University of Houston Law Center
Fall 2026
Course Syllabus
Law 5267, Sec 14880: Tax Accounting

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1. Purpose of this Syllabus. The purpose of this syllabus is to provide details of how this course will proceed, including what you should expect for readings and what will be expected of you during class sessions, how I will grade you, and when I will be available to answer any questions you might have.

2. Introduction, Course Objectives, and Prerequisites. This course will examine the allocation of income and expense items to the proper taxable year. Topics include: the adoption and change of accounting methods; the cash and accrual methods; capitalization v. expensing; depreciation and cost recovery; original issue discount, imputed interest and other time value of money problems; and the annual accounting period concept, including the claim of right doctrine and the tax benefit rule. The only prerequisite for this course is an introductory course in federal income taxation. I assume no prior knowledge of accounting concepts.

3. Course Materials. There is no required text or casebook. I have put together the bulk of the readings and other assignments in the accompanying course packet, which covers the first eleven class sessions. The reading list set out at the beginning of the course packet assigns readings by week. Our first few class sessions will help me get a better sense of how much progress we are likely to make during the entire semester. I will then compile and distribute a second course packet that will span the remainder of the semester. I may occasionally supplement the course packet materials with topical administrative guidance, such as revenue rulings and revenue procedures, and journal articles. I will email you PDFs of such supplementary readings several days before we discuss them in class. You are responsible for looking up and reviewing the relevant statutory and regulatory provisions that you encounter in all your readings. I highlight the more salient of these provisions in the reading list. You are free to access these provisions online or purchase a compilation.

4. **Conduct of Class Sessions, Assignments, and Grading.** The "canonical" time for class sessions is 9:00 a.m. to 11:00 a.m., on Fridays, for a total of 14 weeks. We will meet in synchronous session via Zoom for some or all of that time on most but maybe not all weeks. When we are not meeting via Zoom during the scheduled class time, you will be working on "asynchronous assignments," which are included in the readings for that class session in the course packet, or on "synchronous assignments," questions and problems that I will email you in real time, and which will require you to apply the concepts introduced in the readings for that week.

The problems in the asynchronous assignments, presenting hypothetical fact patterns, will be my main teaching tool. You should study the assigned reading materials with the goal of analyzing the problems that follow. You won't be required to turn in solutions to these problems, but you should come to class sessions prepared to discuss them.

I will ask you to submit your answers to the synchronous assignments, but as long as you send me a timely and substantive response, you will receive full credit. I won't assign any letter grades to your responses, but will be glad to provide you individual feedback at your request.

We will spend a lot of our Zoom time discussing the solutions to the problems in both the asynchronous and synchronous assignments.

Your participation in class discussions over the semester will count for half your course grade.

The remaining half of your course grade will reflect your performance on a self-scheduling 24-hour take-home final exam that you can take any time during exam period. That exam will consist of problems a lot like the problems assigned during the semester.

5. **My Availability.** I will generally be available to answer questions after the end of each class session. You may also make an appointment to meet with me in a Zoom session at a mutually convenient time. Feel free to contact me by email at ajguptaemail@gmail.com or by telephone at (630) 854-7194.

6. **Counseling Options.** Counseling and Psychological Services (CAPS) can help students who are having difficulties managing stress, adjusting to the demands of a

professional program, or feeling sad and hopeless. You can reach CAPS (www.uh.edu/caps) by calling 713-743-5454 during and after business hours for routine appointments or if you or someone you know is in crisis. No appointment is necessary for the "Let's Talk" program, a drop-in consultation service at convenient locations and hours around campus.
http://www.uh.edu/caps/outreach/lets_talk.html

Law 5267: Tax Accounting
Reading List
(Weeks #1 through #11)

Week #1: Introduction; Annual Accounting Concept.

Code § 441(a).
Burnet v. Sanford & Brooks Co., 282 U.S. 359 (1931).

Week #2: Tax Benefit Rule.

Code § 111.
Hillsboro National Bank v. Commissioner, 460 U.S. 370 (1983).

Week #3: Erroneous Deduction Exception.

Mayfair Minerals, Inc. v. Commissioner, 56 T.C. 82 (1971);
Rosen v. Commissioner, 71 T.C. 226 (1978);
Unvert v. Commissioner, 72 T.C. 807 (1979);
Rojas v. Commissioner, 901 F.2d 810 (9th Cir. 1990); and
Hughes & Luce L.L.P. v. Commissioner, 70 F.3d 16 (5th Cir. 1995).

Week #4: Claim of Right Doctrine.

Code § 1341.
North American Oil Consolidated v. Burnet, 286 U.S. 417 (1932);
United States v. Lewis, 340 U.S. 590 (1951); and
United States v. Skelly Oil Co., 394 U.S. 678 (1969).

Week #5: Open Transaction Doctrine; Arrowsmith Doctrine.

Burnet v. Logan, 283 U.S. 404 (1931); and
Arrowsmith v. Commissioner, 344 U.S. 6 (1952).

Week #6: Installment Method.

Code §§ 1001(a), (b); 453(a), (b), (c), (d), (f), (j); 453B(a), (b).
Regulations § 1.453-9(a), (b).
Temp. Regulations § 15a.453-1(a), (b), (d).
Problems.

Week #7: The Complications of Indebtedness.

Crane v. Commissioner, 331 U.S. 1 (1947); and
Commissioner v. Tufts, 461 U.S. 300 (1983).

Week #8: Installment Method with Indebtedness.

Problem.

Week #9: Time Value of Money.

Code § 1272.
Problems.

Week #10: Time Value of Money (contd.)

Code §§ 1274, 1274A, 7872.
Problems.

Week #11: Cash v. Accrual.

Code §§ 446(a)-(c); 451(a); 461(a),(h), (i)(1).
Problems.

statutory limitations" upon the assessment *282 of these 1917 taxes. We see no reason for *restricting this language so as to exclude the limitations subsequently imposed by section 250 (d) of the Act of 1921.

[3] Third. It is contended that the first waiver, even if valid, did not operate to extend the period for the assessment of war profits as distinguished from income taxes. The argument is based on the reference in the waiver, which was prepared by the Commissioner, to "all Federal taxes imposed by the Act of Congress, approved September 8, 1916, as amended by the Act of Congress, approved October 3, 1917," and it is contended that the war profits tax was a separate enactment, not an amendment to the 1916 act, and hence not included within the waiver. It is clear that this waiver was intended to embrace all liability under the 1917 return then pending. Moreover, the only statute approved October 3, 1917, was the Revenue Act of that year, chapter 63 (40 Stat. 300), the general object of which was to increase for war purposes the taxes levied by the act of 1916.

[4] Fourth. The petitioner has argued also that the first waiver did not purport to extend the time for collection. This waiver is identical with that before us in Stange v. United States, 282 U. S. 270, 51 S. Ct. 145, 75 L. Ed. 335, decided this day, which we held was intended to embrace all the steps necessary for the ultimate collection of the tax. The second waiver expressly included "determination, assessment, and collection." Consequently, as the assessment of March 12, 1925, was timely, the right of collection is within section 278 (d) and section 280 of the Revenue Act of 1924, c. 234, tit. 2, 43 Stat. 253, 300, 301 (26 USCA §§ 1061 note, 1064 note), which gives six years from the making of the assessment. Florsheim Bros. v. United States, 280 U. S. 453, 467, 50 S. Ct. 215, 74 L. Ed. 542. Compare Russell v. United States, 278 U. S. 181, 49 S. Ct. 121, 73 L. Ed. 255.

Affirmed.

(282 U. S. 359)

BURNET, Commissioner of Internal Revenue, v. SANFORD & BROOKS CO.

No. 31.

Argued Dec. 5-8, 1930.

Decided Jan. 5, 1931.

1. **Internal revenue** ⚷7(3).

Amount recovered on government contract in tax year *held* taxable income, though loosely representing return of expenditures made in prior years in which there were net losses (Revenue Act 1918, §§ 212(b), 213(a), 230, 232, 233(a), 234(a); Const. Amend. 16).

Revenue Act 1918, 40 Stat. 1057, §§ 213 (a), 230, 232, 233(a), 234(a), assess tax on basis of annual returns showing net result of taxpayer's transactions during fixed accounting period. The expenditures were made in defraying expenses incurred in prosecution of work under contract for purpose of earning profits. No returns had been made under section 212 (b), authorizing returns on accrual basis, or under treasury regulations relative to long-term contracts.

2. **Internal revenue** ⚷25.

Burden rests on taxpayer of showing error in failing to apply statutory provisions or departmental regulations in determining income and profits taxes.

On Writ of Certiorari to the United States Circuit Court of Appeals for the Fourth Circuit.

Proceeding by Sanford & Brooks Company against David Burnet, Commissioner of Internal Revenue. An order of the Board of Tax Appeals sustaining a deficiency assessment for income and profits taxes was reversed by the Circuit Court of Appeals [35 F. (2d) 312], and the Commissioner brings certiorari.

Reversed.

*360

*The Attorney General, and Mr. Claude R. Branch, of Providence, R. I., for petitioner.

Messrs. Harry W. Baetjer and Charles McH. Howard, both of Baltimore, Md., for respondent.

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*Mr. Justice STONE delivered the opinion of the Court.

In this case certiorari was granted, Lucas v. Sanford & Brooks Co., 281 U. S. 707, 50 S. Ct. 240, 74 L. Ed. 1130, to review a judgment of the Court of Appeals for the Fourth Circuit, 35 F.(2d) 312, reversing an order of the Board of Tax Appeals, 11 B. T. A. 452, which had sustained the action of the Commissioner of Internal Revenue in making a deficiency assessment against respondent for income and profits taxes for the year 1920.

[1] From 1913 to 1915, inclusive, respondent, a Delaware corporation engaged in business for profit, was acting for the Atlantic Dredging Company in carrying out a contract for dredging the Delaware River, entered into by that company with the United States. In making its income tax returns for the years 1913 to 1916, respondent added to gross income for each year the payments made under the contract that year, and deducted its expenses paid that year in performing the contract. The total expenses exceeded the pay-

ments received by $176,271.88. The tax returns for 1913, 1915, and 1916 showed net losses. That for 1914 showed net income.

In 1915 work under the contract was abandoned, and in 1916 suit was brought in the Court of Claims to recover for a breach of *362 warranty of the character of the material *to be dredged. Judgment for the claimant, 53 Ct. Cl. 490, was affirmed by this Court in 1920. United States v. Atlantic Dredging Co., 253 U. S. 1, 40 S. Ct. 423, 425, 64 L. Ed. 735. It held that the recovery was upon the contract and was "compensatory of the cost of the work, of which the government got the benefit." From the total recovery, petitioner received in that year the sum of $192,577.59, which included the $176,271.88 by which its expenses under the contract had exceeded receipts from it, and accrued interest amounting to $16,305.71. Respondent having failed to include these amounts as gross income in its tax returns for 1920, the Commissioner made the deficiency assessment here involved, based on the addition of both items to gross income for that year.

The Court of Appeals ruled that only the item of interest was properly included, holding, erroneously as the government contends, that the item of $176,271.88 was a return of losses suffered by respondent in earlier years and hence was wrongly assessed as income. Notwithstanding this conclusion, its judgment of reversal and the consequent elimination of this item from gross income for 1920 were made contingent upon the filing by respondent of amended returns for the years 1913 to 1916, from which were to be omitted the deductions of the related items of expenses paid in those years. Respondent insists that as the Sixteenth Amendment and the Revenue Act of 1918, which was in force in 1920, plainly contemplate a tax only on net income or profits, any application of the statute which operates to impose a tax with respect to the present transaction, from which respondent received no profit, cannot be upheld.

If respondent's contention that only gain or profit may be taxed under the Sixteenth Amendment be accepted without qualification, see Eisner v. Macomber, 252 U. S. 189, 40 S. Ct. 189, 64 L. Ed. 521, 9 A. L. R. 1570; Doyle v. Mitchell Brothers Co., 247 U. S. 179, 38 S. Ct. 467, 62 L. Ed. 1054, the question remains *363 whether the gain or profit which is the *subject of the tax may be ascertained, as here, on the basis of fixed accounting periods, or whether, as is pressed upon us, it can only be net profit ascertained on the basis of particular transactions of the taxpayer when they are brought to a conclusion.

All the revenue acts which have been enacted since the adoption of the Sixteenth Amendment have uniformly assessed the tax on the basis of annual returns showing the net result of all the taxpayer's transactions during a fixed accounting period, either the calendar year, or, at the option of the taxpayer, the particular fiscal year which he may adopt. Under sections 230, 232 and 234 (a) of the Revenue Act of 1918, 40 Stat. 1057, respondent was subject to tax upon its annual net income, arrived at by deducting from gross income for each taxable year all the ordinary and necessary expenses paid during that year in carrying on any trade or business, interest and taxes paid, and losses sustained, during the year. By sections 233 (a) and 213 (a) gross income "includes * * * income derived from * * * business * * * or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever." The amount of all such items is required to be included in the gross income for the taxable year in which received by the taxpayer, unless they may be properly accounted for on the accrual basis under Section 212 (b). See United States v. Anderson, 269 U. S. 422, 46 S. Ct. 131, 70 L. Ed. 347; Aluminum Castings Co. v. Routzahn, 282 U. S. 92, 51 S. Ct. 11, 75 L. Ed. 234, decided November 24, 1930.

That the recovery made by respondent in 1920 was gross income for that year within the meaning of these sections cannot, we think, be doubted. The money received was derived from a contract entered into in the course of respondent's business operations for profit. While it equalled, and in a loose sense was a return of, expenditures made in performing the contract, still, as the Board of Tax Appeals found, the expenditures were *364 *made in defraying the expenses incurred in the prosecution of the work under the contract, for the purpose of earning profits. They were not capital investments, the cost of which, if converted, must first be restored from the proceeds before there is a capital gain taxable as income. See Doyle v. Mitchell Brothers Co., supra, page 185 of 247 U. S., 38 S. Ct. 467.

That such receipts from the conduct of a business enterprise are to be included in the taxpayer's return as a part of gross income, regardless of whether the particular transaction results in net profit, sufficiently appears from the quoted words of Section 213 (a) and from the character of the deductions allowed. Only by including these items of gross income in the 1920 return would it have been possible to ascertain respondent's net income for the period covered by the return, which is what the statute taxes. The excess of gross income over deductions did not any the less constitute net income for the taxable period because respondent, in an earlier period, suffered net losses in the conduct of its business which were in some measure attributable to expenditures made to produce the net income of the later period.

Bowers v. Kerbaugh-Empire Co., 271 U. S. 170, 46 S. Ct. 449, 70 L. Ed. 886, on which respondent relies, does not support its position. In that case the taxpayer, which had lost, in business, borrowed money, which was to be repaid in German marks, and which was later repaid in depreciated currency, had neither made a profit on the transaction, nor received any money or property which could have been made subject to the tax.

But respondent insists that if the sum which it recovered is the income defined by the statute, still it is not income, taxation of which without apportionment is permitted by the Sixteenth Amendment, since the particular transaction from which it was derived did not result in any net gain or profit. But we do not think the amendment is to be so narrowly construed. A taxpayer may be in receipt of net income in one year and not in an-
*365
other. *The net result of the two years, if combined in a single taxable period, might still be a loss; but it has never been supposed that that fact would relieve him from a tax on the first, or that it affords any reason for postponing the assessment of the tax until the end of a lifetime, or for some other indefinite period, to ascertain more precisely whether the final outcome of the period, or of a given transaction, will be a gain or a loss.

The Sixteenth Amendment was adopted to enable the government to raise revenue by taxation. It is the essence of any system of taxation that it should produce revenue ascertainable, and payable to the government, at regular intervals. Only by such a system is it practicable to produce a regular flow of income and apply methods of accounting, assessment, and collection capable of practical operation. It is not suggested that there has ever been any general scheme for taxing income on any other basis. The computation of income annually as the net result of all transactions within the year was a familiar practice, and taxes upon income so arrived at were not unknown, before the Sixteenth Amendment. See Bowers v. Kerbaugh-Empire Co., supra, page 174 of 271 U. S., 46 S. Ct. 449; Pacific Insurance Co. v. Soule, 7 Wall. 433, 19 L. Ed. 95; Pollock v. Farmers' Loan & Trust Co., 158 U. S. 601, 630, 15 S. Ct. 912, 39 L. Ed. 1108. It is not to be supposed that the amendment did not contemplate that Congress might make income so ascertained the basis of a scheme of taxation such as had been in actual operation within the United States before its adoption. While, conceivably, a different system might be devised by which the tax could be assessed, wholly or in part, on the basis of the finally ascertained results of particular transactions, Congress is not required by the amendment to adopt such a system in preference to the more familiar method, even if it were practicable. It would not necessarily obviate the kind of inequalities of which respondent complains. If losses from particular transactions were to be set off
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against *gains in others, there would still be the practical necessity of computing the tax on the basis of annual or other fixed taxable periods, which might result in the taxpayer being required to pay a tax on income in one period exceeded by net losses in another.

Under the statutes and regulations in force in 1920, two methods were provided by which, to a limited extent, the expenses of a transaction incurred in one year might be offset by the amounts actually received from it in another. One was by returns on the accrual basis under Section 212 (b), which provides that a taxpayer keeping accounts upon any basis other than that of actual receipts and disbursements, unless such basis does not clearly reflect its income, may, subject to regulations of the Commissioner, make its return upon the basis upon which its books are kept. See United States v. Anderson, and Aluminum Castings Co. v. Routzahn, supra. The other was under Treasury Regulations (article 121 of Reg. 33 of Jan. 2, 1918, under the Revenue Acts of 1916 and 1917; article 36 of Reg. 45, April 19, 1919, under the Revenue Act of 1918) providing that in reporting the income derived from certain long term contracts, the taxpayer might either report all of the receipts and all of the expenditures made on account of a particular contract in the year in which the work was completed, or report in each year the percentage of the estimated profit corresponding to the percentage of the total estimated expenditures which was made in that year.

[2] The Court of Appeals said that the case of the respondent here fell within the spirit of these regulations. But the court did not hold, nor does respondent assert, that it ever filed returns in compliance either with these regulations, or Section 212 (b), or otherwise attempted to avail itself of their provisions; nor on this record do any facts appear tending to support the burden, resting on the taxpayer, of establishing that the Commissioner
*367
erred in failing to *apply them. See Niles Bement Pond Co. v. United States, 281 U. S. 357, 361, 50 S. Ct. 251, 74 L. Ed. 901.

The assessment was properly made under the statutes. Relief from their alleged burdensome operation which may not be secured under these provisions, can be afforded only by legislation, not by the courts.

Reversed.

460 U.S. 370, 75 L.Ed.2d 130

HILLSBORO NATIONAL BANK, Petitioner

v.

COMMISSIONER OF INTERNAL REVENUE.

UNITED STATES, Petitioner

v.

BLISS DAIRY, INC.

Nos. 81-485, 81-930.

Argued Nov. 1, 1982.

Decided March 7, 1983.

In one case, the United States Tax Court, 73 T.C. 61, found that tax refunds were income to a bank, and the Court of Appeals, Seventh Circuit, 641 F.2d 529, affirmed. In a second case, a summary judgment was granted to a corporate taxpayer in its action for refund, and the judgment was affirmed by the Court of Appeals for the Ninth Circuit, 645 F.2d 19. On writs of certiorari, the cases were consolidated for review. The Supreme Court, Justice O'Connor, held that: (1) where bank paid state property tax on shares for shareholders and was allowed deduction under Internal Revenue Code, while shareholders were not, and, after rejection of challenge to constitutionality of property tax the amounts of the property tax in escrow were refunded to shareholders, and as long as corporation's payment of property tax was not negated by refund to corporation, change in character of funds in hands of state did not require corporation to recognize income for federal income tax purposes under tax benefit rule, but (2) where closely held corporation operating dairy deducted, on purchase, full cost of cattle feed but held substantial portion at end of taxable year and, two days into next taxable year, adopted plan of liquidation and distributed assets, including remaining cattle feed, to shareholders, corporation was bound to include in income the amount of the unwarranted deduction, and the proper increase in taxable income, under tax benefit rule, was that portion of the cost of the grain attributable to amount on hand at time of liquidation.

Reversed in the one case, and reversed and remanded in the other.

Justice Brennan, joining parts of the court's opinion, dissented in the case brought by the bank, and filed statement.

Justice Stevens, with whom Justice Marshall joined, filed statement concurring in the judgment in the case brought by the bank, and dissenting in the case brought by the dairy company.

Justice Blackmun, dissented and filed opinion in each case.

1. Internal Revenue ⚷3138

Purpose of tax benefit rule is not simply to tax "recoveries," but, on contrary, is to approximate results produced by tax system based on transactional rather than annual accounting, and basic purpose is to achieve rough transactional parity in tax and to protect government and taxpayer from adverse effects of reporting transaction on basis of assumptions that an event in subsequent year proves to have been erroneous. 26 U.S.C.A. §§ 111, 162, 162(a), 166(a), 333, 334(c), 336, 1341, 6501(a).

2. Internal Revenue ⚷3138

Tax benefit rule must be applied on case-by-case basis, and court must consider facts and circumstances of each case in light of purpose and function of the provisions granting the deductions. 26 U.S.C.A. §§ 111, 162(a), (a)(3), 166(a)(1).

3. Internal Revenue ⚷3138

Statutory codification of exclusionary aspect of tax benefit rule, requiring taxpayer to include in income only amount of deduction that gave rise to tax benefit, by its terms applies only to bad debt, taxes and delinquency amounts, and does not limit application of exclusionary aspect of tax benefit rule but, on contrary, lists a few applications and represents general endorsement of exclusionary aspect of tax benefit rule to other situations within inclusionary part of the rule. 26 U.S.C.A. § 111.

