that year."[92] The effect is to deny the taxpayer interest on the overpayment for the years intervening between receipt and restoration. Were the congressional solution purely transactional, it would recognize the taxpayer's right to interest on his monies, which the Government used between the receipt and repayment years. Section 1341, however, utilizes the annual accounting concept in treating the restoration year as a unit by regarding the prior year's overpayment as overpayment in the later year, although it does adopt a transactional approach in allowing reference to the prior year to determine the amount of the over-

88. H.R. REP. No. 1337, 83d Cong., 2d Sess. A294 (1954).

89. INT. REV. CODE of 1954, § 1341(a). The section is limited to restoration items in excess of $3,000. In setting that limit, the House Ways and Means Committee said, "The $3,000 limitation is imposed for administrative reasons. Moreover with smaller amounts, excluding the repaid amount from the earlier year's income is likely to have little, if any, tax advantage over taking a deduction in the year of restitution." H.R. REP. No. 1337, 83d Cong., 2d Sess. 87 (1954). Section 1341 does not apply in the case of deduction allowable regarding certain items included in gross income because of their sale or disposition as an inventory item, nor to certain refunds made by a regulated public utility. INT. REV. CODE of 1954, § 1341(b)(2). The former exception was made because of congressional feeling that such returns could be adequately provided for by means of reserves for estimated expenses under section 462. H.R. REP. No. 1337, 83d Cong., 2d Sess. A294 (1954).

90. S. SURREY & W. WARREN, FEDERAL INCOME TAXATION CASES AND MATERIALS 551 (1960).

91. Casey & Craig, *supra* note 81, at 387; Webster, *supra* note 81, at 384. Webster maintains that when "the claim of right doctrine is used to justify and explain the requirement that the correction of that income item on the basis of later developed facts may not be made in the year of receipt, it is being conceptually confused with the annual accounting concept . . . ." *Id.*

92. H.R. REP. No. 1337, 83d Cong., 2d Sess. A295 (1954).

payment. In those situations where the taxpayer does not elect to forego the deduction upon restoration,[93] the approach is clearly not transactional, but is in line with the annual accounting concept as applied in *Lewis.*

C. *Recommendation of Transactional Approach for Claim of Right Restorations*

Although the section 1341 election is always to the taxpayer's benefit,[94] adoption of a purely transactional approach is preferable. As one writer declared, a "conceptually acceptable approach" would not tolerate election.[95] Nor is there any sound policy reason for providing a windfall to the chance taxpayer who finds that a deduction in the restoration year will result in greater tax savings. Rather, to achieve conceptual consistency and assure fairness among taxpayers, the transaction should be viewed as a whole and the taxpayer required to adjust his prior year's tax liability, thereby receiving as a refund or credit only that amount which he actually overpaid. He should not receive a windfall because tax rates or his own personal income have risen between the years of receipt and restoration. Furthermore, as other writers have suggested,[96] the taxpayer should be awarded interest on the amount overpaid for the years during which the Government had the use of his money. Thus, the overpayment would not be treated fictitiously as an overpayment of tax for the year of restoration, but would be acknowledged as an overpayment for the year of receipt, the year in which the erroneous payment actually occurred.

V. RECOMMENDATION OF TRANSACTIONAL ACCOUNTING FOR TRANSACTIONAL ITEMS

A. *Elimination of Inconsistencies of Strict Annual Accounting*

The transactional approach recommended for restoration of items held under a claim of right is also the proper manner in which to deal with the recovery of items which previously produced a tax beneficial deduction.[97] Although the Tax Benefit Rule adequately

93. INT. REV. CODE of 1954, § 1341(a)(4).

94. The taxpayer must take a deduction in the restoration year or readjust his liability in light of the prior year, depending on which alternative produces the *lesser* tax.

95. Webster, *supra* note 81, at 387.

96. *See, e.g.,* Bierman & Helstein, *Accounting for Prepaid Income and Estimated Expenses Under the Internal Revenue Code of 1954,* 10 TAX L. REV. 83, 116 (1954); Webster, *supra* note 81, at 400.