4. Internal Revenue ⚷3138

Tax benefit rule is of limited nature, and only if occurrence of event in earlier year would have resulted in disallowance of deduction can Internal Revenue Commissioner require compensating recognition of income when event occurs in later year. 26 U.S.C.A. §§ 111, 1245(b)(1, 2), 1250(d)(1, 2).

5. Internal Revenue ⚷3138

Tax benefit rule does not permit Internal Revenue Commissioner or taxpayer to rematch properly recognized income with properly deducted expenses but merely permits balancing entry when apparently proper expense turns out to be improper. 26 U.S.C.A. §§ 111, 166(c), 351.

6. Internal Revenue ⚷3138

To determine applicability of tax benefit rule, it was necessary for court to examine particular provisions of Internal Revenue Code governing transactions to determine whether deductions taken by income taxpayers were actually inconsistent with later events and whether specific nonrecognition provisions prevailed over principle of the tax benefit rule. 26 U.S.C.A. §§ 164(e), 166(c), 351.

7. Internal Revenue ⚷3138

Internal Revenue Code general rule for taxable year of deduction, as applied to case of contested liabilities, does not grant deductions of its own force, but, rather, expenditure must qualify as deductible in character under some other section, and if expenditure does qualify independently as deductible but, because contested, lacks certainty otherwise required for deduction, such provision grants deduction, on condition that tax benefit rule apply, but for tax benefit rule to apply there must be some event that is inconsistent with provision granting the deduction. 26 U.S.C.A. §§ 164(e), 461(f).

8. Internal Revenue ⚷3750

Payment by corporation for benefit of its shareholders is constructive dividend, for income tax purposes. 26 U.S.C.A. §§ 116(a), (a)(1), (b), 164(e), 301(c), 311(a), 316(a).

9. Internal Revenue ⚷3740

At least in some circumstances, dividend deductible by corporation for income tax purposes is within contemplation of the Internal Revenue Code. 26 U.S.C.A. §§ 116(a)(1), (b), 164(e), 301(c), 311(a), 316(a).

10. Internal Revenue ⚷3631

Purpose of Internal Revenue Code provision under which corporation paying tax imposed on shareholder on his interest as shareholder, if shareholder does not reimburse the corporation, is entitled to deduction but shareholder is not allowed deduction for such tax was to provide relief for corporations making such payments, and focus of Congress was on act of payment rather than on ultimate use of funds by state. 26 U.S.C.A. § 164(e).

11. Internal Revenue ⚷3138

Where bank paid state property tax on shares for shareholders and was allowed deduction under Internal Revenue Code, while shareholders were not, and, after rejection of challenge to constitutionality of property tax the amounts of the property tax in escrow were refunded to shareholders, and as long as corporation's payment of property tax was not negated by refund to corporation, change in character of funds in hands of state did not require corporation to recognize income for federal income tax purposes under tax benefit rule. Ill.S.H.A. ch. 120, ¶¶ 557, 558, 676.01; 26 U.S.C.A. §§ 116(a), (a)(1), (b), 164(a, e), 301(c), 311(a), 316(a); U.S.C.A. Const. Amend. 14.

12. Internal Revenue ⚷3138, 3707, 3820

Internal Revenue Code provision providing generally that no gain or loss shall be recognized to corporation on distribution of property in partial or complete liquidation stemmed from Congress' real concern to prevent recognition of market appreciation that has not been realized by an arm's-length transfer to unrelated party rather than to shield all types of income that might arise from disposition of asset, and even in absence of countervailing statutory provisions the command of nonrecognition in such provision is not absolute, and such provision does not prevent application of tax benefit rule. 26 U.S.C.A. §§ 162, 162(a), 262, 336, 1001(a, c), 1245, 1245(a)(1), 1250.

13. Internal Revenue ⚷3707, 3820

Internal Revenue Code section providing generally that no gain or loss shall be recognized to corporation on distribution of property in partial or complete liquidation should be construed in tandem with section concerning gain or loss on sales or exchanges in connection with certain liquidations, the very purpose of the latter section being to create same consequences as the former section. 26 U.S.C.A. §§ 162, 311, 336, 337, 1245, 1245(a), (a)(1), 1250, 1250(a).

14. Internal Revenue ⟹3707, 3820

Congress in providing general rule that no gain or loss should be recognized to corporation for income tax purposes on distribution of property in partial or complete liquidation and in enacting provision concerning gain or loss on sales or exchanges in connection with certain liquidations did not intend to allow corporations to escape taxation on business income earned while carrying on business in corporate form but, rather, intended to shield market appreciation. 26 U.S.C.A. §§ 162, 311, 336, 337, 1245, 1245(a), (a)(1), 1250, 1250(a).

15. Internal Revenue ⟹3138

Tax benefit rule overrides Internal Revenue Code section concerning nonrecognition of gain or loss, for income tax purposes, on sales or exchanges in connection with certain corporate liquidations, and, to extent that the latter statute permits recognition, Congress intended same construction of same language in parallel provision in section providing generally that no gain or loss shall be recognized to corporation on distribution of property in partial or complete liquidation. 26 U.S.C.A. §§ 336, 337.

16. Internal Revenue ⟹3138

Where closely held corporation operating dairy deducted, on purchase, full cost of cattle feed but held substantial portion at end of taxable year and, two days into next taxable year, adopted plan of liquidation and distributed assets, including remaining cattle feed, to shareholders, corporation was bound to include in income the amount of the unwarranted deduction, and the proper increase in taxable income, under tax benefit rule, was that portion of the cost of the grain attributable to amount on hand at time of liquidation.

Syllabus *

Until 1970, Illinois imposed a property tax on shares of stock held in incorporated banks, but in 1970 the Illinois Constitution was amended to prohibit such taxes. The Illinois courts thereafter held that the amendment violated the Federal Constitution, but, pending disposition of the case in this Court, Illinois enacted a statute providing for collection of the disputed taxes and placement of the receipts in escrow. Petitioner Bank in No. 81–485 paid the taxes for its shareholders in 1972, taking the deduction for the amount of the taxes pursuant to § 164(e) of the Internal Revenue Code of 1954 (IRC), which grants a corporation a deduction for taxes imposed on its shareholders but paid by the corporation and denies the shareholders any deduction for the tax. The authorities placed the receipts in escrow. After this Court upheld the constitutional amendment, the amounts in escrow were refunded to the shareholders. When petitioner, on its federal income tax return for 1973, recognized no income from this sequence of events, the Commissioner of Internal Revenue assessed a deficiency against petitioner, requiring it to include as income the amount paid its shareholders from the escrow. Petitioner then sought a redetermination in the Tax Court, which held that the refund of the taxes was includible in petitioner's income. The Court of Appeals affirmed.

In No. 81–930, respondent corporation, which operated a dairy, in the taxable year ending June 30, 1973, deducted the full cost of the cattle feed purchased for use in its operations as permitted by § 162 of the IRC, but a substantial portion of the feed was still on hand at the end of the taxable year. Two days into the next taxable year, respondent adopted a plan of liquidation and distributed its assets, including the cattle feed, to its shareholders. Relying on

* The syllabus constitutes no part of the opinion of the Court but has been prepared by the Reporter of Decisions for the convenience of the reader. See *United States v. Detroit Lumber Co.*, 200 U.S. 321, 337, 26 S.Ct. 282, 287, 50 L.Ed.2d 499.

§ 336 of the IRC, which shields a corporation from the recognition of gain on the distribution of property to its shareholders on liquidation, respondent reported no income on the transaction. The Commissioner challenged respondent's treatment of
371 the transaction, asserting that it should have included as income the value of the feed distributed to the shareholders, and therefore increased respondent's income by $60,000. Respondent paid the resulting assessment and sued for a refund in Federal District Court, which rendered a judgment in respondent's favor. The Court of Appeals affirmed.

Held:

1. Unless a nonrecognition provision of the IRC prevents it, the tax benefit rule ordinarily applies to require the inclusion of income when events occur that are fundamentally inconsistent with an earlier deduction. Pp. 1140–1147.

2. In No. 81–485, the tax benefit rule does not require petitioner to recognize income with respect to the tax refund. The purpose of § 164(e) was to provide relief for corporations making payments for taxes imposed on their shareholders, the focus being on the act of payment rather than on the ultimate use of the funds by the State. As long as the payment itself was not negated by a refund to the corporation, the change in character of the funds in the hands of the State does not require the corporation to recognize income. Pp. 1147–1149.

3. In No. 81–930, however, the tax benefit rule requires respondent to recognize income with respect to the distribution of the cattle feed to its shareholders on liquidation. The distribution of expensed assets to shareholders is inconsistent with the earlier deduction of the cost as a business expense. Section 336, which clearly does not shield the taxpayer from recognition of all income on distribution of assets, does not prevent application of the tax benefit rule in this case. Section 336's legislative history, the application of other general rules of tax law, and the construction of identical language in § 337, which governs sales of assets followed by distribution of the proceeds in liquidation and shields a corporation from the recognition of gain on the sale of the assets, all indicate that § 336 does not permit a liquidating corporation to avoid the tax benefit rule. Pp. 1149–1153.

No. 81–485, 641 F.2d 529 (CA 7), reversed; No. 81–930, 645 F.2d 19 (CA 9), reversed and remanded.

Harvey B. Stephens, Springfield, Ill., for Hillsboro Nat. Bank. 372

James Silhasek, Phoenix, Ariz., for Bliss Dairy, Inc.

Rex E. Lee, Sol. Gen., Washington, D.C., for the C.I.R. and United States.

Justice O'CONNOR delivered the opinion of the Court.

These consolidated cases present the question of the applicability of the tax benefit rule to two corporate tax situations: the repayment to the shareholders of taxes for which they were liable but that were originally paid by the corporation; and the distribution of expensed assets in a corporate liquidation. We conclude that, unless a nonrecognition provision of the Internal Revenue Code prevents it, the tax benefit rule ordinarily applies to require the inclusion of income when events occur that are fundamentally inconsistent with an earlier deduction. Our examination of the provisions granting the deductions and governing the liquidation in these cases leads us to hold that the rule requires the recognition of income in the case of the liquidation but not in the case of the tax refund.

I

In No. 81–485, *Hillsboro National Bank v. Commissioner*, the petitioner, Hillsboro National Bank, is an incorporated bank doing business in Illinois. Until 1970, Illinois imposed a property tax on shares held in incorporated banks. Ill.Rev.Stat., ch. 120, § 557 (1971). Banks, required to retain earnings sufficient to cover the taxes, ⊥373 § 558, customarily paid ⊥the taxes for the shareholders. Under § 164(e) of the Internal Revenue Code of 1954, 26 U.S.C. § 164(e),[1] the bank was allowed a deduction for the amount of the tax, but the shareholders were not. In 1970, Illinois amended its Constitution to prohibit ad valorem taxation of personal property owned by individuals, and the amendment was challenged as a violation of the Equal Protection Clause of the Federal Constitution. The Illinois courts held the amendment unconstitutional in *Lake Shore Auto Parts Co. v. Korzen,* 49 Ill.2d 137, 273 N.E.2d 592 (1971). We granted certiorari, 405 U.S. 1039, 92 S.Ct. 1307, 31 L.Ed.2d 579 (1972), and, pending disposition of the case here, Illinois enacted a statute providing for the collection of the disputed taxes and the placement of the receipts in escrow. Ill. Rev.Stat., ch. 120, ¶ 676.01 (1979). Hillsboro paid the taxes for its shareholders in 1972, taking the deduction permitted by § 164(e), and the authorities placed the receipts in escrow. This Court upheld the state constitutional amendment in *Lehnhausen v. Lake Shore Auto Parts Co.,* 410 U.S. 356, 93 S.Ct. 1001, 35 L.Ed.2d 351 (1973). Accordingly, in 1973 the County Treasurer refunded the amounts in escrow that were attributable to shares held by individuals, along with accrued interest. The Illinois courts held that the refunds belonged to the shareholders rather than to the banks. See *Bank & Trust Co. of Arlington Heights v. Cullerton,* 25 Ill.App.3d ⊥374 721, 726, 324 N.E.⊥2d 29, 32 (1975) (alternative holding); *Lincoln National Bank v. Cullerton,* 18 Ill.App.3d 953, 310 N.E.2d 845 (1974). Without consulting Hillsboro, the Treasurer refunded the amounts directly to the individual shareholders. On its return for 1973, Hillsboro recognized no income from this sequence of events.[2] The Commissioner assessed a deficiency against Hillsboro, requiring it to include as income the amount paid its shareholders from the escrow. Hillsboro sought a redetermination in the Tax Court, which held that the refund of the taxes, but not the payment of accrued interest, was includible in Hillsboro's income. On appeal, relying on its earlier decision in *First Trust and Savings Bank of Taylorville v. United States,* 614 F.2d 1142 (1980), the Court of Appeals for the Seventh Circuit affirmed. 641 F.2d 529, 531 (1981).

In No. 81–930, *United States v. Bliss Dairy, Inc.,* the respondent, Bliss Dairy, Inc., was a closely held corporation engaged in the business of operating a dairy. As a cash basis taxpayer, in the taxable year ending June 30, 1973, it deducted upon purchase the full cost of the cattle feed purchased for use in its operations, as permitted by § 162 of the Internal Revenue Code, 26 U.S.C. § 162.[3] A substantial portion of the feed was still on hand at the end of the taxable year. On July 2, 1973, two days into the next taxable year, Bliss adopted a plan of liquidation, and, during the month of July, it distributed its assets, including the remaining cattle feed, to the shareholders. Relying on § 336, which

1. Section 164(e) provides:

"Where a corporation pays a tax imposed on a shareholder on his interest as a shareholder, and where the shareholder does not reimburse the corporation, then—

"(1) the deduction allowed by subsection (a) shall be allowed to the corporation; and

"(2) no deduction shall be allowed the shareholder for such tax."

Subsection (a) provides, in part:

"Except as otherwise provided in this section, the following taxes shall be allowed as a deduction for the taxable year within which paid or accrued:

. . . . .

"(2) State and local personal property taxes."

2. Although the returns of the shareholders of the bank are not before us, the Commissioner explained that they were required to recognize the refund as income. See 641 F.2d 529, 533, and n. 4 (CA7 1981) (Pell, J., dissenting).

3. Section 162(a) provides in relevant part:

"There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business ...."

shields the corporation from the recogni- ⊥375 tion of gain on the distribution of property to its shareholders on liquidation,[4] Bliss reported no income on the transaction. The shareholders continued to operate the dairy business in noncorporate form. They filed an election under § 333 to limit the gain recognized by them on the liquidation,[5] and they therefore calculated their basis in the assets received in the distribu- ⊥376 tion as provided in § 334(c).[6] Under that provision, their basis in the assets was their basis in their stock in the liquidated corporation, decreased by the amount of money received, and increased by the amount of gain recognized on the transaction. They then allocated that total basis over the assets, as provided in the regulations, Treas.Reg. § 1.334–2, 26 CFR § 1.334–2 (1982), presumably taking a basis greater than zero in the feed, although the amount of the shareholders' basis is not in the record. They in turn deducted their basis in the feed as an expense of doing business under § 162. On audit, the Commissioner challenged the corporation's treatment of the transaction, asserting that Bliss should have taken into income the value of the grain distributed to the shareholders. He therefore increased Bliss' income by $60,000. Bliss paid the resulting assessment and sued for a refund in the District Court for the District of Arizona, where it was stipulated that the grain had a value of $56,565, see Pretrial Order, at 3. Relying on *Commissioner v. South Lake Farms, Inc.*, 324 F.2d 837 (CA9 1963), the District Court rendered a judgment in favor of Bliss. While recognizing authority to the contrary, *Tennessee-Carolina Transportation, Inc. v. Commissioner*, 582 F.2d 378 (CA6 1978), cert. denied, 440 U.S. 909, 99 S.Ct. 1219, 59 L.Ed.2d 457 (1979), the Court of Appeals saw *South Lake Farms* as controlling and affirmed. 645 F.2d 19 (CA9 1981) (*per curiam*).

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4. Section 336 provides:
"Except as provided in subsection (b) of this section and in section 453B (relating to disposition of installment obligations), no gain or loss shall be recognized to a corporation on the distribution of property in partial or complete liquidation." 26 U.S.C. § 336 (1976 ed., Supp. V).

5. Section 333 provides, in relevant part:
"(a) In the case of property distributed in complete liquidation of a domestic corporation . . ., if—
"(1) the liquidation is made in pursuance of a plan of liquidation adopted, and
"(2) the distribution is in complete cancellation or redemption of all the stock, and the transfer of all the property under the liquidation occurs within some one calendar month,
"then in the case of each qualified electing shareholder . . . gain on the shares owned by him at the time of the adoption of the plan of liquidation shall be recognized only to the extent provided in subsections (e) and (f).

. . . . .

"(e) In the case of a qualified electing shareholder other than a corporation—
"(1) there shall be recognized, and treated as a dividend, so much of the gain as is not in excess of his ratable share of the earnings and profits of the corporation accumulated after February 28, 1913, such earnings and profits to be determined as of the close of the month in which the transfer in liquidation occurred under subsection (a)(2), but without diminution by reason of distributions made during such month; but by including in the computation thereof all amounts accrued up to the date on which the transfer of all the property under the liquidation is completed; and
"(2) there shall be recognized, and treated as short-term or long-term capital gain, as the case may be, so much of the remainder of the gain as is not in excess of the amount by which the value of that portion of the assets received by him which consists of money, or of stock or securities acquired by the corporation after December 31, 1953, exceeds his ratable share of such earnings and profits."

6. Section 334(c) provides:
"If—
"(1) property was acquired by a shareholder in the liquidation of a corporation in cancellation or redemption of stock, and
"(2) with respect to such acquisition—
"(A) gain was realized, but
"(B) as the result of an election made by the shareholder under section 333, the extent to which gain was recognized was determined under section 333,
"then the basis shall be the same as the basis of such stock cancelled or redeemed in the liquidation, decreased in the amount of any money received by the shareholder, and increased in the amount of gain recognized to him."

The Government[7] in each case relies solely on the tax benefit rule—a judicially developed principle[8] that allays some of the inflexibilities of the annual accounting system. An annual accounting system is a practical necessity if the federal income tax is to produce revenue ascertainable and payable at regular intervals. *Burnet v. Sanford & Brooks Co.,* 282 U.S. 359, 365, 51 S.Ct. 150, 152, 75 L.Ed. 383 (1931). Nevertheless, strict adherence to an annual accounting system would create transactional inequities. Often an apparently completed transaction will reopen unexpectedly in a subsequent tax year, rendering the initial reporting improper. For instance, if a taxpayer held a note that became apparently uncollectable early in the taxable year, but the debtor made an unexpected financial recovery before the close of the year and paid the debt, the transaction would have no tax consequences for the taxpayer, for the repayment of the principal would be recovery of capital. If, however, the debtor's financial recovery and the resulting repayment took place after the close of the taxable year, the taxpayer would have a deduction for the apparently bad debt in the first year under § 166(a) of the Code, 26 U.S.C. § 166(a). Without the tax benefit rule, the repayment in the second year, representing a return of capital, would not be taxable. The second transaction, then, although economically identical to the first, could, because of the differences in accounting, yield drastically different tax consequences. The Government, by allowing a deduction that it could not have known to be improper at the time, would be foreclosed[9] ⌊from recouping any 378
of the tax saved because of the improper deduction.[10] Recognizing and seeking to

7. In No. 81–485, the Solicitor General represents the Commissioner of Internal Revenue, while in No. 81–930, he represents the United States. We refer to the Commissioner and the United States collectively as "the Government."

8. Although the rule originated in the courts, it has the implicit approval of Congress, which enacted 26 U.S.C. § 111 as a limitation on the rule. See n. 12, *infra.*

9. A rule analogous to the tax benefit rule protects the taxpayer who is required to report income received in one year under claim of right that he later ends up repaying. Under that rule, he is allowed a deduction in the subsequent year. See generally 26 U.S.C. § 1341; 1 B. Bittker, Federal Taxation of Income, Estates and Gifts ¶ 6.3 (1981).

10. When the event proving the deduction improper occurs after the close of the taxable year, even if the statute of limitations has not run, the Commissioner's proper remedy is to invoke the tax benefit rule and require inclusion in the later year rather than to re-open the earlier year. See *Lexmont Corp. v. Commissioner,* 20 T.C. 185 (1953); *South Dakota Concrete Products Co. v. Commissioner,* 26 B.T.A. 1429, 1432 (1932); 1 J. Mertens, Law of Federal Income Taxation § 7.34 (J. Doheny rev. ed. 1981); Bittker & Kanner, The Tax Benefit Rule, 26 UCLA L.Rev. 265, 266 (1978)(hereinafter Bittker & Kanner).

Much of Justice BLACKMUN's dissent takes issue with this well-settled rule. The inclusion of the income in the year of the deductions by amending the returns for that year is not before us in these cases, for none of the parties has suggested such a result, no doubt because the rule is so settled. It is not at all clear what would happen on the remand that Justice BLACKMUN desires. Neither taxpayer has ever sought to file an amended return. The statute of limitations has now run on the years to which the dissent would attribute the income, § 6501(a), and we have no indication in the record that the Government has held those years open for any other reason.