97. Other proponents of some form of a transactional approach include Casey & Craig, *supra* note 81; Plumb, *supra* note 6, at 176-82; Surrey & Warren, *The Income*

treats recoveries where a prior deduction resulted in no tax benefit,[98] where the prior deduction was beneficial the later recovery is often inconsistently treated to the detriment of the taxpayer or the Government.[99] The recommended transactional approach would allow tax consequences to be measured by the actual economic effect of a transaction and would eliminate timing as determinative of tax consequences. Under the transactional approach it makes no difference when the taxpayer recovers an item previously deducted. In all cases, he must repay the tax savings occasioned by the earlier deduction to which later events show he was not entitled.

Not only would the transactional approach more accurately reflect economic reality, but it also would better effect the underlying equitable basis for the Tax Benefit Rule, a basis acknowledged by both Congress[100] and the courts,[101] including the United States Supreme Court.[102] The transactional approach would carry, as Judge Collins said in *Sullivan*, "an equitable doctrine . . . to an equitable conclusion."[103] It would eliminate the criticism that the "tax benefit doctrine . . . is an erratic and arbitrary one, disregarding completely the impact of changing tax rates and changing tax brackets."[104]

Moreover, the transactional approach would be more consonant with the values of good tax law than is the current approach. It would assure fairness among taxpayers by treating them uniformly, whereas the annual accounting approach, except in rare cases,[105] results in either inequity or windfall to the taxpayer.[106] The transactional approach would pose no substantial problem in administration. Under the *Sullivan* view prior tax returns must be examined, first, to

Tax Project of the American Law Institute: Gross Income, Deductions, Accounting, Gains and Losses, Cancellation of Indebtedness, 66 HARV. L. REV. 761, 797-99 (1953); Webster, *supra* note 81, at 401-02.

98. *See* text accompanying notes 8 & 9 *supra*, which demonstrates application of the Tax Benefit Rule to eliminate the "dry deduction" problem.

99. Text accompanying notes 10-14 *supra*.

100. H.R. REP. No. 2333, 77th Cong., 2d Sess. 44-45 (1942).

101. *See, e.g.*, Alice Phelan Sullivan Corp. v. United States, 381 F.2d 399 (Ct. Cl. 1967); *and* Perry v. United States, 160 F. Supp. 270, 271 (Ct. Cl. 1958), discussed in this regard at text accompanying notes 51 & 52 *supra*.

102. Dobson v. Commissioner, 320 U.S. 489, 505 (1943).

103. 381 F.2d at 403 n.5.

104. Surrey & Warren, *supra* note 97, at 798.

105. Only where tax rates and taxpayer income remain constant and recovery occurs over the same number of years and in the same amounts per year as the original deductions will the transactional and strict annual accounting approaches produce identical results.

106. If rates go down, or the taxpayer has less income in the year of recovery than in the deduction year, or recovery is effected over more years than deduction, the taxpayer will receive a windfall. If these factors are reversed, the taxpayer pays more than he equitably owes. In either set of circumstances, timing of the recovery determines the tax consequence.

see if there was a deduction in the earlier year and, second, to determine the extent to which the deduction was tax beneficial.[107] Once the prior returns are involved, calculation of the tax attributable to the deduction would be a relatively minor additional step.

Furthermore from the standpoint of revenue, neither alternative is certain of higher productivity than the other. The result under strict annual accounting depends on when the later recovery comes and the effect of variables, such as change in tax rate and fluctuation of taxpayer income in the years between deduction and recovery. While the transactional approach could not assure more revenue, it would assure a full return of tax monies due the Government. The transactional approach achieves "exact justice by assuring that the taxpayer restores the precise amount, in dollars of tax, by which he profited from the deduction."[108]

B. *Judicial or Administrative Adoption*

While adoption of a purely transactional approach in taxing restoration of items held under a claim of right requires amendment of section 1341, it is suggested that implementation of that approach for tax benefit situations can be done by judicial or administrative decision.

The Supreme Court in *Dobson* referred to questions in this area as "matters of tax accounting."[109] If so, transactional accounting is no less proper than the *Sullivan* method, since both involve essentially the same mechanics.[110] Furthermore, Congress impliedly acknowledged this area to be one for judicial discretion when it originally enacted section 111. The purpose of enactment was to deter courts who refused to follow the approach taken by the Board of Tax Appeals,[111] which had applied the Tax Benefit Rule for at least fourteen years prior to the enactment of section 111.[112] Since this legislation was designed solely to preserve a remedy of purely judicial and administrative origin, it should be presumed that, in the

107. Text accompanying notes 69 & 70 *supra.*

108. Plumb, *supra* note 6, at 182.

109. 320 U.S. at 505.