Even if the question were before us, we could not accept the view of Justice BLACKMUN's dissent. It is, of course, true that the tax benefit rule is not a precise way of dealing with the transactional inequities that occur as a result of the annual accounting system, *post,* at 1164, 1165. See n. 12, *infra.* Justice BLACKMUN's approach, however, does not eliminate the problem; it only multiplies the number of rules. If the statute of limitations has run on the earlier year, the dissent recognizes that the rule that we now apply must apply. *Post,* at 1166. Thus, under the proposed scheme, the only difference is that, if the inconsistent event fortuitously occurs between the end of the year of the deduction and the running of the statute of limitations, the Commissioner must reopen the earlier year or permit an amended return even though it is settled that the acceptance of such a return after the date for filing a return is not covered by statute but within the discretion of the Commissioner. See, *e.g., Koch v. Alexander,* 561 F.2d 1115 (CA4 1977) (*per curiam*); *Miskovsky v. United States,* 414 F.2d 954 (CA3 1969). In any other situation, the income must be recog-

avoid the possible distortions of income,[11]
379 the courts have long required the taxpayer to recognize the repayment in the second year as income. See, *e.g., Estate of Block v. Commissioner,* 39 B.T.A. 338 (1939), aff'd *sub nom. Union Trust Co. v. Commissioner,* 111 F.2d 60 (CA7), cert. denied, 311 U.S. 658, 61 S.Ct. 12, 85 L.Ed. 421 (1940); *South Dakota Concrete Products Co. v. Commissioner,* 26 B.T.A. 1429 380
(1932); Plumb, The Tax Benefit Rule Today, 57 Harv.L.Rev., 129, 176, 178, and n. 172 (1943) (hereinafter Plumb).[12]

nized in the later year. Surely a single rule covering all situations would be preferable to several rules that do not alleviate any of the disadvantages of the single rule.

A second flaw in Justice BLACKMUN's approach lies in his assertion that the practice he proposes is like any correction made after audit. Changes on audit reflect the proper tax treatment of items under the facts as they were known at the end of the taxable year. The tax benefit rule is addressed to a different problem—that of events that occur *after* the close of the taxable year.

In any event, whatever the merits of amending the return of the year of the improper deduction might originally have been, we think it too late in the day to change the rule. Neither the judicial origins of the rule nor the subsequent codification permits the approach suggested by Justice BLACKMUN.

The dissent suggests that the reason that the early cases expounding the tax benefit rule required inclusion in the later year was that the statute of limitations barred adjustment in the earlier year. *Post,* at 1164, n. That suggestion simply does not reflect the cases cited. In *Burnet v. Sanford & Brooks Co.,* 282 U.S. 359, 51 S.Ct. 150, 75 L.Ed. 383 (1931), the judgment of the Court of Appeals reflected Justice BLACKMUN's approach, holding that the amount recovered in the later year was not income in that year but that the taxpayer had to amend its returns for the years of the deductions. *Id.,* at 362, 51 S.Ct., at 151. This Court reversed, stating: "That the recovery made by respondent in 1920 was gross income *for that year* ... cannot, we think, be doubted." *Id.,* at 363, 51 S.Ct., at 151. (Emphasis added.) Neither does *Healy v. Commissioner,* 345 U.S. 278, 73 S.Ct. 671, 97 L.Ed. 1007 (1953), a case dealing with income received under claim of right, provide any support for this novel theory. On the contrary, the Court's discussion of the statute of limitations, cited by the dissent, in context, is as follows:

"A rule which required that the adjustment be made in the earlier year of receipt instead of the later year of repayment would generally be unfavorable to taxpayers, for the statute of limitations would frequently bar any adjustment of the tax liability for the earlier year. 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, and would violate the spirit of the annual accounting system." *Id.,* at 284–285, 73 S.Ct., at 675 (footnote omitted).

Even the earliest cases, then, reflect the currently accepted view of the tax benefit rule.

Further, § 111, the partial codification of the tax benefit rule, see n. 8, *supra,* contradicts Justice BLACKMUN's view. It provides that gross income for a year does not include a specified portion of a recovery of amounts earlier deducted, implying that the remainder of the recovery *is* to be included in gross income for that year. See, *e.g.,* S.Rep. No. 830, 88th Cong., 2d Sess. 100 (1964); S.Rep.No. 1631, 77th Cong., 2d Sess. 79 (1942). Even if the judicial origins of the rule supported Justice BLACKMUN, we would still be obliged to bow to the will of Congress.

11. As the rule developed, a number of theories supported taxation in the later year. One explained that the taxpayer who had taken the deduction "consented" to "return" it if events proved him not entitled to it, *e.g., Philadelphia National Bank v. Rothensies,* 43 F.Supp. 923, 925 (ED Pa.1942), while another explained that the deduction offset income in the earlier year, which became "latent" income that might be recaptured, *e.g., National Bank of Commerce v. Commissioner,* 115 F.2d 875, 876–877 (CA9 1940); Lassen, The Tax Benefit Rule and Related Problems, 20 Taxes 473, 476 (1942). Still a third view maintained that the later recognition of income was a balancing entry. *E.g., South Dakota Concrete Products Co. v. Commissioner,* 26 B.T.A. 1429, 1431 (1932). All these views reflected that the initial accounting for the item must be corrected to present a true picture of income. While annual accounting precludes reopening the earlier year, it does not prevent a less precise correction—far superior to none—in the current year, analogous to the practice of financial accountants. See W. Meigs, A. Mosich, C. Johnson, & T. Keller, Intermediate Accounting 109 (3d ed. 1974). This concern with more accurate measurement of income underlies the tax benefit rule and always has.

12. Even this rule did not create complete transactional equivalence. In the second version of the transaction discussed in the text, the taxpayer might have realized no benefit from the deduction, if, for instance, he had no taxable income for that year. Application of the tax bene-

⌊381 ⌊The taxpayers and the Government in these cases propose different formulations of the tax benefit rule. The taxpayers contend that the rule requires the inclusion of amounts *recovered* in later years, and they do not view the events in these cases as "recoveries." The Government, on the other hand, urges that the tax benefit rule requires the inclusion of amounts previously deducted if later events are inconsistent with the deductions; it insists that no "recovery" is necessary to the application of the rule. Further, it asserts that the events in these cases are inconsistent with the deductions taken by the taxpayers. We are not in complete agreement with either view.

[1, 2] An examination of the purpose and accepted applications of the tax benefit rule reveals that a "recovery" will not always be necessary to invoke the tax benefit rule. The purpose of the rule is not simply to tax "recoveries." On the contrary, it is to approximate the results produced by a tax system based on transactional rather than annual accounting. See generally Bittker & Kanner, 270; Byrne, The Tax Benefit Rule as Applied to Corporate Liquidations and Contributions to Capital: Recent Developments, 56 Notre Dame Law. 215, 221, 232 (1980); Tye, The Tax Benefit Doctrine Reexamined, 3 Tax L.Rev. 329 (1948) (hereinafter Tye). It has long been accepted that a taxpayer using accrual accounting who accrues and deducts an expense in a tax year before it becomes payable and who for some reason eventually does not have to ⌊pay the liability must ⌊382
then take into income the amount of the expense earlier deducted. See, *e.g., Mayfair Minerals, Inc. v. Commissioner,* 456 F.2d 622 (CA5 1972) (*per curiam*); *Bear Manufacturing Co. v. United States,* 430 F.2d 152 (CA7 1970), cert. denied, 400 U.S. 1021, 91 S.Ct. 583, 27 L.Ed.2d 632 (1971); *Haynsworth v. Commissioner,* 68 T.C. 703 (1977), affirmance order, 609 F.2d 1007 (CA5 1979); *G.M. Standifer Construction Corp. v. Commissioner,* 30 B.T.A. 184, 186–187 (1934), petition for review dism'd, 78 F.2d 285 (CA9 1935). The bookkeeping entry canceling the liability, though it increases the balance sheet net worth of the taxpayer, does not fit within any ordinary definition of "recovery." [13] Thus, the taxpayers' formulation of the rule neither serves the purposes of the rule nor accurately reflects the cases that establish the rule. Further, the taxpayers' proposal would introduce an undesirable formalism into the application of the tax benefit rule. Lower courts have been able to stretch the definition of "recovery" to include a great variety of events. For instance, in cases of corporate liquidations, courts have viewed

fit rule as originally developed would require the taxpayer to recognize income on the repayment, so that the net result of the collection of the principal amount of the debt would be recognition of income. Similarly, the tax rates might change between the two years, so that a deduction and an inclusion, though equal in amount, would not produce exactly offsetting tax consequences. Congress enacted § 111 to deal with part of this problem. Although a change in the rates may still lead to differences in taxes due, see *Alice Phelan Sullivan Corp. v. United States,* 381 F.2d 399, 180 Ct.Cl. 659 (1967), § 111 provides that the taxpayer can exclude from income the amount that did not give rise to some tax benefit. See *Dobson v. Commissioner,* 320 U.S. 489, 505–506, 64 S.Ct. 239, 248–249, 88 L.Ed. 248 (1943). This exclusionary rule and the inclusionary rule described in the text are generally known together as the tax benefit rule. It is the inclusionary aspect of the rule with which we are currently concerned.

13. See, *e.g.,* Bittker & Kanner, 267; cf. Zysman, Income Derived from the Recovery of Deductions, 19 Taxes 29, 30 (1941) (We are "not concerned with a theoretical or pure economic concept of income, but with gross income within the meaning of the statute").

Although Justice STEVENS insists that this situation falls within the standard meaning of "recovery," it does so only in the sense that an increase in balance sheet net worth is to be considered a recovery. *Post,* at 1161, n. 26. But in *Bliss,* Justice STEVENS asserts that there is no recovery. There, the corporation's balance sheet shows zero as the historic cost of the grain on hand, because the corporation expensed the asset upon acquisition. At the date of liquidation, the historic cost of the grain on hand was in fact greater than zero, and an accurate balance sheet would have reflected an asset account balance greater than zero. The necessary adjustment thus reflects an increase in balance sheet net worth.

the corporation's receipt of its own stock as a "recovery," reasoning that, even though the instant that the corporation receives the stock it becomes worthless, the stock has value as it is turned over to the corporation, and that ephemeral value represents
⌊383 a recovery for the corporation. ⌊See, *e.g., Tennessee-Carolina Transportation, Inc. v. Commissioner,* 582 F.2d, at 382. Or, payment to another party may be imputed to the taxpayer, giving rise to a recovery. See *First Trust and Savings Bank of Taylorville v. United States,* 614 F.2d, at 1146 (alternative holding). Imposition of a requirement that there be a recovery would, in many cases, simply require the Government to cast its argument in different and unnatural terminology, without adding anything to the analysis.[14]

The basic purpose of the tax benefit rule is to achieve rough transactional parity in tax, see n. 12, *supra,* and to protect the Government and the taxpayer from the adverse effects of reporting a transaction on the basis of assumptions that an event in a subsequent year proves to have been erroneous. Such an event, unforeseen at the time of an earlier deduction, may in many cases require the application of the tax benefit rule. We do not, however, agree that this consequence invariably follows. Not every unforeseen event will require the taxpayer to report income in the amount of his earlier deduction. On the contrary, the tax benefit rule will "cancel out" an earlier deduction only when a careful examination shows that the later event is indeed fundamentally inconsistent with the premise on which the deduction was initially based.[15] That is, if that event had occurred within the ⌊same taxable year, it ⌊384
would have foreclosed the deduction.[16] In some cases, a subsequent recovery by the taxpayer will be the only event that would be fundamentally inconsistent with the provision granting the deduction. In such a case, only actual recovery by the taxpayer would justify application of the tax benefit rule. For example, if a calendar-year taxpayer made a rental payment on December 15 for a 30-day lease deductible in the current year under § 162(a)(3), see Treas. Reg. § 1.461–1(a)(1), 26 CFR § 1.461–1(a)(1) (1982); *e.g., Zaninovich v. Commissioner,* 616 F.2d 429 (CA9 1980),[17] the tax benefit

14. Despite Justice STEVENS' assertion that *Tennessee-Carolina* was wrong, *post,* at 1161, n. 26, the case fits what seems to be his definition of a recovery—an enhancement of the taxpayer's wealth—for the corporation in *Tennessee-Carolina* received stock worth more than the balance sheet book value of its assets. See n. 13, *supra.* Thus we disagree with the assertion that the recovery rule is a bright-line rule easily applied.

15. Justice STEVENS accuses us of creating confusion at this point in the analysis by requiring the courts to distinguish "inconsistent events" from "fundamentally inconsistent events." *Post,* at 1161. That line is not the line we draw; rather, we draw the line between merely unexpected events and inconsistent events.

This approach differs from that proposed by the Government in that the Government has not attempted to explain why two events are inconsistent. Apparently, in the Government's view, any unexpected event is inconsistent with an earlier deduction. That view we cannot accept.

16. Justice STEVENS apparently disagrees with this rule, for, although he concurs in the result in *Hillsboro,* he asserts that the events there would have resulted in denial of the deduction had they all occurred in one year. *Post,* at 1161. We find it difficult to believe that Congress placed such a premium on having a transaction straddle two tax years.

17. Justice STEVENS questions whether this amount was properly deductible under § 162(a)(3) and seems to suggest that if it was, Congress meant the deduction to be irrevocable. *Post,* at 1160, n. 25. It is clear that § 162(a)(3) permits the deduction of prepaid expenses that will benefit the taxpayer for a short time into the next taxable year, as in our example, rather than benefiting the taxpayer substantially beyond the taxable year. See generally 1 B. Bittker, *supra* n. 9, ¶ 20.4.1.

The dissent's view that the preferable approach is to scrutinize the deduction more carefully in the year it is taken ignores two basic problems. First, reasons unrelated to the certainty that the taxpayer will eventually consume the asset as expected often enter into the decision when to allow the deduction. For instance, the desire to save taxpayers the burden of careful allocation of relatively small expenditures favors the allowance of the entire deduction in a single year of some business expenditures attributable to operations after the close of the taxable year. See generally *ibid.* Second, 385 rule would not require the recognition of income if the leased premises were destroyed by fire on January 10. The resulting inability of the taxpayer to occupy the building would be an event not fundamentally inconsistent with his prior deduction as an ordinary and necessary business expense under § 162(a). The loss is attributable to the business [18] and therefore is consistent with the deduction of the rental payment as an ordinary and necessary business expense. On the other hand, had the premises not burned and, in January, the taxpayer decided to use them to house his family rather than to continue the operation of his business, he would have converted the leasehold to personal use. This would be an event fundamentally inconsistent with the business use on which the deduction was based.[19] In the case of the fire, only if the lessor—by virtue of some provision in the lease—had refunded the rental payment would the taxpayer be required under the tax benefit rule to recognize income on the subsequent destruction of the building. In other words, the subsequent recovery of the previously deducted rental payment would be the only event inconsistent with the provision allowing the deduction. It therefore is evident that the tax benefit rule must be applied on a case-by-case basis. A court must consider the facts and circumstances of each case in the light of the purpose and function of the provisions granting the deductions.

When the later event takes place in the context of a nonrecognition provision of the Code, there will be an inherent tension between the tax benefit rule and the nonrecognition provision. See *Putoma Corp. v. Commissioner,* 601 F.2d 734, 742 (CA5 1979); *id.,* at 751 (Rubin, J., dissenting); cf. *Helvering v. American Dental Co.,* 318 U.S. 322, 3 S.Ct. 577, 87 L.Ed. 785 (1943)
(tension between exclusion of gifts from 386
income and treatment of cancellation of indebtedness as income). We cannot resolve that tension with a blanket rule that the tax benefit rule will always prevail. Instead, we must focus on the particular provisions of the Code at issue in any case.[20]

we simply cannot predict the future, no matter how carefully we scrutinize the deduction in the earlier year. For instance, in the case of the bad debt that is eventually repaid, we already require that the debt be apparently worthless in the year of deduction, see § 166(a)(1), but we often find that the future does not conform to earlier perceptions, and the taxpayer collects the debt. Then, "the deductions are practical necessities due to our inability to read the future, and the inclusion of the recovery in income is necessary to offset the deduction." *South Dakota Concrete Products Co. v. Commissioner,* 26 B.T.A., at 1432.

18. The loss is properly attributable to the business because the acceptance of the risk of loss is a reasonable business judgment that the courts ordinarily will not question. See *Welch v. Helvering,* 290 U.S. 111, 113, 54 S.Ct. 8, 9, 78 L.Ed. 212 (1933); 1 B. Bittker, *supra* n. 9, ¶ 20.3.2.

19. See 1 B. Bittker, *supra* n. 9, ¶ 20.2.2 ("[F]ood and shelter are quintessential nondeductible personal expenses"). See also pp. 1149–1150, *infra.*

20. An unreserved endorsement of the Government's formulation might dictate the results in a broad range of cases not before us. See, *e.g.,* Brief for United States in No. 81–930 and for Respondent in No. 81–485, p. 20; Reply Brief for Petitioner in No. 81–485, p. 12; Tr. of Oral Arg. 33. For instance, the Government's position implies that an individual proprietor who makes a gift of an expensed asset must recognize the amount of the expense as income, but cf. *Campbell v. Prothro,* 209 F.2d 331, 335 (CA5 1954). See generally 2A J. Rabkin & M. Johnson, Federal Income, Gift and Estate Taxation § 6.01(3) (1982) (discussing Commissioner's treatment of gifts of expensed assets). Similarly, the Government's view suggests the conclusion that one who dies and leaves an expensed asset to his heirs would, in his last return, recognize income in the amount of the earlier deduction. Our decision in the cases before us now, however, will not determine the outcome in these other situations; it will only demonstrate the proper analysis. Those cases will require consideration of the treatment of gifts and legacies as well as §§ 1245(b)(1), (2), and 1250(d)(1), (2), which are a partial codification of the tax benefit rule, see O'Hare, Statutory Nonrecognition of Income and the Overriding Principle of the Tax Benefit Rule in the Taxation of Corporations and Shareholders, 27 Tax L.Rev. 215, 216 (1972), and which exempt dispositions by gift and transfers at death from the operation of the general depreciation recapture rules. Although there may be an inconsistent event in the personal use of an expensed asset,

The formulation that we endorse today follows clearly from the long development of the tax benefit rule. Justice STEVENS' assertion that there is no suggestion in the early cases or from the early commentators that the rule could ever be applied in any case that did not involve a physical recovery, *post,* at 1155–1156 is incorrect. The early cases frequently framed the rule in terms consistent with our view and irreconcilable with that of the dissent. See *Bar-*
387 *nett v. Commissioner,* 39 B.T.A. 864, 867 (1939) ("Finally, the present case is analogous to a number of others, where ... [w]hen some event occurs which is *inconsistent* with a deduction taken in a prior year, adjustment may have to be made by reporting a balancing item in income for the year in which the change occurs") (emphasis added); *Estate of Block v. Commissioner,* 39 B.T.A., at 341 ("When recovery *or some other event which is inconsistent* with what has been done in the past occurs, adjustment must be made in reporting income for the year in which the change occurs") (emphasis added); *South Dakota Concrete Products Co. v. Commissioner,* 26 B.T.A., at 1432 ("[W]hen an *adjustment* occurs which is *inconsistent* with what has been done in the past in the determination of tax liability, the adjustment should be reflected in reporting income for the year in which it occurs") (emphasis added).[21] The reliance of the dissent on the early commentators is equally misplaced, for the articles cited in the dissent, like the early cases, often stated the rule in terms of inconsistent events.[22]

[3] Finally, Justice STEVENS' dissent 388
relies heavily on the codification in § 111 of the exclusionary aspect of the tax benefit rule, which requires the taxpayer to include in income only the amount of the deduction that gave rise to a tax benefit, see n. 12, *supra.* That provision does, as the dissent observes, speak of a "recovery." By its terms, it only applies to bad debts, taxes, and delinquency amounts. Yet this Court has held, *Dobson v. Commissioner,* 320 U.S. 489, 505–506, 64 S.Ct. 239, 248–249, 88 L.Ed. 248 (1943), and it has always been accepted since,[23] that § 111 does not *limit* the application of the exclusionary aspect of the tax benefit rule. On the contrary, it lists a few applications and represents a general endorsement of the exclusionary

that event occurs in the context of a nonrecognition rule, see, *e.g., Campbell v. Prothro, supra,* at 336; 1 B. Bittker, *supra* n. 9, ¶ 5.21, and resolution of these cases would require a determination whether the nonrecognition rule or the tax benefit rule prevails.

21. Justice STEVENS' attempt to discount the explicit statement in *Estate of Block* that inconsistent events would trigger the recognition of income, *post,* at 1156, n. 9, is singularly unpersuasive. The Board of Tax Appeals used the word "recovery" later in the opinion because it was faced with a recovery in that case, not because it meant to repudiate hastily its discussion in the same opinion of the general rule. Similarly, the mere assertion that the broad formulation in *Barnett* followed a discussion of a Treasury Regulation, *post,* at 1156, n. 10, does not support the view of the dissent that the concept of inconsistent events represents a break with the early cases.

22. "The rule requiring taxation of income from the recovery or *cancellation* of items previously deducted is a remedial expedient, designed to prevent the unjust enrichment of a taxpayer and to offset the benefit derived from a deduction to which, *in the light of subsequent events,* the taxpayer was not entitled." Plumb 176 (emphasis added). See also *id.,* at 131, 178.

"In a few words, the basic idea of the Tax Benefit Rule is this: If a taxpayer has derived a benefit from a deduction by reducing his taxable income in the year of deduction, he must declare as taxable income any recovery *or other change of his status* which—*ex nunc*—makes the original deduction seem unjustified." Lassen, The Tax Benefit Rule and Related Problems, 20 Taxes 473 (1942) (emphasis added).