110. The only difference is that transactional accounting examines a prior year to determine the tax attributable to deductions in that year, whereas the *Sullivan* approach turns to the prior year to see only if there were a deduction and if it were tax beneficial. *See* text accompanying note 107 *supra.*

111. *See* H.R. REP. No. 2333, 77th Cong., 2d Sess. 44-45 (1942); Dobson v. Commissioner, 320 U.S. 489, 505 (1943).

112. The first application of the tax benefit principle was apparently in Edward E. Marshall, 10 B.T.A. 1140 (1928), discussed in text accompanying notes 48 & 49 *supra.* Section 111 was originally enacted in 1942. Rev. Act of 1942, § 116, INT. REV. CODE of 1939, § 22(b)(12).

silence of Congress, the proper implementation of that remedy was intended to be accomplished by the administrative body and courts which formulated the rule.

Section 111 does not speak to the problem of recovery of tax beneficial deductions; its concern is a "recovery exclusion" where prior deduction was of no benefit.[113] It has been argued that, since Congress enacted section 1346 (which takes a transactional approach regarding recovery of unconstitutional taxes) in the same year in which it enacted section 111, the maxim *expressio unius est exclusio alterius* requires a strict annual accounting approach; that is, the designation of a transactional approach for recovery of unconstitutional taxes implies strict annual accounting was intended for items not mentioned.[114] Another maxim, however, says statutes *in pari materia* are to be construed together. Since Congress was silent as to treatment of recovery of items beneficially deducted in a prior year, if sections 111 and 1346 are read together, under this maxim it could be presumed that Congress intended that such recoveries be taxed similarly to recoveries under section 1346. The point, however, is that Congress did not deal with this problem in section 111. It is of little avail to argue what the silence of Congress meant or means, especially since the tax benefit doctrine is purely of judicial and administrative origin. Its current application, except as to bad debts, prior taxes and delinquency amounts, is wholly dependent upon judicial decision and administrative ruling.[115] A doctrine so independent of statute in origin and current application surely is not dependent on statutory amendment to achieve equitable implementation.

Nor does the annual accounting principle bar the transactional approach. As one writer expressed: "there is one reply [to the objection of violation of annual accounting]: Congress, in enacting section [111], departed from the principle of the annual system . . . in the name of equity."[116] Even the Supreme Court, which spoke of annual accounting as an almost inviolable principle in *Sanford & Brooks*, *Lewis*, and *Healy*,[117] recognized that the principle was not breached when reference to a prior year was to determine tax incidence of a related transaction in a later year. In *Arrowsmith v. Commissioner*, the Court said:

113. INT. REV. CODE of 1954, § 111.

114. Brief for Government at 17, Alice Phelan Sullivan Corp. v. United States, 381 F.2d 399 (Ct. Cl. 1967).

115. That the Tax Benefit Rule remains primarily one of judicial application, despite section 111, see Note, *The Tax Benefit Rule and the Loss Carryover Provisions of the 1954 Code*, 67 YALE L.J. 1394, 1415-17 (1958).

116. Plumb, *supra* note 6, at 178.

117. *See* text accompanying notes 3 & 4, 84 *supra*.

> this principle [of annual accounting] is not breached by considering all the 1937-1944 liquidation transaction events in order to properly classify the nature of the 1944 loss for tax purposes. Such an examination is not an attempt to reopen and readjust the 1937 to 1940 tax returns, an action that would be inconsistent with the annual tax accounting principle.[118]

Congress explicitly approved the *Arrowsmith* approach as to restoration of claim of right items when it enacted section 1341.[119] Furthermore, whereas annual accounting was at one time a rigid tenet of federal income taxation, current exceptions to that principle are so numerous that one may almost question whether the exceptions have eaten up the rule. In the Internal Revenue Code alone there are at least 58 deviations from annual accounting.[120] Transactional accounting is not inconsistent with this statutory scheme, and, as discussed above,[121] does no more violence to annual accounting than current judicial applications of the Tax Benefit Rule.

118. 344 U.S. 6, 8-9 (1952).

119. S. Rep. No. 1622, 83d Cong., 2d Sess. 452 (1954); H.R. Rep. No. 1337, 83d Cong., 2d Sess. A294 (1954).

120. Exceptions are contained in sections: 46(b) (carryback and carryforward of investment tax credit); 47 (recapture of investment tax credit); 72(n)(2) (averaging of certain distributions to self-employed); 72(m)(5) (spreading penalty applicable to certain owner-employee pension plans); 80(b) (tax benefit rule regarding recovery of certain securities); 111; 167 (depreciation); 168 (amortization of emergency facilities); 169 (amortization of grain-storage facilities); 171 (amortization of bond premium); 172 (net operating loss carryback and carryforward); 178 (amortization, depreciation allowance to lessees); 179 (small business additional depreciation); 248 (amortization of "organizational expenses"); 267 (disallowance of deduction between related taxpayers); 332 (nonrecognition on subsidiary liquidation); 336 (nonrecognition on corporate liquidation); 337 (nonrecognition on 12-month liquidation); 401-05 (qualified pension, profit-sharing plans); 421-25 (qualified stock options); 441(f) (election of 53-week taxable year); 443 (return for less than 12 months); 451 (long-term income reporting methods); 453 (installment income reporting); 454 (election regarding discount obligations); 455-56 (prepaid income); 472 (last-in, first-out inventories); 481 (change in accounting method); 482 (allocation of income and deductions among taxpayers); 563 (extension of taxable year to determine dividends paid); 564 (carryover for dividends paid deduction); 663(b) (estate distribution); 666 (throwback rules); 812 (insurance company operations loss carryback and carryforward); 825 (mutual insnrance company unused loss deduction carryback and carryforward); 855 (regulated investment company dividend declaration); 858 (real estate investment trust dividend declaration); 1016(a)(2); 1031-38 (common nonrecognition situations); 1201-02 (capital gain provisions); 1242 (net operating loss carryback and carryforward for small business company stock); 1245, 1250 (depreciation recapture); 1247(a)(2)(B) (extension of taxable year for foreign investment company to determine dividends paid); 1301-05 (income averaging); 1311-15 (correction of errors of prior years); 1321 (involuntary liquidation of LIFO inventory); 1331-37 (tax benefit rule regarding war loss recoveries); 1341; 1342 (recovery of item held by another under claim of right); 1346 (recovery of unconstitutional federal taxes); 1351 (tax benefit rule regarding recovery of foreign expropriation losses); 1375(f) (extension of taxable year to determine distributions of small business corporations); 1383 (co-op redemption of nonqualified written notices or per-unit retain certificates); 1481-82 (mitigation of effect of renegotiation of government contracts); 1501 (filing of consolidated return by certain affiliated corporations); 6851 (termination of taxable year in jeopardy situation).

121. Text accompanying notes 106 & 107 *supra*.

The statute of limitations[122] would not present a problem, because there would be no assessment or collection of tax for the prior year, but rather a determination of tax liability for the recovery in the later year.[123]

C. *Statutory Amendment*

1. *Tax Benefit Rule.*—Although judicial or administrative implementation of the transactional approach is possible, decisions such as *Sullivan*—where the court, though presented with a direct precedent for the transactional approach[124] and recognizing the inequity of its nontransactional result,[125] felt judicial implementation would have been invalid—indicate a legislative solution may be necessary. The American Law Institute's 1953 Income Tax Project recommended an approach similar to that of section 1341.[126] It provided an election between inclusion of the recovery in income and reopening of the prior year to account exactly for tax savings. It is submitted that a more appropriate approach would be to *require* reopening of the prior year. The election, as discussed in regard to claim of right restorations,[127] is not "conceptually acceptable" and nearly always results in an inexact tax accounting.

The taxpayer should be liable for interest on the amount of tax savings from the earlier year, since he has had the use of the equivalent of this amount, to which later events show he was not entitled.[128] While the statute of limitations would not have to be waived to require accounting for the prior tax savings,[129] it is likely that a waiver would be necessary in order to require payment of interest on the amount found due. Precedent for such a waiver exists in the mitigation sections, 1311-1314.