One author saw his subject—the recovery of deductions—as an example of the broader rule: "Sometimes a *subsequent event* reveals the income or deductions as reported by the taxpayer to be erroneous. Thus the unexpected recovery of a portion of an amount lost and already deducted reduces the loss as originally determined. There are even cases in which items apparently finally and accurately determined have to be adjusted *on account of a subsequent event.*" Zysman, Income Derived from the Recovery of Deductions, 19 Taxes 29 (1941) (emphasis added).

23. See, *e.g.,* Bittker & Kanner, 266; Tye 330; Plumb 144–145.

aspect of the tax benefit rule to other situations within the inclusionary part of the rule. The failure to mention inconsistent events in § 111 no more suggests that they do not trigger the application of the tax benefit rule than the failure to mention the recovery of a capital loss suggests that it does not, see *Dobson, supra.*

[4, 5] Justice STEVENS also suggests that we err in recognizing transactional equity as the reason for the tax benefit rule. It is difficult to understand why even the clearest recovery should be taxed if not for the concern with transactional equity, see *supra,* at 1140. Nor does the concern with transactional equity entail a change in our approach to the annual accounting system. Although the tax system relies basically ⌊389 on annual accounting, see *Burnet v. Sanford & Brooks Co.,* 282 U.S., at 365, 51 S.Ct., at 152, the tax benefit rule eliminates some of the distortions that would otherwise arise from such a system. See, *e.g.,* Bittker & Kanner, 268–270; Tye 350; Plumb 178, and n. 172. The limited nature of the rule and its effect on the annual accounting principle bears repetition: *only* if the occurrence of the event in the earlier year would have resulted in the disallowance of the deduction can the Commissioner require a compensating recognition of income when the event occurs in the later year.[24]

Our approach today is consistent with our decision in *Nash v. United States,* 398 U.S. 1, 90 S.Ct. 1550, 26 L.Ed.2d 1 (1970). There, we rejected the Government's argument that the tax benefit rule required a taxpayer who incorporated a partnership under § 351 to include in income the amount of the bad debt reserve of the ⌊390 partnership. The Government's theory was that, although § 351 provides that there will be no gain or loss on the transfer of assets to a controlled corporation in such a situation, the partnership had taken bad debt deductions to create the reserve, see § 166(c), and when the partnership terminated, it no longer needed the bad debt reserve. We noted that the receivables were transferred to the corporation along with the bad debt reserve. *Id.,* at 5, and n. 5, 90 S.Ct., at 1552, and n. 5. Not only was there no "recovery," but there was no inconsistent event of any kind. That the fair market value of the receivables was equal to the face amount less the bad debt reserve, *ibid.,* reflected that the reserve, and the deductions that constituted it, were still an accurate estimate of the debts that would ultimately prove uncollectible, and the deduction was therefore completely consistent with the later transfer of the receivables to the incorporated business. See *Citizens' Acceptance Corp. v. United States,* 320 F.Supp. 798 (Del.1971), rev'd on other grounds, 462 F.2d 751 (CA3 1972); Rev.Rul. 78–279, 1978–2 Cum.Bull. 135; Rev.Rul. 78–278, 1978–2 Cum.Bull. 134; see generally O'Hare, Statutory Nonrecog-

24. Justice STEVENS seems to fear that our approach to the annual accounting system is inconsistent with *Sanford & Brooks* in a way that will vest new power in the tax collector to ignore the annual accounting system. The fear is unfounded. In *Sanford & Brooks,* a taxpayer who had incurred a net loss on a long-term contract managed to recoup the loss in a lawsuit in a later year. The earlier net losses on the contract contributed to net losses for the business in most of the tax years during the performance of the contract. The Court rejected the taxpayer's contention that it should be able to exclude the award on the theory that the award offset the earlier net losses. This adherence to the annual accounting system is perfectly consistent with the approach we follow in the cases now before us. In situations implicating the tax benefit rule or the analogous doctrine permitting the taxpayer to take a deduction when income recognized earlier under a claim of right must be repaid, see n. 9, *supra,* the problem is that the taxpayer has mischaracterized some event. Either he has recognized income that eventually turns out not to be income, or he has taken a deduction that eventually turns out not to be a deduction. Neither of these problems arose in *Sanford & Brooks.* Instead, the problem there was that the taxpayer had properly deducted expenditures and was properly recognizing income but thought that the two should have been matched in the same year. The tax benefit rule does not permit the Commissioner or the taxpayer to rematch properly recognized income with properly deducted expenses; it merely permits a balancing entry when an apparently proper expense turns out to be improper.

nition of Income and the Overriding Principle of the Tax Benefit Rule in the Taxation of Corporations and Shareholders, 27 Tax L.Rev. 215, 219–221 (1972).[25]

[6] In the cases currently before us, then, we must undertake an examination of the particular provisions of the Code that govern these transactions to determine
⊥391 whether the deductions taken by the taxpayers were actually inconsistent with later events and whether specific nonrecognition provisions prevail over the principle of the tax benefit rule.[26]

III

[7] In *Hillsboro,* the key provision is § 164(e).[27] That section grants the corporation a deduction for taxes imposed on its shareholders but paid by the corporation. It also denies the shareholders any deduction for the tax. In this case, the Commissioner has argued that the refund of the taxes by the State to the shareholders is the equivalent of the payment of a dividend from Hillsboro to its shareholders. If Hillsboro does not recognize income in the amount of the earlier deduction, it will have deducted a dividend. Since the general structure of the corporate tax provisions does not permit deduction of dividends, the Commissioner concludes that the payment to the shareholders must be inconsistent with the original deduction and therefore requires the inclusion of the amount of the taxes as income under the tax benefit rule.

⊥**[8]** In evaluating this argument, it is ⊥392
instructive to consider what the tax consequences of the payment of a shareholder tax by the corporation would be without § 164(e) and compare them to the consequences under § 164(e). Without § 164(e), the corporation would not be entitled to a deduction, for the tax is not imposed on it. See Treas.Reg. § 1.164–1(a), 26 CFR § 1.164–1(a) (1982); *Wisconsin Gas & Electric Co. v. United States,* 322 U.S. 526, 527–530, 64 S.Ct. 1106, 1107–1108, 88 L.Ed. 1434 (1944). If the corporation has earnings and profits, the shareholder would have to recognize income in the amount of the taxes, because a payment by a corporation for the benefit of its shareholders is a constructive dividend. See §§ 301(c), 316(a); *e.g., Ireland v. United States,* 621 F.2d 731, 735 (CA5 1980); B. Bittker & J. Eustice, Federal Income Taxation of Corporations and Shareholders ¶ 7.05 (4th ed. 1979). The shareholder, however, would be entitled to a deduction since the construc-

25. Justice STEVENS attempts to read our prior cases as somehow inconsistent with our approach here. *Nash* is the only case in which we have dealt with the inclusionary aspect of the tax benefit rule, and, as we have established, there was neither a recovery nor an inconsistent event in that case. In *Dobson v. Commissioner,* 320 U.S. 489, 64 S.Ct. 239, 88 L.Ed. 248 (1943), we considered the exclusionary aspect of the rule. That case involved a recovery that was clearly inconsistent with the deduction, and the only question was whether the deduction had created a benefit. The references to "recovery" in the opinion describe the case before the Court. They do not in any way impose general requirements for inclusion, as the dissent seems to suggest.

26. It is worth noting that a holding requiring no recognition of income is not, as Justice BLACKMUN's dissent suggests, a conclusion that the tax benefit rule "has no application to the situation presented." *Post,* at 1164. As a general principle of tax law, the rule of course applies; it simply does not require the recognition of income.

27. The Commissioner asserts also that Hillsboro deducted the taxes as a contested liability under § 461(f), and that the legislative history of § 461(f) shows that Congress intended that the tax benefit rule apply if a taxpayer successfully contested a liability deducted under § 461(f). We do not view this argument as in any way separate from the Commissioner's argument under § 164(e). Section 461(f) does not grant deductions of its own force; the expenditure must qualify as deductible in character under some other section. See Treas.Reg. § 1.461–2(a)(1)(iv), 26 CFR § 1.461–2(a)(1)(iv) (1982). If the expenditure does qualify independently as deductible, but, because it is contested, it lacks the certainty otherwise required for deduction, § 461(f) grants the deduction, on the condition that the tax benefit rule will apply. But for the tax benefit rule to apply, there must be some event that is inconsistent with the provision granting the deduction. The question here then remains whether the deduction is appropriate under § 164(e) or whether later events are inconsistent with that deduction.

tive dividend is used to satisfy his tax liability. § 164(a)(2). Thus, for the shareholder, the transaction would be a wash: he would recognize the amount of the tax as income,[28] but he would have an offsetting deduction for the tax. For the corporation, there would be no tax consequences, for the payment of a dividend gives rise to neither income nor a deduction. 26 U.S.C. § 311(a) (1976 ed., Supp. V).

[9] Under § 164(e), the economics of the transaction of course remain unchanged: the corporation is still satisfying a liability of the shareholder and is therefore paying a constructive dividend. The tax consequences are, however, significantly different, at least for the corporation. The transaction is still a wash for the shareholder; although § 164(e) denies him
393 the deduction to which he would otherwise be entitled, he need not recognize income on the constructive dividend, Treas.Reg. § 1.164–7, 26 CFR § 1.164–7 (1982). But the corporation is entitled to a deduction that would not otherwise be available. In other words, the only effect of § 164(e) is to permit the corporation to deduct a dividend. Thus, we cannot agree with the Commissioner that, simply because the events here give rise to a deductible dividend, they cannot be consistent with the deduction. In at least some circumstances, a deductible dividend is within the contemplation of the Code. The question we must answer is whether § 164(e) permits a deductible dividend in these circumstances—when the money, though initially paid into the state treasury, ultimately reaches the shareholder—or whether the deductible dividend is available, as the Commissioner urges, only when the money remains in the state treasury, as properly assessed and collected tax revenue.

Rephrased, our question now is whether Congress, in granting this special favor to corporations that paid dividends by satisfying the liability of their shareholders, was concerned with the *reason* the money was paid out by the corporation or with the *use* to which it was ultimately put. Since § 164(e) represents a break with the usual rules governing corporate distributions, the structure of the Code does not provide any guidance on the reach of the provision. This Court has described the provision as "prompted by the plight of various banking corporations which paid and voluntarily absorbed the burden of certain local taxes imposed upon their shareholders, but were not permitted to deduct those payments from gross income." *Wisconsin Gas & Electric Co. v. United States, supra,* 322 U.S., at 531, 64 S.Ct., at 1109 (footnote omitted). The section, in substantially similar form, has been part of the Code since the Revenue Act of 1921, 42 Stat. 227. The provision was added by the Senate, but its Committee Report merely mentions the deduction without discussing it, see S.Rep. No. 275, 67th Cong., 1st Sess., 19 (1921).
The only discussion of the provision ap- 394
pears to be that between Dr. T.S. Adams and Senator Smoot at the Senate hearings. Dr. Adams' statement explains why the States imposed the property tax on the shareholders and collected it from the banks, but it does not cast much light on the reason for the deduction. Hearings on H.R. 8245 before the Committee on Finance, 67th Cong., 1st Sess., 250–251 (1921) (statement of Dr. T.S. Adams, tax advisor, Treasury Department). Senator Smoot's response, however, is more revealing:

> "I have been a director in a bank ... for over 20 years. They have paid that tax ever since I have owned a share of stock in the bank.... I know nothing about it. I do not take 1 cent of credit for deductions, and the banks are entitled to it.

28. There would be an exception for a shareholder who had not yet earned $200 in interest and dividend income from his stock holdings in this and other corporations during the taxable year. He would be able to exclude up to $200 received in dividend and interest income for the year. See 26 U.S.C. §§ 116(a)(1), (b) (1976 ed., Supp. V). At the time of the Hillsboro transaction, the exclusion was $100. See 26 U.S.C. § 116(a).

They pay it out." *Id.*, at 251 (emphasis added).

[10, 11] The *payment* by the corporations of a liability that Congress knew was not a tax imposed on them[29] gave rise to the entitlement to a deduction; Congress was unconcerned that the corporations took a deduction for amounts that did not satisfy their tax liability. It apparently perceived the shareholders and the corporations as independent of one another, each "know[ing] nothing about" the payments by the other. In those circumstances, it is difficult to conclude that Congress intended that the corporation have no deduction if the State turned the tax revenues over to these independent parties. We conclude that the purpose of § 164(e) was to provide relief for corporations making these payments, and the focus of Congress was on the act of payment rather than on the ultimate use of the funds by the State. As long as the payment itself was not negated by a refund to the corporation, the change in character of the funds in the hands of
⊥395 the ⊥State does not require the corporation to recognize income, and we reverse the judgment below.[30]

IV

The problem in *Bliss* is more complicated. Bliss took a deduction under § 162(a), so we must begin by examining that provision. Section 162(a) permits a deduction for the "ordinary and necessary expenses" of carrying on a trade or business. The deduction is predicated on the consumption of the asset in the trade or business. See Treas.Reg. § 1.162–3, 26 CFR § 1.162–3 (1982) ("Taxpayers ... should include in expenses the charges for materials and supplies only in the amount that they are *actually consumed and used in operation* in the taxable year...") (emphasis added.) If the taxpayer later sells the asset rather than consuming it in furtherance of his trade or business, it is quite clear that he would lose his deduction, for the basis of the asset would be zero, see, *e.g., Spitalny v. United States,* 430 F.2d 195 (CA9 1970), so he would recognize the full amount of the proceeds on sale as gain. See §§ 1001(a), (c). In general, if the taxpayer converts the expensed asset to some other, nonbusiness use, that action is inconsistent with his earlier deduction, and the tax benefit rule would require inclusion in income of the amount of the unwarranted deduction. That nonbusiness use is inconsistent with a deduction for an ordinary and necessary business expense is clear from an examination of the Code. While § 162(a) permits a deduction for ordinary and necessary business expenses, § 262 explicitly
⊥denies a deduction for personal expenses. ⊥396
In the 1916 Act, the two provisions were a single section. See § 5(a) (First), 39 Stat. 756. The provision has been uniformly interpreted as providing a deduction only for those expenses attributable to the business of the taxpayer. See, *e.g., Kornhauser v. United States,* 276 U.S. 145, 48 S.Ct. 219, 72 L.Ed. 505 (1928); Hearings on Proposed Revision of Revenue Laws before the Subcommittee of the House Committee on Ways and Means, 75th Cong., 3d Sess., 54 (1938) ("a taxpayer should be granted a reasonable deduction for the direct expenses he has incurred *in connection with his income*") (emphasis added); see generally, 1 Bittker, *supra* n. 9, ¶ 20.2. Thus, if a corporation turns expensed assets to the analog of personal consumption, as Bliss

29. Dr. Adams testified repeatedly that the banks paid the tax "voluntarily." Hearings on H.R. 8245 before the Committee on Finance, 67th Cong., 1st Sess. 250 (1921).

30. Our examination of the legislative history thus leads us to reject Justice BLACKMUN's unsupported suggestion that Congress focused on the payment of a tax. *Post,* at 1164. The theory he suggests leads to the conclusion that, even if the State had not refunded the taxes, the bank would not have been entitled to the deduction, because it had not paid a "tax." It is difficult to believe that the Congress that acted to alleviate "the plight of various banking corporations which paid and voluntarily absorbed the burden," *Wisconsin Gas & Electric Co. v. United States,* 322 U.S. 526, 531, 64 S.Ct. 1106, 1109, 88 L.Ed. 1434 (1944), intended the result suggested by the dissent.

did here—distribution to shareholders [31]—it would seem that it should take into income the amount of the earlier deduction.[32]

397 [12] That conclusion, however, does not resolve this case, for the distribution by Bliss to its shareholders is governed by a provision of the Code that specifically shields the taxpayer from recognition of gain—§ 336. We must therefore proceed to inquire whether this is the sort of gain that goes unrecognized under § 336. Our examination of the background of § 336 and its place within the framework of tax law convinces us that it does not prevent the application of the tax benefit rule.[33]

Section 336 was enacted as part of the 1954 Code. It codified the doctrine of *General Utilities Co. v. Helvering,* 296 U.S. 200, 206, 56 S.Ct. 185, 187, 80 L.Ed. 154 (1935), that a corporation does not recognize gain on the distribution of appreciated property to its shareholders. Before the enactment of the statutory provision, the 398
rule was expressed in the regulations, which provided that the corporation would not recognize gain or loss, "however [the assets] may have *appreciated or depreciated* in value since their acquisition." Treas.Regs. 118, § 39.22(a)–20 (1953) (emphasis added). The Senate Report recognized this regulation as the source of the new § 336, S.Rep. No. 1622, 83d Cong., 2d Sess., 258 (1954), U.S.Code Cong. & Admin. News 1954, p. 4017. The House Report explained its version of the provision: "Thus, the fact that the property distributed has *appreciated or depreciated* in value over its adjusted basis to the distributing

31. "Paying the dividend was the enjoyment of [the corporate] income. A body corporate can be said to enjoy its income in no other way." *Williamson v. United States,* 292 F.2d 524, 530, 155 Ct.Cl. 279, 289 (1961).

32. Justice STEVENS' dissent takes issue with this conclusion, characterizing the situation as identical to that in *Nash v. United States,* 398 U.S. 1, 90 S.Ct. 1550, 26 L.Ed.2d 1 (1970), which he explains as a case in which we held that, although "a business asset matching a prior deduction ... would not be used up ... until it had passed to a different taxpayer," the transfer did not require the recognition of income. *Post,* at 1160. What is misleading in this description is its failure to recognize that in *Nash* the prior deduction was reflected in the asset transferred because of the contra-asset account: uncollectible accounts. That contra-asset diminished the asset, see generally W. Meigs, A. Mosich, C. Johnson, & T. Keller, Intermediate Accounting 140–141 (3d ed. 1974), and was inseparable from it. Therefore, the transfer of the notes did not establish that they were worth their face value, and there was no inconsistent event.

In *Bliss,* the taxpayers took a deduction for an expense and credited the asset account. Unlike the debit to the expense account in *Nash,* the debit to the expense account did not reflect any economic decrease in the value of the asset. When the taxpayers transferred the asset, it became clear that the economic decrease would not take place in the hands of Bliss—and possibly never would occur.

To see the difference more clearly, consider the views of a third party contemplating purchasing the asset on hand in *Nash* and one contemplating purchasing the asset on hand in *Bliss.* In *Nash,* the purchaser would be willing to pay only the face amount of the receivables *less the amount in the contra-asset account*—the amount earlier deducted by the taxpayer—because that is all the purchaser could expect to realize on them. In other words, the deduction reflected a real decrease in the value of the asset. In *Bliss,* on the other hand, the purchaser would be happy to pay the value of the grain, *undiminished by the expense deducted by the taxpayer.* The deduction and the asset remain separable, and the taxpayer can transfer one without netting out the other.

33. We are aware that Congress considered but failed to enact a bill amending §§ 1245 and 1250 to cover any deduction of the purchase price of property. H.R. 10936, 94th Cong., 1st Sess. (1975). That bill would have settled the question here, since it is clear that § 1245 overrides § 336. § 1245(a)(1); Treas.Reg. § 1.1245–6(b), 26 CFR § 1.1245–6(b) (1982). The failure to enact the bill does not suggest that Congress intended that deductions under § 162 not be subject to recapture. Both the House and Senate Committees reported favorably on the bill, S.Rep. No. 94–1346 (1976); H.R.Rep. No. 94–1350 (1976), the House passed it, and Congress adjourned without any action by the Senate. See Calendars of the United States House of Representatives and History of Legislation 174 (Final ed. 1977). The Reports suggest that Congress focused on disposition by sale and thought the income subject to recapture in any event, but possibly at capital gains rather than ordinary income rates. S.Rep. No. 94–1346, *supra,* at 2; H.R.Rep. No. 94–1350, *supra,* at 2. Given this background, we cannot draw any inference from the failure to enact the amendment.

corporation will in no way alter the application of subsection (a) [providing nonrecognition]." H.R.Rep. No. 1337, 83d Cong., 2d Sess., A90 (1954) (emphasis added), U.S. Code Cong. & Admin.News 1954, p. 4227. This background indicates that the real concern of the provision is to prevent recognition of market appreciation that has not been realized by an arm's-length transfer to an unrelated party rather than to shield all types of income that might arise from the disposition of an asset.

Despite the breadth of the nonrecognition language in § 336, the rule of nonrecognition clearly is not without exception. For instance, § 336 does not bar the recapture under § 1245 and § 1250 of excessive depreciation taken on distributed assets. §§ 1245(a), 1250(a); Treas.Reg. §§ 1.1245–6(b), 1.1250–1(c)(2), 26 CFR §§ 1.1245–6(b), 1.1250–1(c)(2) (1982). Even in the absence of countervailing statutory provisions, courts have never read the command of nonrecognition in § 336 as absolute. The "assignment of income" doctrine has always applied to distributions in liquidation. See, *e.g., Siegel v. United States,* 464 F.2d 891 (CA9 1972), cert. dism'd, 410 U.S. 918, 93 S.Ct. 978, 35 L.Ed.2d 581 (1973); *Williamson v. United States,* 292 F.2d 524, 155 Ct.Cl. 279 (1961); see also *Idaho First National Bank v. United States,* 265 F.2d 6 (CA9 1959) (decided before *General Utilities* codified in § 336). That judicial doctrine prevents taxpayers from avoiding taxation by shifting income from the person or entity that earns it to ⌊399 someone who pays taxes at a lower rate.[34] Since income recognized by the corporation is subject to the corporate tax and is again taxed at the individual level upon distribution to the shareholder, shifting of income from a corporation to a shareholder can be particularly attractive: it eliminates one level of taxation. Responding to that incentive, corporations have attempted to distribute to shareholders fully performed contracts or accounts receivable and then to invoke § 336 to avoid taxation on the income. In spite of the language of nonrecognition, the courts have applied the assignment-of-income doctrine and required the corporation to recognize the income.[35] Section 336, then, clearly does not shield the taxpayer from recognition of *all* income on the distribution.

[13] Next, we look to a companion provision—§ 337, which governs sales of assets followed by distribution of the proceeds in liquidation.[36] It uses essentially

34. For instance, a taxpayer cannot avoid recognizing the interest income on bonds that he owns by clipping the coupons and giving them to another party. See, *e.g., Helvering v. Horst,* 311 U.S. 112, 61 S.Ct. 144, 85 L.Ed. 75 (1940); *Lucas v. Earl,* 281 U.S. 111, 50 S.Ct. 241, 74 L.Ed. 731 (1930).

35. Indeed, the legislative history of § 336 compels such a result. Section 336 arose out of the same provision in the House bill as did § 311, which provides for nonrecognition of gain on nonliquidating distributions of appreciated property, and the Senate comment on § 311 explicitly provides for the application of the assignment-of-income doctrine. S.Rep. No. 1622, 83d Cong., 2d Sess., 247 (1954).

36. In relevant part, § 337 provides:

"(a) If within the 12-month period beginning on the date on which a corporation adopts a plan of complete liquidation, all of the assets of the corporation are distributed in complete liquidation, less assets retained to meet claims, then no gain or loss shall be recognized to such corporation from the sale or exchange by it of property within such 12-month period.

"(b)(1) For purposes of subsection (a), the term 'property' does not include—

"(A) stock in trade of the corporation, or other property of a kind which would properly be included in the inventory of the corporation if on hand at the close of the taxable year, and property held by the corporation primarily for sale to customers in the ordinary course of its trade or business,

"(B) installment obligations acquired in respect of the sale or exchange (without regard to whether such sale or exchange occurred before, on, or after the date of the adoption of the plan referred to in subsection (a)) of stock in trade or other property described in subparagraph (A) of this paragraph, and

"(C) installment obligations acquired in respect of property (other than property described in subparagraph (A)) sold or exchanged before the date of the adoption of such plan of liquidation.

"(2) Notwithstanding paragraph (1) of this subsection, if substantially all of the property de-

⊥400 the same broad language to shield the corporation from the recognition of gain on the sale of the assets. The similarity in language alone would make the construction of § 337 relevant in interpreting § 336. In addition, the function of the two provisions reveals that they should be construed in tandem. Section 337 was enacted in response to the distinction created by *United States v. Cumberland Public Service Co.*, 338 U.S. 451, 70 S.Ct. 280, 94 L.Ed. 251 (1950), and *Commissioner v. Court Holding Co.*, 324 U.S. 331, 65 S.Ct. 707, 89 L.Ed. 981 (1945). Under those cases, a corporation that liquidated by distributing appreciated assets to its shareholders recognized no income, as now provided in § 336, even though its shareholders might sell the assets shortly after the distribution. See *Cumberland.* If the corporation sold the assets, though, it would recognize income on the sale, and a sale by the shareholders after distribution in kind might be attributed to the corporation. See *Court Holding.* To eliminate the necessarily formalistic distinctions and the uncertainties created by *Court Holding* and *Cumberland,* Congress enacted § 337, permitting the corporation to adopt a plan of liquidation,
⊥401 sell its assets without recognizing gain or loss at the corporate level, and distribute the proceeds to the shareholders. The very purpose of § 337 was to create the same consequences as § 336. See *Midland-Ross Corp. v. United States,* 485 F.2d 110 (CA6 1973); S.Rep. No. 1622, *supra,* at 258.

There are some specific differences between the two provisions, largely aimed at governing the period during which the liquidating corporation sells its assets, a problem that does not arise when the corporation distributes its assets to its shareholders. For instance, § 337 does not shield the income produced by the sale of inventory in the ordinary course of business; that income will be taxed at the corporate level before distribution of the proceeds to the shareholders. See § 337(b). These differences indicate that Congress did not intend to allow corporations to escape taxation on business income earned while carrying on business in the corporate form; what it did intend to shield was market appreciation.

[14, 15] The question whether § 337 protects the corporation from recognizing income because of unwarranted deductions has arisen frequently, and the rule is now well established that the tax benefit rule overrides the nonrecognition provision. *Connery v. United States,* 460 F.2d 1130 (CA3 1972); *Commissioner v. Anders,* 414 F.2d 1283 (CA10), cert. denied, 396 U.S. 958 (1969); *Krajeck v. United States,* 75–1 USTC ¶ 9492 (ND 1975); *S.E. Evans, Inc. v. United States,* 317 F.Supp. 423 (Ark. 1970); *Anders v. United States,* 462 F.2d 1147, 199 Ct.Cl. 1, cert. denied, 409 U.S. 1064, 93 S.Ct. 557, 34 L.Ed.2d 517 (1972); *Estate of Munter v. Commissioner,* 63 T.C. 663 (1975); Rev.Rul. 61–214, 1961–2 Cum.Bull. 60; Byrne, The Tax Benefit Rule as Applied to Corporate Liquidations: Recent Developments, 56 Notre Dame Law. 215, 221 (1980); Note, Tax Treatment of Previously Expensed Assets in Corporate Liquidations, 80 Mich.L.Rev. 1636, 1638–39 (1982); cf. *Spitalny v. United States,* 430 F.2d 195 (CA9 1970) (when deduction and liquidation occur within a single year, though tax benefit rule does not apply, principle does). Congress has recently undertaken major revisions of the Code, see ⊥402
Economic Recovery Tax Act of 1981, Pub.L. 97–34, 95 Stat. 172, and has made changes in the liquidation provisions, *e.g.,*

scribed in subparagraph (A) of such paragraph (1) which is attributable to a trade or business of the corporation is, in accordance with this section, sold or exchanged to one person in one transaction, then for purposes of subsection (a) the term 'property' includes—

"(A) such property so sold or exchanged, and

"(B) installment obligations acquired in respect of such sale or exchange.

"(c)(1) This section shall not apply to any sale or exchange—

"(A) made by a collapsible corporation (as defined in section 341(b)), or

"(B) following the adoption of a plan of complete liquidation, if section 333 applies with respect to such liquidation."

Pub.L.95–600, 92 Stat. 2904 (amending § 337); Pub. 95–628, 92 Stat. 3628 (same), but it did not act to change this longstanding, universally accepted rule. If the construction of the language in § 337 as permitting recognition in these circumstances has the acquiescence of Congress, *Lorillard v. Pons,* 434 U.S. 575, 580, 98 S.Ct. 866, 869, 55 L.Ed.2d 40 (1978), we must conclude that Congress intended the same construction of the same language in the parallel provision in § 336.

[16] Thus, the legislative history of § 336, the application of other general rules of tax law, and the construction of the identical language in § 337 all indicate that § 336 does not permit a liquidating corporation to avoid the tax benefit rule. Consequently, we reverse the judgment of the Court of Appeals and hold that, on liquidation, Bliss must include in income the amount of the unwarranted deduction.[37]

⌊403 ⌊IV

Bliss paid the assessment on an increase of $60,000 in its taxable income. In the District Court, the parties stipulated that the value of the grain was $56,565, but the record does not show what the original cost of the grain was or what portion of it remained at the time of liquidation. The proper increase in taxable income is the portion of the cost of the grain attributable to the amount on hand at the time of liquidation. In *Bliss,* then, we remand for a determination of that amount. In *Hillsboro,* the taxpayer sought a redetermination in the Tax Court rather than paying the tax, so no further proceedings are necessary, and the judgment of the Court of Appeals is reversed.

It is so ordered.

Justice BRENNAN, concurring in No. 81–930 and dissenting in No. 81–485.

I join Parts I, II, and IV of the Court's opinion. For the reasons expressed in Part I of Justice BLACKMUN's dissenting opinion, however, I believe that a proper application of the principles set out in Part II of the Court's opinion would require an affirmance rather than a reversal in No. 81–485.

Justice STEVENS, with whom Justice MARSHALL joins, concurring in the judgment in No. 81–485 and dissenting in No. 81–930.

These two cases should be decided in the same way. The taxpayer in each case is a corporation. In 1972 each taxpayer made a deductible expenditure, and in 1973 its shareholders received an economic benefit. Neither corporate taxpayer ever recovered any part of its 1972 expenditure. In my opinion, the benefits received by the shareholders in 1973 are matters that should affect their returns; those benefits should not give rise to income on the 1973 return of the taxpayer in either case.

37. Some commentators have argued that the correct measure of the income that Bliss should include is the lesser of the amount it deducted or the basis that the shareholders will take in the asset. See Feld, The Tax Benefit of *Bliss.* 62 B.U.L.Rev. 443, 463–464 (1982); see also Rev. Rul. 74–396, 1974–2 Cum.Bull. 106. Since Bliss has not suggested that, if there is an amount taken into income, it should be less than the amount previously deducted, we need not address the point.

As Justice STEVENS observes, *post,* at 1162, n. 29, we do not resolve this question. His perception of ambiguities elsewhere in our discussion of the amount recognized as income is simply inaccurate. Our discussion of the tax consequences on the sale of an expensed asset, *supra,* at 1150, does not suggest that the entire amount of proceeds on sale is attributable to the tax benefit rule. Instead, we illustrated that the basis rules automatically lead to inclusion of the amount attributable to the operation of the tax benefit rule. That is, the proceeds will equal the cost plus any appreciation (or less any decrease in value). The appreciation would be recognized as gain (or the decrease as loss) in the ordinary sale, regardless of whether the taxpayer had expensed the asset upon acquisition. The reduction of the basis to zero when the item is expensed ensures that if it is sold rather than consumed the unwarranted deduction will be included in income along with any appreciation, and it is this amount that the tax benefit rule requires to be recognized as income.

Both cases require us to apply the tax benefit rule. This rule has always had a
404 limited, but important office: it determines whether certain events that enrich the taxpayer—recoveries of past expenditures—should be characterized as income.[1] It does not create income out of events that do not enhance the taxpayer's wealth.

Today the Court declares that the purpose of the tax benefit rule is "to approximate the results produced by a tax system based on transactional rather than annual accounting." *Ante,* at 1142. Whereas the rule has previously been used to determine the character of a current wealth-enhancing event, when viewed in the light of past deductions, the Court now suggests that the rule requires a study of the propriety of earlier deductions, when viewed in the light of later events. The Court states that the rule operates to "cancel out" an earlier deduction if the premise on which it is based is "fundamentally inconsistent" with an event in a later year. *Ante,* at 1143.[2]

The Court's reformulation of the tax benefit rule constitutes an extremely significant enlargement of the tax collector's powers. In order to identify the groundbreaking character of the decision, I shall review the history of the tax benefit rule. I shall then discuss the *Bliss Dairy* case in some detail, to demonstrate that it fits com-
405 fortably within the class of cases to which the tax benefit rule has not been applied in the past. Finally, I shall explain why the Court's adventure in lawmaking is not only misguided but does not even explain its inconsistent disposition of these two similar cases.

I

What is today called the "tax benefit rule" evolved in two stages, reflecting the rule's two components. The "inclusionary" component requires that the recovery within a taxable year of an item previously deducted be included in gross income. The "exclusionary component," which gives the rule its name, allows the inclusionary component to operate only to the extent that the prior deduction benefited the taxpayer.

The inclusionary component of the rule originated in the Bureau of Internal Revenue in the context of recoveries of debts that had previously been deducted as uncollectible. The Bureau sensed that it was inequitable to permit a taxpayer to characterize the recovery of such a debt as "return of capital" when in a prior year he had been allowed to reduce his taxable income to compensate for the loss of that capital. As one commentator described it, "[t]he allowance of a deduction results in a portion of gross income not being taxed; when the deducted item is recouped, the recovery stands in the place of the gross income which had not been taxed before and is therefore taxable."[3] This principle was quickly endorsed by the Board of Tax Appeals and the courts. See *Excelsior Printing Co. v. Commissioner,* 16 B.T.A. 886 (1929); *Putnam National Bank v. Commissioner,* 50 F.2d 158 (CA5 1931).

The exclusionary component was not so 406
readily accepted. The Bureau first incorpo-

1. Cf. H. Simons, Personal Income Taxation 50 (1938) (defining income as net accumulation of property rights over the course of a year, plus consumption during that year).

2. Notwithstanding this focus on the legitimacy of the 1972 deductions, scrutinized with the aid of hindsight after the completion of a multiyear transaction, the Court is careful not to require that "transactional inequities" be dealt with in the most "precise way" imaginable. *Ante,* at 1140, n. 10. It rejects Justice BLACKMUN's suggestion that the 1972 tax returns be reopened, quite properly noting our past observations that " '[i]t 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, and would violate the spirit of the annual accounting system.' " *Ante,* at 1140, n. 10, quoting *Healy v. Commissioner,* 345 U.S. 278, 285, 73 S.Ct. 671, 675, 97 L.Ed. 1007 (1953). See also *ante,* at 1142, n. 12.

3. Plumb, The Tax Benefit Rule Today, 57 Harv. L.Rev. 129, 131, n. 10 (1943). Accord, *Estate of Collins v. Commissioner,* 46 B.T.A. 765, 769 (1942), rev'd *sub nom. Harwick v. Commissioner,* 133 F.2d 732 (CA8), rev'd *sub nom. Dobson v. Commissioner,* 320 U.S. 489, 64 S.Ct. 239, 88 L.Ed. 248 (1943).

rated it during the Great Depression as the natural equitable counterweight to the inclusionary component. G.C.M. 18525, 1937–1 Cum.Bull. 80. It soon retreated, however, insisting that a recovery could be treated as income even if the prior deduction had not benefited the taxpayer. G.C.M. 22163, 1940–2 Cum.Bull. 76. The Board of Tax Appeals protested, *e.g., Corn Exchange National Bank & Trust Co. v. Commissioner,* 46 B.T.A. 1107 (1942), but the Circuit Courts of Appeals sided with the Bureau. *Helvering v. State-Planters Bank & Trust Co.,* 130 F.2d 44 (CA4 1942); *Commissioner v. United States & International Securities Corp.,* 130 F.2d 894 (CA3 1942). At that point, Congress intervened for the first and only time. It enacted the forerunner of § 111 of the present Code, ch. 619, Title I, § 116(a), Act of Oct. 21, 1942, 56 Stat. 812, using language that by implication acknowledges the propriety of the inclusionary component by explicitly mandating the exclusionary component.[4]

The most striking feature of the rule's history is that from its early formative years, through codification, until the 1960's, Congress,[5] the Internal Revenue Service,[6] courts,[7] ⊥407 and commentators,[8] understood it in essentially the same way. They all saw it as a theory that appropriately characterized certain recoveries of capital as income. Although the rule undeniably helped to accommodate the annual accounting system to multiyear transactions, I have found no sugges⊥408tion that it was regarded as a generalized method of approximating a transactional accounting system through the fabrication of income

4. Section 111(a) provides:

"Gross income does not include income attributable to the *recovery* during the taxable year of a bad debt, prior tax, or delinquency amount, to the extent of the amount of the recovery exclusion with respect to such debt, tax, or amount" (emphasis added).

5. *Ibid.* See also the detailed provisions of ch. 619, Title I, § 156(a) of the Act of Oct. 21, 1942, 56 Stat. 852, amended, Act of Aug. 16, 1954, ch. 736, 68A Stat. 343, repealed, Pub.L. 94–455, Title XIX, § 1901(a)(145)(A), Act of Oct. 4, 1976, 90 Stat. 1788, establishing a mechanism for including the recoveries of previously claimed war losses in current income to the extent of tax benefit.

6. Consider the following passages from the regulations under § 111.

"*General.* Section 111 provides that income attributable to the *recovery during any taxable year* of bad debts, prior taxes, and delinquency amounts shall be excluded from gross income to the extent of the 'recovery exclusion' with respect to such items. The rule of exclusion so prescribed by statute applies equally with respect to all other losses, expenditures and accruals made the basis of deductions from gross income for prior taxable years, including war losses ..., but not including deductions with respect to depreciation, depletion, amortization, or amortizable bond premiums....

. . . . .

"*Definition of 'recovery'.* Recoveries result from the *receipt of amounts* in respect of the previously deducted or credited section 111 items, such as from the collection or sale of a bad debt, refund or credit of taxes paid, or cancellation of taxes accrued." Treas.Reg. § 1.111–1(a), 26 CFR § 1.111–1(a) (1982) (emphasis added).

Consider also:

"If the taxpayer deducted a loss in accordance with the provisions of this paragraph and in a subsequent taxable year receives reimbursement for such loss, he does not recompute the tax for the taxable year in which the deduction was taken but includes the amount of such reimbursement in his gross income for the taxable year in which received, subject to the provisions of section 111, relating to recovery of amounts previously deducted." Treas.Reg. § 1.165–1(d)(2)(iii), 26 CFR § 1.165–1(d)(2)(iii) (1982).

7. *E.g., National Bank of Commerce v. Commissioner,* 115 F.2d 875 (CA9 1940); *South Dakota Concrete Products Co. v. Commissioner,* 26 B.T.A. 1429 (1932).

8. See Costigan, Income Taxes on Recoveries from Civil Litigation, Proceedings of the U.S.C. Tax Inst. 559, 567–570 (1954); Atlas, Tax Free Recoveries: The Tax Benefit Rule, N.Y.U. 9th Inst. on Fed. Tax. 847 (1951); Tye, The Tax Benefit Doctrine Reexamined, 3 Tax L.Rev. 329 (1948); Plumb, The Tax Benefit Rule Today, 57 Harv.L.Rev. 129, 131, n. 10, 176 (1943); Lassen, The Tax Benefit Rule and Related Problems, 20 Taxes 473, 475 (1942) (statute of limitations not a problem because "all these cases have a new element, namely, a recovery or increment in value or decrease of liability in the year in which income was determined by the Commissioner to have been received"); Note, 56 Harv.L.Rev. 434, 436 (1942); Zysman, Income Derived From the Recovery of Deductions, 19 Taxes 29 (1941); Ayers, Bad Debts—Deductions and Recoveries, 18 Taxes 549 (1940).

at the drop of a fundamentally inconsistent event.[9] An inconsistent event was always a necessary condition, but with the possible exception of the discussion of the Board of Tax Appeals in *Barnett v. Commissioner,* 39 B.T.A. 864, 867 (1939), inconsistency was never by itself a sufficient reason for applying the rule.[10] Significantly, the first case from this Court dealing with the tax benefit rule emphasized the role of a recovery.[11] And when litigants in ⌊409 this Court suggested that a transactional accounting system would be more equitable, we expressly declined to impose one, stressing the importance of finality and practicability in a tax system.[12]

9. Except for *Barnett v. Commissioner,* 39 B.T.A. 864 (1939), all of the early cases cited by the Court, *ante,* at 1145, involved a recovery. In *Estate of Block v. Commissioner,* 39 B.T.A. 338, 341 (1939), the Board of Tax Appeals made the following statement:

"When recovery or some other event which is inconsistent with what has been done in the past occurs, adjustment must be made in reporting income for the year in which the change occurs. No other system would be practical in view of the statute of limitations, the obvious administrative difficulties involved, and the lack of finality in income tax liability, which would result. The foregoing principles, which have been established by the following cases, require that the refund here be included in the income of this estate for the year of recovery."

Notwithstanding the general reference to an inconsistent event in the first quoted sentence, it is obvious from the two succeeding sentences that the Board was not intending to lay the groundwork for a new theory of the tax benefit rule. Rather, it was attempting to respond to the suggestion that the adjustment be made in the year of deduction rather than the year of recovery. This conclusion is confirmed by the fact that the third quoted sentence speaks of "the year of recovery," not "the year of inconsistent event," and by the fact that each of the 14 cases cited by the Board following the conclusion of the quoted passage, like *Estate of Block* itself and like *South Dakota Concrete Products Co. v. Commissioner, supra,* involved recoveries in the traditional sense.

10. It should be noted that even in *Barnett,* the Board of Tax Appeals included its discussion of inconsistent events only after emphasizing that the inclusion in income of a prior oil depletion deduction was required by Treasury Regulations that had been ratified by Congress. 39 B.T.A., at 867.

11. In *Dobson v. Commissioner,* 320 U.S. 489, 64 S.Ct. 239, 88 L.Ed. 248 (1943), the taxpayer had bought stock, sold it at a loss, and then claimed a deductible loss on his tax return. Eight years later, the taxpayer had sued for rescission of the stock purchase, claiming fraud; he settled the suit and received approximately $30,000 for the stock on which he had sustained the loss. We upheld the Tax Court's determination that the $30,000 recovery did not need to be reported as income, since the earlier deductible losses had not reduced the taxpayer's taxes in the year he had claimed them. For present purposes, the holding in *Dobson* was less significant than the way it endorsed the Tax Court's analysis:

"The Tax Court has not attempted to revise liability for earlier years closed by the statute of limitation, nor used any expense, liability, or deficit of a prior year to reduce the income of a subsequent year. *It went to prior years only to determine the nature of the recovery, whether return of capital or income.*" *Id.,* at 493, 64 S.Ct., at 242 (emphasis added).

The tax benefit question was not one of inconsistent events, but whether a recovery should be characterized as return of capital or as income.