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122. INT. REV. CODE of 1954, § 6501.

123. "The statute of limitations bars assessment or collection of an additional tax for *that year*; but it has no bearing on the determination of a recovery exclusion in a later year." Plumb, *supra* note 6, at 170-71. *Accord,* Lassen, *supra* note 2, at 475: "The new element in the later taxable period is the decisive factor."

124. Perry v. United States, 160 F. Supp. 270 (Ct. Cl. 1958).

125. 381 F.2d at 403 n.5.

126. *See* discussion of the ALI proposal by Surrey & Warren, *supra* note 97, at 797-99.

127. Text accompanying notes 94-96 *supra.*

128. Precedent for requirement of interest exists in § 1342, which applies when a party takes a deduction because another is paid money or property by a court decision in a patent infringement suit. If the decision is reversed, the person who took the deduction because of the other's claim of right may elect between inclusion of the recovery in income for the year of the reversal and accounting for the tax savings occasioned by the prior deduction. If the latter alternative is chosen, the taxpayer is required to pay interest on the tax savings for the years between deduction and recovery. *See* S. REP. No. 1254, 1955 U.S. CODE, CONG. & ADMIN. NEWS 3106.

129. *See* note 123 *supra.*

The ALI Project recommended the transactional approach only if the amount involved were significant.[130] Apparently the limitation to significant recoveries was in deference to administrative convenience.[131] If such a limitation is necessary, it is suggested that a recovery should be considered significant only if in excess of 3,000 dollars. This would be consistent with the present limitation in section 1341, and since under the present progressive rate structure, tax brackets usually vary from 2,000 to 4,000 dollars, the taxpayer would likely achieve little benefit from the transactional approach[132] when amounts under 3,000 dollars are involved. Such a limitation would still effectively guard against inequity due to fluctuation of taxpayer income, and also eliminate any substantial inequity in the case of deduction taken over several years but recovered in one year. While it would not provide relief in the case where tax rates have changed between deduction and recovery, rates have remained fairly constant since 1954,[133] and the impact of rate change on an item of less than 3,000 dollars is likely to be slight.

2. *Section 1341.*—Consistent with the proposed legislative treatment for tax benefit problems, section 1341 should be amended to eliminate election and require Government refund of the tax attributable to the restored claim of right item. As discussed above,[134] this amendment should provide interest to the taxpayer for the years during which the Government had use of the tax monies to which later events show it was not entitled.

D. *Characterization Problem*

It should be observed that the approach recommended by this paper resolves the characterization problem with which the Supreme Court was faced in *Arrowsmith v. Commissioner.*[135] There taxpayers had liquidated a corporation and taken capital gain. A hidden liability emerged several years later and the taxpayers were forced to

130. A recovery was deemed significant if in excess of $2000 or 20% of the taxpayer's current net income. Surrey & Warren, *supra* note 97, at 798.

131. That was the reason advanced for a similar limitation in § 1341. *See* H.R. REP. No. 1337, 83d Cong., 2d Sess. 87 (1954).

132. In addition to § 1341, the income averaging provision, §§ 1301-05 also conditions application on a $3000 minimum amount. In selecting that figure, the House Ways and Means Committee said, "with the progressive rate structure with tax brackets usually of $2000 to $4000, smaller amounts achieve little, if any, benefit from averaging." H.R. REP. No. 749, 88th Cong., 1st Sess. 111 (1963).

133. *See* Surrey & Warren, *supra* note 90, at 21. The Revenue Act of 1964, 78 Stat. 19 (1964), reduced rates somewhat, including a reduction in the overall maximum rates applicable to individuals from 91% to 77%.

134. Text accompanying notes 94-96 *supra.*

135. 344 U.S. 6 (1952).

pay the obligation as transferees of the liquidated corporation's assets. They attempted to deduct the payment against ordinary income, but the Supreme Court, noting that had the liability been satisfied during liquidation it would have offset income taxed as capital gain, required the taxpayers to take a capital loss.