12. *Burnet v. Sanford & Brooks Co.,* 282 U.S. 359, 51 S.Ct. 150, 75 L.Ed. 383 (1931), was a mirror image of this case. The taxpayer argued that a recovery of previously deducted funds should not be income because, seen from a transactional view, no net profits had been realized. The Court framed the issue as whether net profits are to be determined "on the basis of fixed accounting periods, or ... on the basis of particular transactions of the taxpayer when they are brought to a conclusion." *Id.,* at 363, 51 S.Ct., at 151. The answer was unanimous and unflinching:

"A taxpayer may be in receipt of net income in one year and not in another. The net result of the two years, if combined in a single taxable period, might still be a loss; but it has never been supposed that that fact would relieve him from a tax on the first, or that it affords any reason for postponing the assessment of the tax until the end of a lifetime, or for some other indefinite period, to ascertain more precisely whether the final outcome of the period, or of a given transaction, will be a gain or a loss.

"The Sixteenth Amendment was adopted to enable the government to raise revenue by taxation. It is the essence of any system of taxation that it should produce revenue ascertainable, and payable to the government, at regular intervals. Only by such a system is it practicable to produce a regular flow of income and apply methods of accounting, assessment, and collection capable of practical operation. It is not suggested that there has ever been any general scheme for taxing income on any other basis.... While, conceivably, a different system

⊥410 In the 1960's, the Commissioner, with the support of some commentators and the Tax Court, began to urge that the tax benefit rule be given a more ambitious office.[13] In *Nash v. United States,* 398 U.S. 1, 90 S.Ct. 1550, 26 L.Ed.2d 1 (1970), the Commissioner argued that the rule should not be limited to cases in which the taxpayer had made an economic recovery, but rather should operate to cancel out an earlier deduction whenever later events demonstrate that the taxpayer is no longer entitled to it. The arguments advanced, and rejected, in that case were remarkably similar to those found in the Court's opinion today.[14]

⊥411 The *Nash* case arose out of the sale of a partnership business to a corporation. The partnership had taken deductions for ledger entries in a "bad debt reserve"—an account that reflected the firm's estimate of its future losses from accounts receivable that would *eventually* become uncollectible. When the partnership business was sold to a corporation, the Commissioner sought to apply the tax benefit rule, arguing that even though the partnership had made no recovery of the amount in the bad debt reserve, the deductibility of the presale additions to the taxpayer's reserve had been justified on the basis of an assumption that was no longer valid after the business was sold.[15]

This Court flatly rejected the Commissioner's position. Rather than scrutinizing the premises of the prior deduction in the light of subsequent events, the Court used the subsequent events themselves as its starting point. Since the transfer of the

might be devised by which the tax could be assessed, wholly or in part, on the basis of the finally ascertained results of particular transactions, Congress is not required by the amendment to adopt such a system in preference to the more familiar method, even if it were practicable." *Id.,* at 364–365, 51 S.Ct., at 151–152.

Healy v. Commissioner, 345 U.S. 278, 73 S.Ct. 671, 97 L.Ed. 1007 (1953), dealt with a more extreme effort to approximate a transactional accounting system—more closely analogous to Justice BLACKMUN's approach than to the Court's today. In that case, a taxpayer received money under a claim of right in an early year and was forced to disgorge it in a later year. The Government was perfectly willing to allow the taxpayer to take a deduction in the year of disgorgement (presumably under a "tax detriment" theory, since repayments of loans are usually not deductible), but the taxpayer wanted to be able to go back and reopen the prior year, in which he had included the receipt in income. The Court refused to allow the reopening, extolling the virtues of an annual accounting system. *Id.,* at 284–285, 73 S.Ct., at 675. See n. 2, *supra.*

13. See Rev.Rul. 62–128, 1962–2 Cum.Bull. 139; Note, 21 Vand.L.Rev. 995 (1968); *Estate of Schmidt v. Commissioner,* 42 T.C. 1130 (1964), rev'd, 355 F.2d 111 (CA9 1966).

14. For example:

"The [tax benefit] rule rests on the notion that a taxpayer should not be permitted to retain the tax benefit of a deduction when later events demonstrate that he no longer is entitled to it.... To limit application of the rule to cases in which there has been an economic recovery would frustrate its purpose, which is to insure that a taxpayer not retain the benefit of a deduction to which he is no longer entitled. Fulfillment of that purpose requires application of the rule, whether the lack of need for a bad debt reserve arises from a sale or collection of accounts receivable, or merely by reason of the termination of the existence of the owner of the receivables.... The proper analysis of the transaction where accounts receivable are sold for their net value by a reserve method taxpayer is to restore the reserve to his income and accord him a loss on the sale of property. That this loss (face value less amount realized) equals the amount of the restoration to income does not militate against the basic principle that the reserve must be restored to income when it is no longer needed, irrespective of whether there has been an economic recovery." Brief for United States in *Nash v. United States,* O.T. 1969, No. 678, pp. 8–14.

15. The Commissioner argued that (a) an accrual basis taxpayer is normally only allowed to deduct accounts receivable that are uncollectible, (b) the taxpayer had been allowed to take a deduction because the taxpayer was being allowed to represent that it would eventually find some presently collectible accounts to be uncollectible, and (c) those accounts had *not* in fact become uncollectible at the time they left the taxpayer's hands. The Commissioner asserted that the earlier deduction had been allowed on the assumption that it fairly represented the taxpayer's continuing "need" for bad debt deductions across taxable years. He argued that once the accounts receivable left the taxpayer's hands, it had no further "need" for the bad debt reserve and that the premise for the prior deduction had become invalid. See *ibid.*

bad debt reserve did not enrich the taxpayer, there was no current realization event justifying the application of the tax benefit rule. "[A]lthough the 'need' for the reserve ended with the transfer, the end of 412 that need did not mark a 'recovery' within the meaning of the tax benefit cases." *Id.*, at 5, 90 S.Ct., at 1552.[16]

Today, the Court again has before it a case in which the Commissioner, with the endorsement of some commentators and a closely divided Tax Court, is pushing for a more ambitious tax benefit rule.[17] This time, the Court accepts the invitation. Since there has been no legislation since *Nash* suggesting that our approach over the past half-century [18] has been wrongheaded, cf. n. 32, *infra*, the new doctrine that emerges from today's decision is of the Court's own making.

II

In the *Bliss Dairy* case, the Court today reaches a result contrary to that dictated by a recovery theory. One would not expect such a break with the past unless it were apparent that prior law would produce a palpable inequity—a clear windfall for the taxpayer. Yet that is not the case in *Bliss Dairy.* Indeed, the tax economics of the case are indistinguishable from those of the *Nash* case.

413 Three statutory provisions, as interpreted by the Commissioner, interact in *Bliss Dairy.* First, pursuant to § 162(a),[19] the Commissioner allowed the corporation to deduct the entire cost of all grain purchased in 1972. That deduction left it with a basis of zero in that grain. Second, under the terms of § 336,[20] the corporation was not required to recognize any gain or loss when it went through a § 333 liquidation in 1973. And third, pursuant to the regulations implementing § 334,[21] the shareholders were allowed to assign some portion of their basis in the corporation's stock to the grain they received in the liquidation. Admittedly, this combination of provisions could in some cases cause a "step-up" in the grain's basis that is not reflected in the income of either the corporation or the shareholders. That possibility figured strongly in the decision of the Court of Appeals for the Sixth Circuit to

16. The taxpayer's receipts from the sale of the business was not a recovery because, to the extent the accounts receivable were offset by the bad debt reserve, the corporation had not paid the taxpayer a penny for them. It was this fact that distinguished *Nash* and *Schmidt* from earlier cases applying the tax benefit rule to bad debt reserves such as *Arcadia Savings & Loan Assn. v. Commissioner,* 300 F.2d 247 (CA9 1962), *Citizens Federal Savings & Loan Assn. v. United States,* 290 F.2d 932, 154 Ct.Cl. 305 (1961), *West Seattle National Bank v. Commissioner,* 288 F.2d 47 (CA9 1961), and *S. Rossin & Sons, Inc. v. Commissioner,* 113 F.2d 652 (CA2 1940).

17. See Rev.Rul. 74–396, 1974–2 Cum.Bull. 106; Feld, The Tax Benefit of *Bliss*, 62 B.U.L.Rev. 443 (1982); *Tennessee-Carolina Transportation, Inc. v. Commissioner,* 65 T.C. 440 (CA6 1978), aff'd, 582 F.2d 378 (CA6 1978), cert. denied, 440 U.S. 909, 99 S.Ct. 1219, 59 L.Ed.2d 457 (1979). Contra, O'Hare, Application of Tax Benefit Rule in New Case Threatens Certain Liquidations, 44 J. Taxation 200 (1976), Broenen, The Tax Benefit Rule and Sections 332, 334(b)(2) and 336, 53 Taxes 231 (1975).

18. *Nash* and *Dobson* are the only tax benefit rule cases ever decided in this Court. On one other occasion, the Court invoked the tax benefit rule by analogy. *United States v. Skelly Oil Co.,* 394 U.S. 678, 688, and n. 5, 89 S.Ct. 1379, 1385, and n. 5, 22 L.Ed.2d 642 (1969).

19. In relevant part, 26 U.S.C. § 162(a) provides that "[t]here shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. . . ."

20. In relevant part, 26 U.S.C. § 336 provides that "no gain or loss shall be recognized to a corporation on the distribution of property in partial or complete liquidation."

21. In relevant part, 26 U.S.C. § 334 provides that "[i]f . . . property was acquired by a shareholder in the liquidation of a corporation in cancellation or redemption of stock, and . . . the extent to which gain was recognized was determined under § 333, then the basis shall be the same as the basis of such stock cancelled or redeemed in the liquidation, decreased in the amount of any money received by the shareholder, and increased in the amount of gain recognized to him." The relevant implementing regulations are found at Treas.Reg. § 1.334–2, 26 CFR § 1.334–2 (1982).

endorse an inconsistent-event theory in a precursor of this case. See *Tennessee-Carolina Transportation, Inc. v. Commissioner*, 582 F.2d 378, 382, and n. 14 (1978). And it is stressed by the Solicitor General in his argument in this case. Brief for United States in No. 81–930 and for Respondent in No. 81–485, pp. 39–42. Yet close analysis reveals that the potential untaxed step-up is not the sort of extraordinary and inequitable windfall that calls for extraordinary measures in *this* case.

⊥414 ⊥As a factual matter, the record does not include the tax returns of Bliss Dairy's shareholders. We have no indication of how much, if any, step-up in basis actually occurred. And as a legal matter, a § 333 liquidation expressly contemplates steps-up in basis that are not reflected in income. Thus, even if the corporation had behaved as the Court believes it should have and had fed all the grain to the cows before liquidating, whatever shareholder stock basis was assigned to the grain in this case would have been used to step up the basis of some other asset that passed to the shareholders in the liquidation.

I suppose it might be argued that this sort of untaxed step-up is acceptable if it happens accidentally, but not if a taxpayer manipulates business transactions solely to take advantage of it. Yet here again we have too little information to conclude that there has been any such manipulation in the case of Bliss Dairy. To begin with, the Government has never questioned the propriety of the 1972 deduction, viewed in the light of 1972 events.[22] Moreover, the record before us on appeal does not tell us how much feed the Dairy's cattle consumed in 1972, whether 1972 consumption exceeded 1972 purchases, or how the volume purchased in 1972 compared with purchases in prior years. Indeed, it is quite possible that in 1971 the Dairy had made abnormally large purchases as a hedge against a possible rise in the market price, and that its 1972 consumption of grain actually exceeded its $150,000 in purchases during that year.

It is no doubt for these reasons that the Court never relies on the untaxed step-up argument in its opinion today.[23] Un⊥fortunately, the only argument the Court offers in its place is an *ipse dixit:* it seems wrong for a taxpayer not to realize income if it fails to use up an asset, when it was allowed to deduct the value of that asset in a prior year. We rejected that precise proposition in *Nash.* In both *Nash* and *Bliss Dairy*, the transfer of the business in a subsequent year revealed that a business asset matching a prior deduction (*i.e.*, grain matching the expense deduction, or the account receivable matching the bad debt deduction) would not be used up (*i.e.*, consumed or become uncollectable) until it had passed to a different taxpayer.[24] The only explanation for today's decision to detach the tax benefit rule from the recovery mooring appears to be the challenge to be found in an open sea of troublesome and inconclusive hypothetical cases.[25] ⊥415

22. The Court's partial quotation of Treas.Reg. § 1.162–3, 26 CFR 1.162–3 (1982), *ante*, at 1150, suggests that it may regard the deduction for unconsumed feed as improper because the feed was not "actually *consumed and used in operation* in the taxable year," *ibid.* Of course, if the Court really believed that such a deduction should not be allowed, the proper course of action would be to modify the rules authorizing the deduction, see n. 31, *infra*, rather than to modify the tax benefit rule.

23. It should also be noted that the potential for an untaxed step-up, which may give rise to a second deduction in cases such as this, is analytically the same as the potential for a double deduction that was present in *Nash.* See Brief for United States in *Nash v. United States*, O.T. 1969, No. 678, pp. 20–31.

24. The Solicitor General made this timing point explicit in *Nash.* "Since a reserve for bad debts represents losses that are estimated will be sustained in subsequent taxable years, ... any unabsorbed amounts in such a reserve must be restored to income when ... it becomes clear that the taxpayer will not suffer some or all of the estimated losses as a result of the uncollectibility of accounts receivable." *Id.*, at 8–9.

25. The flaws in the Court's approach are exemplified by its discussion, *ante*, at 1144, of a hypothetical situation involving a tenant who has paid the entire cost of a 30-day lease that

416 III

Because tax considerations play such an important role in decisions relating to the investment of capital, the transfer of operating businesses, and the management of going concerns, there is a special interest in the orderly, certain, and consistent interpretation of the Internal Revenue Code. Today's decision seriously compromises that interest. It will engender uncertainty, it will enlarge the tax gatherer's discretionary power to reexamine past transactions, and it will produce controversy and litigation.

Any inconsistent-event theory of the tax benefit rule would make the tax system more complicated than it has been under the recovery theory.[26] Inconsistent-event analysis forces a deviation from the tradi- 417 tional pattern of calculating income during a given year: identify the transactions in which the taxpayer was made wealthier, determine from the history of those transactions which apparent sources of enrichment should be characterized as income, and then determine how much of that income must be recognized. Of course, in several specific contexts, Congress has al-

straddles two taxable years on December 15 of the first year.

The Court first invites consideration of what tax consequences would result if the premises burn down in January of the second year. I would think it obvious that a taxpayer does not realize income under such circumstances, and the Court manages to accommodate this result to its theory. Even though the original explanation for the deduction (the business would make use of the premises) is no longer valid, the Court finds no fundamental inconsistency because "the loss is attributable to the business."

The Court goes through this exercise in order to reach the next hypothetical, wherein the taxpayer *voluntarily* stops using the leasehold for a business purpose during the second year. Having assumed that the entire cost of the lease was deductible during the first year, the Court now declares that the tax benefit rule must be invoked to prevent a tax inequity. The Court's methodology in this regard is quite revealing. It has presumed the validity of the deduction in the first year, citing *Zaninovich v. Commissioner,* 616 F.2d 429 (CA9 1980). Yet *Zaninovich* is still being debated in the lower courts, in part because of hypothetical cases such as this one, and has not been endorsed by either the Commissioner or the Tax Court. See *Keller v. Commissioner,* 79 T.C. 7, 40, n. 24 (1982); *Dunn v. United States,* 468 F.Supp. 991, 994, and n. 17 (SDNY 1979) (Weinfeld, J.). See also *Van Raden v. Commissioner,* 71 T.C. 1083, 1107 (1979) (suggesting a distinction between "period" costs and "product" costs), aff'd, 650 F.2d 1046 (CA9 1981). Thus, the Court creates its own problem by blithely allowing a deduction in the initial period, with the intention of continuously second-guessing that decision in subsequent years. I do not see the advantage of this approach over Justice BLACKMUN's suggestion, which is criticized by the Court *ante,* at 1140–1141, n. 10. Instead, I would prefer to think carefully about whether or not the deduction should be allowed in the first place (taking into account such factors as the ease with which a lease can be prorated, the likelihood of nonbusiness uses, and the bright-line recovery rule) and, if that results in a decision to grant the deduction, to abide by whatever consequences follow from the application of traditionally accepted tax principles.

26. The Court suggests, *ante,* at 1142–1143, that a recovery requirement is both too narrow and too broad to give certain guidance. The Court suggests it is too narrow because the Court believes that the cancellations of indebtedness found in *Mayfair Minerals, Inc. v. Commissioner,* 456 F.2d 622 (CA5 1972), *Bear Manufacturing Co. v. United States,* 430 F.2d 152 (CA7 1970), *Haynsworth v. Commissioner,* 68 T.C. 703 (1977), and *G.M. Standifer Construction Corp. v. Commissioner,* 30 B.T.A. 184 (1934), "[do] not fit within any ordinary definition of 'recovery.'" *Ante,* at 1143. I disagree. As the Court concedes, *ibid.,* cancellation of a legally enforceable liability quite obviously increases the taxpayer's net worth. The Code therefore explicitly requires a discharge of indebtedness to be included in income. § 61(a)(12). Cf. § 108. It does no damage to the English language to say that a taxpayer who has previously incurred an expense by assuming a liability recovers that expense when the liability is canceled.

The Court suggests that the term "recovery" is too broad because two courts have claimed to find a recovery in situations the Court finds surprising. *Tennessee-Carolina Transportation, Inc. v. Commissioner,* 582 F.2d 378 (CA6 1978) (alternative holding); *First Trust and Savings Bank of Taylorville v. United States,* 614 F.2d 1142 (CA7 1980). Since I believe both cases were wrongly decided (*Tennessee-Carolina* applied the tax benefit rule to a case closely analogous to *Bliss Dairy,* and *First Trust* applied the rule to a case closely analogous to *Hillsboro Bank*), I do not find the Court's criticism any more persuasive than I would find a suggestion that someone might incorrectly think there was a "recovery" in the cases before us today.

ready mandated deviations from that traditional pattern,[27] and the additional complications are often deemed an appropriate price for enhanced tax equity. But to my knowledge Congress has never even considered so sweeping a deviation as a general inconsistent-event theory.

Nonetheless, a general inconsistent-event theory would surely give more guidance than the vague hybrid established by the Court today. The dimensions of the Court's newly fashioned "fundamentally inconsistent event" version of the ⊥418 tax benefit rule are by no means clear. It obviously differs from both the Government's "inconsistent event" theory and the familiar "recovery" theory, either of which would require these two cases to be decided in the same way. I do not understand, however, precisely why the Court's theory distinguishes between these cases, or how it is to be applied in computing the 1973 taxes of Bliss Dairy, Inc.

The Government describes its test as whether "subsequent events eliminate the factual premise on which the deduction was originally claimed." Brief for United States in No. 81–930 and for Respondent in No. 81–485, p. 18. The Court describes its test as whether "the later event is indeed fundamentally inconsistent with the premise on which the deduction was initially based." *Ante,* at 1143. One might infer that the difference between these tests is a difference between "inconsistent events" and "fundamentally inconsistent events." The Court attempts to place the line more precisely "between merely unexpected events and inconsistent events." *Ante,* at 1143, n. 15. I am afraid the attempt fails because, however it is described, the line does not cleanly and predictably separate the Court's position from the Government's.

The Court presents its test as whether "the occurrence of the [later year's] event in the earlier year would have resulted in the disallowance of the deduction." *Ante,* at 1146. But in *Hillsboro,* the Court rejects the Government's claim. The Court holds that if this Court had decided *Lehnhausen v. Lakeshore Auto Parts Co.,* 410 U.S. 356, 93 S.Ct. 1001, 35 L.Ed.2d 351 (1973), in 1972, the Bank would still have been entitled to deduct a dividend that was not used for the payment of taxes. It attempts to read the legislative history of § 164(e) as establishing that Congress did not care about the use to which the dividend payment was put, but only about the Bank's reason for the dividend. I would simply note that I find Justice BLACKMUN's interpretation of § 164(e) far more plausible.

The Court's analysis of *Bliss Dairy* is equally unsatisfying. Without any mention of a same-year principle, the Court re⊥419solves the case in a single sentence: a § 336 liquidation is assimilated to a dividend distribution, which is deemed "the analog of personal consumption," and therefore "it would seem that it should take into income the amount of the earlier deduction." *Ante,* at 1150, and n. 31.[28] It is not obvious to me why the change in ownership of a going concern is more "the analog of personal consumption" than the gift of an asset.

The new rule will create even more confusion than that which will accompany efforts to reconcile the Court's disposition of these two cases. Given that *Nash* is still considered good law by the Court, it is not clear which prior expenses of Bliss Dairy, Inc., will give rise to income in 1973. Presumably, all expenses for the purchase of tangible supplies will be treated like the cattle feed. Thus, all corporate paper towels, paper clips, and pencils that remain on

27. *E.g.,* §§ 1245, 1250 (mere dispositions of certain depreciable property and certain depreciable realty may give rise to income).

28. It is noteworthy that the Court cites no authority for the assumption—critical under its interpretation of the tax benefit rule—that if the liquidation of Bliss Dairy, Inc., had occurred in 1972, the deduction for purchased but unconsumed cattle feed would have been disallowed.

hand will become income as a result of the liquidation. It is not clear, however, how the Court would react to other expenses that provide an enduring benefit. I find no limiting principle in the Court's opinion that distinguishes cattle feed and pencils from prepaid rent, prepaid insurance, accruals of employee vacation time, advertising, management training, or any other expense that will have made the going concern more valuable when it is owned directly by its shareholders.