Here, then, was an instance where the taxpayer argued for strict annual accounting, citing *North American Oil* and *Lewis*. But the Supreme Court rejected the contention that the annual accounting concept was violated by consideration of the prior tax history of a particular item in order to determine tax treatment for the current year, and as to characterization of restorations of claim of right items, dictated a transactional approach.[136] This approach was explicitly retained under section 1341: both the House Ways and Means and Senate Finance Committees referred to their understanding that the *Arrowsmith* principle was embodied in that section.[137]

Theoretically, the characterization question remains open with regard to the tax benefit situation. Assume, for example, a securities dealer who took an ordinary loss for worthless stock in 1960, which was restored to value in 1965 when he was no longer a dealer, but was engaged in the grocery business. Since the stock represents a capital asset in his hands, may he take a capital gain on the later recovery, although the original deduction offset ordinary income?

136. A portion of the *Arrowsmith* opinion is quoted at note 118 *supra*. Strangely enough, Mr. Justice Douglas, who dissented from the failure to take a transactional approach in *Lewis*, dissented from adoption of the transactional approach here: "There were no capital transactions in the year in which the losses were suffered. These transactions occurred and were accounted for in earlier years in accord with the established principle that each year is a separate unit for tax accounting purposes." 344 U.S. at 9 (dissenting opinion). However, he did explain the inconsistent positions taken in his dissents: "I have not felt, as my dissent in the *Lewis* case indicates, that the law made that [annual accounting] an inexorable principle. But if it is the law, we should require observance of it." 344 U.S. at 9-10 (dissenting opinion). Mr. Justice Jackson also dissented, noting that while the result here prevented a "windfall" to the taxpayer, the Government's "victory may have implications in future cases which will cost the Treasury more than a defeat." If there were undisclosed claims here instead of liabilities, he said, "the logic of the Court's decision . . . if adhered to, would result in a lesser return to the Government than if the recoveries were considered ordinary income. Would it be so clear that this is a capital loss if the shoe were on the other foot?" 344 U.S. at 11-12 (dissenting opinion).

137. S. REP. No. 1622, 83d Cong., 2d Sess. 452 (1954); H.R. REP. No. 1337, 83d Cong., 2d Sess. A294 (1954). The House Ways and Means Committee said, "this section will apply to cases of transferee liability such as Arrowsmith v. Commissioner. Thus while the deduction in the current year is capital in nature, the taxpayer is not deprived of all relief because his tax is reduced at least to the extent of the tax attributable to the prior inclusion." *Id.* The transactional approach as to characterization was recently reaffirmed by the Internal Revenue Service. Taxpayer had a $100,000 gain when his property was condemned by the state. In a later year, following a court action, he had to repay $20,000. The IRS ruled the original transaction determined the character of the loss: since the gain had been capital, the loss was also capital. Rev. Rul 67-331, P-H 1967 FED. TAX SERV. ¶ 55,159.

The question would never be reached under the approach advocated by this note. Rather, the transaction would be viewed as a whole. In light of the subsequent restoration to value of the stock, it is apparent that the earlier loss deduction was unwarranted. Therefore, the taxpayer would be required to account for the tax savings attributable to that deduction. It would not be necessary to characterize the recovery as capital or ordinary, although the tax savings for which he is required to account was dependent on whether his loss deduction in the prior year was capital or ordinary.

VI. CONCLUSION

Federal income taxation is a complex field permeated by technical rules and distinctions which are designed to raise revenue in as fair a manner as possible without undue administrative inconvenience. Circumstances often dictate that one of these values be sacrificed in order that another be achieved. However, where no compelling reason requires otherwise, the tax law should represent a fair compromise between revenue needs, collection ease, and fairness among taxpayers. The current taxation of transactional items does not represent such a compromise. In the name of the technical concept of annual accounting, taxpayers who recover prior deductions or restore claim of right items bear an uneven tax burden. Whether they are unduly favored or treated inequitably is determined by the timing of their recovery or restoration and the intervention of variable factors, such as change in tax rates and fluctuation of personal income. To provide uniform treatment for transactional items, this note recommends the adoption of transactional accounting, which disregards the annual accounting concept to the extent of considering events of prior tax years which are related to events in a later year in order to determine tax liability for the later year. This approach would not sacrifice revenue or administrative convenience. Rather, it would assure exact tax accounting to the Government in all cases, and would involve only a minor additional step in a tax determination process which already requires reference to prior years for both claim of right restorations and recoveries of previously deducted items.

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