The Court's opinion also leaves unclear the amount of income that is realized in the year in which the fundamentally inconsistent event occurs. In most of its opinion, the Court indicates that the taxpayer is deemed to realize "the amount of his earlier deduction," *ante*, at 1143, but from time to time the Court equivocates,[29] and at least once suggests that when ⊥420 an expensed asset is sold, only the "amount of the proceeds on sale," *ante*, at 1150, is income.[30] Even in *Bliss Dairy*, which involves a revolving inventory of a fungible commodity, I am not sure how the Court requires the "cost" of the grain, *ante*, at 1154, to be computed. If the corporation's 1972 consumption matched its 1972 purchases, one might think that the relevant cost was that in the prior years when the surplus was built up. I cannot tell whether or why the fundamentally inconsistent-event theory prefers LIFO accounting over FIFO.

IV

Neither history nor sound tax policy supports the Court's abandonment of its interpretation of the tax benefit rule as a tool for characterizing certain recoveries as income. If Congress were dissatisfied with the tax treatment that I believe *Bliss Dairy* should be accorded under current law, it could respond by changing any of the three provisions that bear on this case. See *supra*, at 1159. It could modify the manner in which deductions are authorized under § 162.[31] It could ⊥421 legislate another statutory exception to the annual accounting system, much as it did when it made the depreciation recapture provisions,

29. In a footnote, *ante*, at 1153, n. 37, the Court suggests that it is not addressing the issue of whether some figure less than the amount previously deducted might be appropriate. Two possibilities have been suggested: lesser-of-prior-deduction-and-current-fair-market-value, see *Tennessee Carolina Transportation, Inc. v. Commissioner*, 65 T.C. 440, 448 (1975), and lesser-of-prior-deduction-and-shareholder's-basis, see Feld, The Tax Benefit of *Bliss*, 62 B.U.L.Rev. 443 (1982). Given the uniform tenor of the Court's theory that the tax benefit rule serves to " 'cancel out' an earlier deduction," *ante*, at 1143, I think it unlikely that it would endorse either possibility.

30. This view, of course, conforms to what a recovery theory would dictate. See *Rosen v. Commissioner*, 611 F.2d 942 (CA1 1980) (taxpayer realizes the value of recovered asset, determined at time of recovery).

31. If it were so inclined, it could modify § 162(a) to provide that no deduction would be allowed for the purchase of materials and supplies; instead, a deduction would be allowed only at the time of consumption. Such a sentiment clearly underlies the Court's statement, *ante*, at 1149–1150, that "[t]he deduction is predicated on the consumption of the asset in the trade or business."

Alternatively, it could provide that a purchase of materials and supplies not be considered an "ordinary and necessary expense" to the extent it includes items that will probably not be consumed during the taxable year. As the Solicitor General notes in his brief before this Court, "income might be more accurately reflected through the use of inventory accounting for such supplies," Brief for United States in No. 81–930 and for Respondent in No. 81–485, pp. 37–38. It bears mention that the Commissioner presently takes the position that an expenditure for feed that will be consumed in a subsequent year will not be allowed unless three tests are satisfied: it must be a payment (not a refundable deposit), it must be made for a business purpose and not merely for tax avoidance, and the deduction must not result in a material distortion of income. Rev.Rul. 79–229, 1979–2 Cum.Bull. 210. Cf. Treas.Reg. 1.162–12, 26 CFR § 1.162–12 (1982). The courts have divided over whether the Commissioner's position is consistent with the present § 162(a). Compare *Clement v. United States*, 580 F.2d 422, 217 Ct.Cl. 495 (1978), cert. denied, 440 U.S. 907, 99 S.Ct. 1214, 59 L.Ed.2d 455 (1979); *Dunn v. United States*, 468 F.Supp. 991 (SDNY 1979) (Weinfeld, J.) (supporting the Commissioner), with *Frysinger v. Commissioner*, 645 F.2d 523 (CA5 1981); *Commissioner v. Van Raden*, 650 F.2d 1046 (CA9 1981) (supporting the taxpayer).

§§ 1245, 1250, apply to § 336 liquidations.[32] Or it could modify the manner in which basis is allocated under § 334.[33] But in the absence of legislative action, I cannot join in the Court's attempt to achieve similar results by distorting the tax benefit rule.[34]

422 Accordingly, I concur in the Court's judgment in No. 81–485 and respectfully dissent in No. 81–930.

Justice BLACKMUN, dissenting.

These consolidated cases present issues concerning the so-called "tax benefit rule" that has been developed in federal income tax law. In No. 81–485, the Court concludes that the rule has no application to the situation presented. In No. 81–930, it concludes that the rule operates to the detriment of the taxpayer with respect to its *later* tax year. I disagree with both conclusions.

I

In No. 81–485, the Court interprets § 164(e) of the Internal Revenue Code of 1954, 26 U.S.C. § 164(e). See *ante,* at 1148–1149. It seems to me that the propriety of a 1972 deduction by the Bank under § 164(e) depended upon the payment by the Bank of a state tax on its shares. This Court's decision in *Lehnhausen v. Lake Shore Auto Parts Co.,* 410 U.S. 356, 93 S.Ct. 1001, 35 L.Ed.2d 351 (1973), rendered any such tax nonexistent and any deduction therefore unavailable. I sense no "focus of Congress ... on the act of payment rather than on the ultimate use of the funds by the State." *Ante,* at 1149. The focus, instead, is on the payment of a *tax.* Events proved that there was no tax. The situation, thus, is one for the application, not the nonapplication, of some tax benefit rule.

I therefore turn to the question of the application of a proper rule in each of these cases.

II 423

The usual rule, as applied to a deduction, appears to be this: Whenever a deduction is claimed, with tax benefit, in a taxpayer's federal return for a particular tax year, but factual developments in a later tax year prove the deduction to have been asserted mistakenly in whole or in part, the deduction, or that part of it which the emerging facts demonstrate as excessive, is to be regarded as income to the taxpayer in the later tax year. With that general concept (despite occasionally expressed theoretical differences between "transactional parity" or "transactional inconsistency," on the one hand, and, on the other, a need for a "recovery") I have no basic disagreement.

32. In 1975, Congress had before it, but was unable to pass, such legislation. H.R. 10936, 94th Cong., 1st Sess. (1975).

33. In particular, it could prohibit the allocation of any shareholder basis to an expensed asset, thereby completely eliminating the possibility of the step-up discussed *supra,* at 1159. Indeed, the Internal Revenue Service could do so consistently with the present text of § 334 by modifying Treas.Reg. § 1.334–2, 26 CFR § 1.334–2 (1982).

34. Because I disagree with the Court's conclusion that Bliss Dairy, Inc., realized income upon liquidation, I obviously do not reach the issue of how § 336, the nonrecognition provision, should be construed. I would observe, however, that in order to justify its conclusion, the Court is forced to override the plain language of § 336. See *ante,* at 1151–1153, n. 20, *supra.* The Court justifies this course of action by invoking the lower court decisions that have held the nonrecognition language of § 337 superseded by the tax benefit rule in the context of recoveries. *E.g., Commissioner v. Anders,* 414 F.2d 1283 (CA10), cert. denied, 396 U.S. 958, 90 S.Ct. 431, 24 L.Ed.2d 423 (1969); *Anders v. United States,* 462 F.2d 1147, 199 Ct.Cl. 1, cert. denied, 409 U.S. 1064, 93 S.Ct. 557, 34 L.Ed.2d 517 (1972). Those cases are relevant because when Congress enacted § 337, it hoped to allow taxpayers to enjoy some of the tax benefits of § 336 even when they do not precisely satisfy the formal prerequisites for applying that section. But assuming that the *Anders* construction of § 337 is correct (a point this Court has never decided), I would think the tail wags the dog if one construes § 336 in light of § 337, rather than vice versa. Cf. *Tennessee-Carolina Transportation, Inc. v. Commissioner, supra,* at 453 (Tannenwald, J., dissenting) ("Section 337 was designed to be a shield for taxpayers and not a sword to be used against them in applying other sections of the Code").

Regardless of the presence of § 111 in the Internal Revenue Code of 1954, 26 U.S.C. § 111 (1976 ed. and Supp. V), it is acknowledged that the tax benefit rule is judge-made. See, *e.g.*, 1 J. Mertens, Law of Federal Income Taxation § 7.34, p. 114 (J. Doheny rev. ed. 1981); Bittker and Kanner, The Tax Benefit Rule, 26 UCLA L.Rev. 265, 266 (1978). It came into being, apparently, because of two concerns: 1) a natural reaction against an undeserved and otherwise unrecoverable (by the Government) tax benefit, and 2) a perceived need, because income taxes are payable at regular intervals, to promote the integrity of the annual tax return. Under this approach, if a deduction is claimed, with some justification, in an earlier tax year, it is to be allowed in that year, even though developments in a later year show that the deduction in the earlier year was undeserved in whole or in part. This impropriety is then counterbalanced (concededly in an imprecise manner, see *ante*, at 1140, n. 10, and 1142, n. 12) by the inclusion of a reparative item in gross income in the later year. See *Burnet v. Sanford & Brooks Co.*, 282 U.S. 359, 51 S.Ct. 150, 75 L.Ed. 383 (1931); *Healy v. Commissioner*, 345 U.S. 278, 73 S.Ct. 671, 97 L.Ed. 1007 (1953).* In
⊥424 ⊥*Nash v. United States*, 398 U.S. 1, 3, 90 S.Ct. 1550, 1551, 26 L.Ed.2d 1 (1970), the Court succinctly phrased it this way: "[A] recovery of an item that has produced an income tax benefit in a prior year is to be added to income in the year of recovery."

I have no problem with the rule with respect to its first underlying concern (the rectification of an undeserved tax benefit). When a taxpayer has received an income tax benefit by claiming a deduction that later proves to be incorrect or, in other words, when the *premise* for the deduction is destroyed, it is only right that the situation be corrected so far as is reasonably possible, and that the taxpayer not profit by the improper deduction. I am troubled, however, by the tendency to carry out the second concern (the integrity of the annual return) to unnecessary and undesirable limits. The rule is not that sacrosanct.

In No. 81–485, Hillsboro National Bank, in its 1972 return, took as a deduction the amount of assessed state property taxes the Bank paid that year on its stock held by its shareholders; this deduction, were there such a tax, was authorized by the unusual, but nevertheless specific, provisions of § 164(e) of the Code, 26 U.S.C. § 164(e). The Bank received a benefit by the deduction, for its net income and federal income tax were reduced accordingly. Similarly, in No. 81–930, Bliss Dairy, Inc., which kept its books and filed its returns on the cash receipts and disbursements method, took a deduction in its return for its fiscal year ended June 30, 1973, for cattle feed it had purchased that year. That deduction was claimed as a business expense under § 162(a) of the Code, 26 U.S.C. § 162(a). The Dairy received a tax benefit, for its net income and federal income tax for fiscal 1973 were reduced by the deduction. Thus far, everything is clear and there is no problem.

In the Bank's case, however, a subsequent development, namely, the final determination by this Court in 1973 in ⊥*Lehn- ⊥425
hausen, supra,* that the 1970 amendment of the Illinois Constitution, prohibiting the imposition of the state property taxes in question, was valid, eliminated any factual justification for the 1972 deduction. And, in the Dairy's case, a post-fiscal year 1973 development, namely, the liquidation of the corporation and the distribution of such feed as was unconsumed on June 30, 1973, to its shareholders, with their consequent ability to deduct, when the feed thereafter was consumed, the amount of their adjusted basis in that feed, similarly demonstrated the impropriety of the Dairy's full-cost deduction in fiscal 1973.

* In *Sanford & Brooks*, the earlier tax years were 1913–1916 and the later year was 1920. In *Healy*, the earlier year was 1945 and the later years were 1947 and 1948. In *Healy*, the Court specifically noted the probable complicating factor of a statute of limitations barrier. 345 U.S., at 284, 73 S.Ct., at 675.

I have no difficulty in favoring some kind of "tax benefit" adjustment in favor of the Government for each of these situations. An adjustment should be made, for in each case the beneficial deduction turned out to be improper and undeserved because its factual premise proved to be incorrect. Each taxpayer thus was not entitled to the claimed deduction, or a portion of it, and this nonentitlement should be reflected among its tax obligations.

This takes me, however, to the difficulty I encounter with the second concern, that is, the unraveling or rectification of the situation. The Commissioner and the United States in these respective cases insist that the Bank and the Dairy should be regarded as receiving income in the very next tax year when the factual premise for the prior year's deduction proved to be incorrect. I could understand that position, if, in the interim, the bar of a statute of limitations had become effective or if there were some other valid reason why the preceding year's return could not be corrected and additional tax collected. But it seems to me that the better resolution of these two particular cases and others like them—and a resolution that should produce little complaint from the taxpayer—is to make the necessary adjustment, whenever it can be made, in the tax year for which the deduction was originally claimed. This makes the correction where the correction is due and it makes the amount of net income for each year a true amount and one that accords with the facts, not ⌊426 one that is structured, imprecise, and fictional. This normally would be accomplished either by the taxpayer's filing an amended return for the earlier year, with payment of the resulting additional tax, or by the Commissioner's assertion of a deficiency followed by collection. This actually is the kind of thing that is done all the time, for when a taxpayer's return is audited and a deficiency is asserted due to an overstated deduction, the process equates with the filing of an amended return.

The Dairy's case is particularly acute. On July 2, 1973, on the second day after the end of its fiscal year, the Dairy adopted a plan of liquidation pursuant to § 333 of the Code, 26 U.S.C. § 333. That section requires the adoption of a plan of liquidation; the making and filing, within 30 days, of written elections by the qualified electing shareholders; and the effectuation of the distribution in liquidation within a calendar month. §§ 333(a), (c), and (d). It seems obvious that the Dairy, its management, and its shareholders, by the end of the Dairy's 1973 fiscal year on June 30, and certainly well before the filing of its tax return for that fiscal year, all had conceived and developed the July 2, 1973, plan of liquidation and were resolved to carry out that plan with the benefits that they felt would be afforded by it. Under these circumstances, we carry the tax benefit rule too far and apply it too strictly when we utilize the unconsumed feed to create income for the Dairy for fiscal 1974 (the month of July 1973), instead of decreasing the deduction for the same feed in fiscal 1973. Any concern for the integrity of annual tax reporting should not demand that much. I thus would have the Dairy's returns adjusted in a realistic and factually true manner, rather than in accord with an inflexibly administered tax benefit rule.

Much the same is to be said about the Bank's case. The decisive event, this Court's decision in *Lehnhausen*, occurred on February 22, 1973, within the second month of the Bank's 1973 tax year. Indeed, it took place before the Bank's calendar year 1972 return would be overdue. Here again, an ac⌊427 curate return for 1972 should be preferred over inaccurate returns for both 1972 and 1973.

This, in my view, is the way these two particular tax controversies should be resolved. I see no need for anything more complex in their resolution than what I have outlined. Of course, if a statute of limitations problem existed, or if the facts in some other way prevented reparation to the Government, the cases and their resolution might well be different.

I realize that my position is simplistic, but I doubt if the judge-made tax benefit rule really was intended, at its origin, to be regarded as applicable in simple situations of the kind presented in these successive-tax-year cases. So often a judge-made rule, understandably conceived, ultimately is used to carry us further than it should.

I would vacate the judgment in each of these cases and remand each case for further proceedings consistent with this analysis.

56 T.C. 82
United States Tax Court

MAYFAIR MINERALS, INC., PETITIONER
v.
COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 5409-68.
|
Filed April 15, 1971.

Attorneys and Law Firms

***82** R. B. Cannon, for the petitioner.

Arthur B. Bleecher and Dennis J. Carlin, for the respondent.

Synopsis

For 4 years (1957 through 1960) while contesting an FPC order disapproving a rate increase, petitioner deducted as accrued liabilities the amounts of refunds which it would have been required to make if the FPC order had not been rescinded in a later year (1961). Held, petitioner realized taxable income in the year in which the FPC order was rescinded; petitioner was estopped, because of its conduct, to deny that the deductions of accrued liabilities for the earlier years were properly claimed.

Opinion

FEATHERSTON, Judge:

Respondent determined a deficiency in petitioner's Federal income tax for its taxable year ending September 30, 1961, in the amount of $785,736.90, and for its taxable year ending September 30, 1963, in the amount of $59,998.63. The only issue presented for decision is whether petitioner realized taxable income in its fiscal year ending September 30, 1961, when it canceled an account payable representing contingent liabilities for customer refunds erroneously deducted as accrued liabilities for its fiscal years ending September 30, 1957, through September 30, 1960. [1]

FINDINGS OF FACT

Mayfair Minerals, Inc. (hereinafter petitioner), is a corporation chartered under the laws of Texas which had its principal office at McAllen, Tex., at the time its petition was filed. It employed the accrual method of accounting and a fiscal year ending September 30. [2] For the years in controversy, petitioner filed its income tax returns with the district director of internal revenue, Austin, Tex.

Prior to 1954, petitioner was engaged, through Delhi-Taylor Oil Corp., in producing natural gas and selling it to pipeline corporations. The gas sales involved in this proceeding were all made to Trunkline Gas Co. (hereinafter Trunkline).

Petitioner and Trunkline negotiated a new contract, effective November 30, 1954, in which the rate to be paid for gas was increased from approximately 7 1/2 to 12 cents per thousand cubic feet, MCF. They then applied to the Federal Power Commission (hereinafter ***83** FPC) for approval of the new 12-cent rate. The FPC declined to approve the rate increase, and, on December 29, 1954, suspended it. On March 1, 1955, petitioner filed with the FPC an agreement to refund to Trunkline any difference between 12 cents per MCF and such rate as the FPC might eventually approve, plus 6-percent interest thereon. Thereafter, petitioner collected from Trunkline and reported on its returns as depletable income the full 12 cents per MCF for the gas which it sold.

By an order dated September 30, 1957, the FPC disallowed the increase in price and ordered petitioner to refund the amount collected in excess of 7 1/2 cents per MCF. The amount of the refund so ordered, including interest, was $2,023,756.88.

Petitioner filed a petition with the FPC for a rehearing, and the petition was denied on November 27, 1957. However, the FPC granted an application for a stay of its order, pending review by the Court of Appeals for the Fifth Circuit. Subsequently, upon a joint motion of the parties, the Court of Appeals remanded the case to the FPC for further consideration. Intermittent pleadings, investigations, and hearings followed, terminating in an order entered by the FPC on October 11, 1960. This order, in effect, approved the rate increase and became final on or about November 10, 1960.

During the period from March 1, 1955, through September 30, 1960, while petitioner was contesting the FPC's disapproval of the rate increase but selling its gas at the increased rate, it made the following liability accruals on its books, charging them to an account payable:

Year	Net total for year	Accumulated total
1955..........	$468,580.51	$468,580.50
1956..........	797,397.25	1,265,977.75
1957..........	757,779.13	2,023,756.88
1958..........	776,719.81	2,800,476.69
1959..........	755,068.07	3,555,544.76
1960..........	719,581.39	4,275,126.15

On its income tax return for 1957, the year in which the FPC ordered the refund, petitioner deducted an item listed on a schedule of 'Income and Deductions' and a 'Refund as ordered by FPC.' The amount deducted ($2,023,756.88) was the amount shown on the above table as the 'Accumulated total' for that year. On its returns for the following years, 1958, 1959, and 1960, petitioner deducted the amounts shown on the above tables as 'Net total for year.' These items were labeled as 'Refund as ordered by FPC.' in the 1958 return, and as 'Refund as order by the FPC,' in the 1959 and 1960 returns. None of these accrued liabilities were ever paid.

***84** From the time it became apparent that petitioner would not be required to refund the amounts attributable to the rate increase, the treatment to be accorded these items for income tax purposes was a matter of discussion among petitioner's officers and tax advisers. Three possible courses of action were considered: (1) Filing amended returns for 1957 through 1960, recomputing the income for each year without the benefit of the accrued liabilities and paying the resulting tax; (2) reporting the full amount of $4,275,126.15 as income for 1961; and (3) doing neither (1) nor (2), but making an entry in Schedule M, part of the 1961 return, reflecting that the previously accrued liabilities had been canceled.

A senior tax partner in the Houston office of a national accounting firm, after consulting with a senior tax partner in the New York office or that firm, advised petitioner that the amount of the canceled liability should be reported as income in petitioner's return for 1961.

Petitioner's own tax adviser disagreed with the advice of the accounting firm. Under date of December 6, 1961, he addressed a letter to petitioner's president, containing an analysis of possible courses of action. The letter advised that petitioner (1) should not file amended returns for 1957 through 1960, (2) should not include the $4,275,126.15 in 1961 taxable income, but (3) should file a return for 1961, making a 'disclosure' of the recision of the FPC order in Schedule M of the return. The letter further stated that, in the opinion of the writer, section 1.461-1(a)(3), Income Tax Regs., relating to amended returns, is 'invalid, merely precatory, or both.'

Pursuant to the recommendation of its tax adviser, petitioner consulted an attorney in private practice. In a letter dated December 15, 1961, the attorney advised that 'the net taxable income of Mayfair Minerals, Inc. for its fiscal year ended September 30, 1961 was not affected in any way by the recision by FPC of its 1957 order directing the payment of refunds,' adding:

May I suggest that, in my view, a proper manner of communicating the recision of the order of the FPC to the

Internal Revenue Service would be through the medium of Schedule M of the 1961 income tax return in which Schedule the restoration to surplus of all accrued accounts payable based on the original FPC order should be shown with the explanation in substance that the amounts were restored to surplus because of the recision of the original order of the FPC.

Petitioner did not file amended income tax returns for 1957 through 1960, and did not report for 1961 any income as a result of the cancellation of its contingent liability to make rate refunds to Trunkline. At the direction of its tax adviser, Schedule M of petitioner's income tax return for 1961 contained the following:

***85** MAYFAIR MINERALS, INC.

RECONCILIATION OF TAXABLE INCOME AND ANALYSIS OF CHANGES IN SURPLUS

FOR CALENDAR YEAR 1961 OR FISCAL YEAR BEGINNING OCTOBER 1, 1960, AND ENDING SEPTEMBER 30, 1961

Net change in surplus:		
Increases:		
Taxable income before net operating loss deduction and special		
deductions (loss)......................		($45,161.36)
Other:		
Depletion allowable for tax purposes..................................		622,503.34
Intangible development costs incurred in the fiscal year..........		538,983.36
Future lifting costs applicable to production payments which		
paid out....................................		50,000.00
Order by FPC for refund of portion of prior years gas sales rescinded—		
contingent liability therefore		
eliminated................................	$4,275,126.15	
Less: Applied directly to		
reserve for amortization of		
intangible development		
costs..$3,665,126.15		

Applied to creation of reserve for taxes and interest...............................	610,000.00	4,275,126.15	....
			1,166,325.34

The Schedule M adjustment to the reserve for amortization of intangible development costs is completely unrelated to the contingent rate refund liability. The former reflects the write-off for business accounting purposes of the intangible development costs which had been previously deducted for income tax purposes. The reserve for taxes and interest represents the amount of additional taxes and interest that would have been owed if amended returns had been filed for 1958, 1959, and 1960, without claiming deductions for the disputed rate increase refunds. At the time the 1961 return was filed, the assessment of a deficiency for 1957 was already barred by the statute of limitations.

Petitioner's returns for 1957 through 1961 were filed on the following dates:

Years	*Date of filing*
1957..............................	Mar. 5, 1958
1958..............................	Mar. 9, 1959
1959..............................	Mar. 17, 1960 [1]
1960..............................	Dec. 13, 1960
1961..............................	Feb. 23, 1962

Because petitioner had assets in excess of $1 million, each of these returns was reviewed in the office of the Internal Revenue Service to ascertain whether the return would be audited. The returns for 1957 through 1960 were accepted as filed, were marked 'Closed on Survey,' and were not audited. The return for 1961 was examined and audited, and a notice of deficiency was issued on October 30, 1968.

The notice of deficiency stated, in part:

(e) As a result of rate hearings before the Federal Power Commission (FPC), Docket No. G-6504, and an agreement and undertaking you filed on or about May 9, 1955, with the FPC to comply with the terms and conditions of the FPC ***86** order making effecting proposed rate changes, you accrued and deducted under your method of accounting, as a result of an order of the FPC, refunds of $4,275,126.15 due your customer in the fiscal years ended on or before September 30, 1960.

It is determined that you realized under your method of accounting taxable income of $4,275,126.15 in the fiscal year ended September 30, 1961, when your liability to make such refunds under the written agreement and undertaking on file with the FPC was terminated or canceled.

It is further determined that, in any event, you are estopped from claiming that taxable income did not result on the elimination of your liability of $4,275,126.15.

OPINION

Petitioner contends that each of its taxable years must be considered separately. Respondent's only recourse for imposing a tax on the disputed income, petitioner argues in substance, was to disallow the deductions for 1957 through 1960. As to 1961, petitioner maintains that it realized no taxable income when the FPC order was rescinded, and that, consequently, respondent's determination is erroneous. We do not agree.

As a general rule, each taxable period is to be treated as separate and independent, and items of income and deductions for one year may not be set off and adjusted in computing the tax for another year. Burnet v. Sanford & Brooks Co., 282 U.S. 359 (1931). Yet there are situations where the proper treatment of an item in one year cannot be resolved without reference to events in a prior year. See, e.g., Dobson v. Commissioner, 320 U.S. 489 (1943), rehearing denied 321 U.S. 231 (1944). One of these situations arises when an amount deducted from gross income in one year is recovered in a later year; in such circumstances, the tax-benefit rule requires that the amount of the recovery be taxed as income in the later year. See, e.g., Merchants Nat. Bank v. Commissioner, 199 F.2d 657, 659 (C.A. 5, 1952), affirming 14 T.C. 1375 (1950); Putnam Nat. Bank v. Commissioner, 50 F.2d 158 C.A. 5, 1931), affirming 20 B.T.A. 45 (1930). The reason for this rule is clear. 'When recovery or some other event which is inconsistent with what has been done in the past occurs, adjustment must be made in reporting income for the year in which the change occurs. No other system would be practical in view of the statute of limitations, the obvious administrative difficulties involved, and the lack of finality in income tax liability, which would result.' Estate of William H. Block, 39 B.T.A. 338, 341 (1939), affirmed sub nom. Union Trust Co. v. Commissioner, 111 F.2d 60 (C.A. 7, 1940), certiorari denied 311 U.S. 658 (1940).

***87** While the tax-benefit rule had its genesis in court decisions, it is now implicitly codified in section 111, [3] relating to recovery exclusions. West Seattle National Bank of Seattle v. Commissioner, 288 F.2d 47, 48-49 (C.A. 9, 1961), affirming 33 T.C. 341 (1959). This section assumes the efficacy of the rule by providing for the exclusion from gross income of any amount attributable to the recovery of a previously deducted bad debt, prior tax, or delinquency amount to the extent the deduction in the prior year did not result in a tax benefit to the taxpayer. The regulations extend similar treatment to 'all other losses, expenditures, and accruals made the basis of reductions from gross income for prior taxable years.' Sec. 1.111-1(a), Income Tax Regs. Thus, the rule applies to accrued but unpaid deductions as well as to deductions actually paid. The adjustment for such an unpaid expense is made in the year in which the liability for the item is extinguished.

Under this rule, petitioner, having received the prior tax benefits from the accrued deductions, realized income in 1961. In that year, its contingent liability to make the refunds terminated, the account payable was closed, and the money which the accruals represented became available for its general use. Bear Manufacturing Co. v. United States, 430 F.2d 152 (C.A. 7, 1970), certiorari denied 400 U.S. 1021 (1971); Wichita Coca Cola Bottling Co. v. United States, 152 F.2d 6 (C.A. 5, 1945); Sneed v. Commissioner, 119 F.2d 767, 771 (C.A. 5, 1941), affirming 40 B.T.A 1136 (1939), certiorari denied sub nom. Thompson v. Helvering, 314 U.S. 686 (1941); Commissioner v. Dallas Title & Guar. Co., 119 F.2d 211 (C.A. 5, 1941), modifying 40 B.T.A. 1022 (1939).

Petitioner seeks to avoid inclusion of the previously deducted accruals in its 1961 income on the ground that the transaction falls within one of the exceptions to the tax-benefit rule. First, it points to the line of authority exemplified by Streckfus Steamers, Inc., 19 T.C. 1 (1952), ***88** acq. 1953-1 C.B. 6,1953-1 C.B. 6, and Adolph B. Canelo III, 53 T.C. 217, 226-227 (1969), acq. 1971-1 C.B. 2,1971-1 C.B. 2, to the effect that the tax-benefit rule does not apply where the original deduction was improper; in such cases, the Commissioner's only remedy ordinarily is to disallow the erroneous deduction. Referring then to Dixie Pine Co. v. Commissioner, 320 U.S. 516 (1944), and Security Mills Co. v. Comm'r., 321 U.S. 281 (1944), for the proposition that contingent liabilities are not properly deductible, petitioner contends that the tax-benefit rule cannot be applied in this case.

We think, however, that the manner in which petitioner handled this transaction estops it from claiming the benefit of this exception to the tax-benefit rule, whether or not all the technical elements of estoppel are present.

Petitioner's treatment of this item on its tax return misled the revenue agents, and it does not matter whether this was done deliberately or unintentionally. Cf. Ross v. Commissioner, 169 F.2d 483, 492, 496 (C.A. 1, 1948), reversing on another point a Memorandum Opinion of this Court. The entries of the deductions in the 1957-60 tax returns— 'Refund as ordered by FPC' or 'Refund as ordered by the FPC'— conveyed the impression that the refunds had already been paid, [4] rather than that the liability was being contested and that payment awaited resolution of that dispute. The entries made no reference to the- pending litigation or to the suspension of the FPC order by the agreement that petitioner would be required to make the refunds only if the rate increase was not ultimately allowed. Indeed, at the time the 1960 return was filed, the rate dispute had already been settled, and petitioner knew that the refunds would never be made. In no circumstance was the item deductible for that year, cf. Fawcus Machine Co. v. United States, 282 U.S. 375 (1931); yet no clue of the rescission of the FPC order appears in the 1960 return. Not until its 1961 return was being prepared did petitioner, deliberately and in the face of conflicting counsel from its tax advisers, switch its legal theory to one designed to provide for the complete tax escape of these sums. Not until that return was filed did petitioner refer to this item as a 'contingent liability.'

Having thus dealt with the Government, petitioner cannot now be heard to say that its 1957-60 accruals were erroneous. To allow it to do so would permit it to 'found * * * (its) claim upon * * * (its) own inequity or take advantage of * * * (its) own wrong' in claiming the ***89** erroneous deductions and using misleading labels to describe them. Stearns Co. v. United States, 291 U.S. 54, 62 (1934).

In a variety of factual settings, the courts have declared that a taxpayer has a duty of consistency in making its returns where the tax consequences of a transaction occurring in one year are projected into a subsequent one. A classic statement of this principle is found in Orange Securities Corp. v. Commissioner, 131 F.2d 662 (C.A. 5, 1942), affirming 45 B.T.A. 24 (1941), where the issue was the basis of notes which had been treated as having no value when they were acquired. The court held that the taxpayer, after the statute of limitations had expired, could not show the notes had value, stating (131 F.2d at 663):

While it is true that income taxes are intended to be settled and paid annually each year standing to itself, and that omissions, mistakes and frauds are generally to be rectified as of the year they occurred, this and other courts have recognized that a taxpayer may not, after taking a position in one year to his advantage and after correction for that year is barred, shift to a contrary position touching the same fact or transaction. When such a fact or transaction is projected in its tax consequences into another year there is a duty of consistency on both the taxpayer and the Commissioner with regard to it, whether or not there be present all the technical elements of an estoppel. * * *

See also Continental Oil Co. v. Jones, 177 F.2d 508, 512 (C.A. 10, 1949), certiorari denied 339 U.S. 931 (1950); Johnson v. Commissioner, 162 F.2d 844, 846 (C.A. 5, 1947), affirming in part 7 T.C. 465 (1946); Wichita Coca Cola Bottling Co. v. United States, supra at 8; Commissioner v. Dallas Title & Guar. Cl., supra at 214; Comar Oil Co. v. Helvering, 107 F.2d 709 (C.A. 8, 1939), affirming 37 B.T.A. 1334 (1938); Alamo Nat. Bank v. Commissioner, 95 F.2d 622, 623 (C.A. 5, 1938), affirming 36 B.T.A. 402 (1937), certiorari denied 304 U.S. 577 (1938); Irving Bartel, 54 T.C. 25 (1970); C. H. Wentworth, 25 T.C. 1210, 1214 (1956), affd. 244 F.2d 874 (C.A. 9, 1957); Lloyd H. Faidley, 8 T.C. 1170, 1173 (1947).

In situations where the duty of consistency or quasi-estoppel applies, a taxpayer is required to follow the tax-benefit rule even though the original deduction was erroneous. Thus, in Askin & Marine Co. v. Commissioner, 66 F.2d 776 (C.A. 2, 1933), affirming 26 B.T.A. 409 (1932), the taxpayer took deductions for debts which, concededly, were not actually ascertained to be worthless. Rejecting the theory that, because the deductions were not allowable, no part of the collections of such debts in a later year may be included in income under the tax-benefit rule, the court said (at 778):

It is obvious that if this is so a taxpayer who gets an unlawful deduction in this way not only cuts down his taxable income in the year the deduction is taken, but gets immunity from income taxation on the account receivable which was deducted whenever it, or any part of it, is received. A result so unjust is not to be reached unless plainly required by law. Having represented that it had ascertained ***90** these accounts charged off its active file to be worthless and having received the benefit of the deduction it claimed when the commissioner took its representation of the ascertainment of worthlessness at its face value, we think the petitioner is now clearly estopped from denying, to the prejudice of the government, the truth of the representations upon which it has succeeded in former years in obtaining deductions from its gross income. While the commissioner must investigate returns to satisfy himself of their correctness in fact and law, a taxpayer may not benefit at the expense of the government by misrepresenting facts under oath; by succeeding in having the commissioner accept its representations as the truth; and by claiming later than what it represented to be true might have been found false had the commissioner refused to have faith in the sworn return. * * *

In a similar factual situation in Commissioner v. Liberty Bank & Trust Co., 59 F.2d 320, 325 (C.A. 6, 1932), reversing Liberty Insurance Bank, 14 B.T.A. 1428 (1929), the court said:

we cannot assent to the view that a taxpayer which has been allowed a deduction for a debt, on its statement under oath that the debt has been ascertained to be worthless, is not estopped thereafter from denying the truth of the statement to . the prejudice of the government. The Commissioner of necessity does and must rely largely upon the representations of the taxpayer, and, in order to estop the taxpayer from assuming a contrary position, he is not compelled to look with suspicion upon all such representations and himself examine, or cause to be examined, the financial condition of all the taxpayer's debtors. It is the duty of the taxpayer to deal fairly and truthfully with the government. * * * we think it is to be presumed from the fact that these deductions were allowed for the years in which they were claimed that the Commissioner relied upon the taxpayer's sworn statements that the debts were worthless. * * *

In Lloyd H. Faidley, supra, the taxpayer claimed and was allowed a loss on its 1930 return and then denied that he had income in 1941, when he received reimbursement for the loss under a guaranty agreement. The Court said (8 T.C.at 1173):

The petitioner took a deduction in his 1930 return which he now claims should not have been allowed. He stated in his return that his investment was 'a complete loss, there being no salvage.' The petitioner, who had knowledge of the true facts, never undertook to correct the return. The return was accepted and audited as being correct. The evidence does not justify any finding that the respondent had knowledge of any facts other than those stated in the return. In short, there was no mutual mistake. The year of deduction is now closed by the statute of limitations and is not before us. It can not be reopened by waiver in this proceeding. We hold that the petitioner is estopped to contend that the recovery in 1941 does not constitute taxable income because of the fact that the deduction may have been erroneously claimed and allowed in 1930. * * *

There is nothing in Streckfus Steamers, Inc., supra, to the contrary; in that case the Court observed (19 T.C.at 9) that 'no estoppel has been pleaded, nor was any evidence presented showing any basis for an estoppel.' And there is no indication in Adolph B. Canelo III, supra, that either quasi-estoppel or the duty of consistency was pleaded or ***91** otherwise relied upon by the Commissioner. On this issue, those cases stand only for the proposition that the tax-benefit rule does not warrant disregard of the statute of limitations; in other words, where the Commissioner is timely apprised, or should know, that a deduction is erroneous, he must disallow it for the year it is claimed rather than await a subsequent year and attempt to recoup the item by employing the tax-benefit rule. Those cases are clearly inapposite where the taxpayer, either deliberately or unintentionally, misleads the Commissioner through erroneous representations of fact in his returns, and the Commissioner, consequently, allows the statute of limitations to run on adjustments of taxable income on the misleading returns.

Petitioner next seeks a partial escape from the tax-benefit rule by stating that it filed ins 1961 return prior to the expiration of the statute of limitations for 1958 through 1960, [5] and arguing that the Commissioner was, therefore, informed of the true facts in time to disallow the deductions for those years. When considered in the light of the evidence, we think this argument borders on the facetious. The record shows that petitioner knew full well how, in 1961, it could have called its erroneous accruals for each of the prior years to the attention of the Commissioner— by filing amended returns for each of the years. It decided not to do this even though its president was expressly advised of section 1.461-1(a)(3), Income Tax Regs., which provides that 'if a taxpayer ascertains that a deduction was improperly claimed in a prior taxable year, he should, if within the period of limitation, file an amended return and pay an additional tax due.' Instead of complying with the directions in this regulation or the advice of two senior partners in its accounting firm to report the previously deducted amounts as 1961 taxable income, petitioner chose to make a 'disclosure' in Schedule M of its 1961 return. Even in doing this, it did not follow the advice of its private attorney merely to report 'the restoration to surplus of all accrued accounts payable based on the original order of the FPC.' Instead, petitioner, through an unusual and confusing notation on Schedule M, camouflaged the restoration to surplus by showing offsetting entries to other liability accounts— i.e., entries increasing its reserve for intangible development costs [6] and creating a reserve for taxes— which precisely equaled the amount of the restored rate refunds.

***92** While the entry in Schedule M of the 1961 return may have provided a technical shield from a charge of 'fraud,' [7] we do not think it constituted the kind of disclosure needed to fulfill petitioner's 'duty of handling * * * (its) accounting so it will fairly subject * * * (its) income (for 1957 through 1960) to taxation.' Wichita Coca Cola Bottling Co. v. United States, supra at 8. The law contemplates that 'Each year's return should be complete in itself.' Sec. 1.461-1(a)(3), Income Tax Regs. The purpose of tax returns 'is not alone to get tax information in some form but also to get it with such uniformity, completeness, and arrangement that the physical task of handling and verifying returns may be readily accomplished.' Commissioner v. Lane-Wells Co., 321 U.S. 219, 223 (1944). This is also, quite obviously, the underlying reason for the provision in section 1.461-1(a)(3) of the regulations, referred to above, on the filing of amended returns to correct errors in claiming deductions. The 'disclosure' on the 1961 return did not provide a uniform, complete, and orderly fashion the information necessary to verify that petitioner's income for 1957 through 1960 was being fairly subjected to taxation.

A fair review of the evidence on how petitioner handled this matter after the FPC order was rescinded shows that petition was not even attempting to discharge its duty to fairly subject its income to taxation. In the 'discussions' which following the rescission of the FPC order, petitioner's representatives were apparently seeking a formula which would reveal only enough information to avoid a charge of fraud while concealing enough to allow this income to escape tax. The course of action finally adopted was obviously an attempt by petitioner to take advantage of its own wrong. Stearns Co. v. United States, supra; Petitioner's 'disclosure,' obscured in its return for 1961, clearly was designed to delay any definitive action with respect to the returns of those years until after the statute of limitations had run.

The testimony describing the examinations of the 1947-60 returns leading to their being marked 'Closed on Survey' indicates that each return was examined separately and at different times. We are not advised when the 1961 return was first examined by the revenue agents, but the notice of deficiency was not mailed until October 30, 1968, more than 4 years after the 3-year statute of limitations for the 1960 return expired. We do not think respondent may be charged with ***93** knowledge of the facts regarding this transaction in time to disallow the erroneous deductions for any of the prior years. [8]

Petitioner next contends that the parties made a mutual mistake of law and, therefore, the duty-of-consistency rule does not apply. Petitioner asserts that its representatives were not aware that a disputed liability is not subject to accrual until the Supreme Court handed down its decision in United States v. Consolidated Edison Co., 366 U.S. 380, on May 22, 1961, after the 1960 and prior returns had been filed. Respondent's representatives who examined petitioner's returns were likewise unaware that a disputed liability is not accruable, [9] so goes the argument, and both groups made a mistake of law.

We reject this argument. The Supreme Court decision in Consolidated Edison did not deal with unpaid, disputed liabilities. It dealt with the effect of payment on the deductibility of a disputed item; indeed, both parties in that case started with the assumption that an unpaid contingent liability, being disputed in the courts, is not accruable. While the record here includes certain self-serving documents suggesting that petitioner's representatives were not aware that the contingent refund liability was not accruable, no one so testified. Nor did anyone explain the misleading notations, 'Refund as ordered by FPC' or 'Refund as order by the FPC,' used in the 1957-60 returns to describe the item. And there is not a syllable of evidence to show that any of the revenue agents became aware of the true facts until the 1961 return was examined. A mutual mistake of law can occur only where the crucial facts are known to both parties, and there is no showing that respondent knew such facts when the 1957-60 returns were surveyed and accepted without change.

***94** Finally, petitioner argues that the doctrine of estoppel, quasi-estoppel, and duty of consistency have been supplanted in the income tax law by sections 1311-1315, originally enacted as part of the Revenue Act of 1938, and those sections do not apply to the present facts. In adopting that legislation, however, Congress disavowed any intention to purge the tax laws of these doctrines (S. Rept. No. 1567, 75th Cong., 3d Sess. (1938), 1939-1 C.B. (Part 2) 815):

In each case, under existing law, an unfair benefit would have been obtained by assuming an inconsistent position and then taking shelter behind the protective barrier of the statute of limitations. Such resort to the statute of limitations is a plain misuse of its fundamental purpose. The purpose of the statute of limitations to prevent the litigation of stale claims is fully recognized and approved. But it was never intended to sanction active exploitation, by the beneficiary of the statutory bar, of opportunities only open to him if he assumes a position diametrically opposed to that taken prior to the running of the statute. The Federal courts in many somewhat similar tax cases have sought to prevent inequitable results by applying principles variously designated as estoppel, quasi-estoppel, recoupment and set-off. For various reasons, mostly technical, these judicial efforts cannot extend to all problems of this type. Nor can they provide a uniform, systematic solution to these problems. Legislation has long been needed to supplement the equitable principles applied by the courts and to check the growing volume of litigation by taking the profit out of inconsistency, whether exhibited by taxpayers or revenue officials and whether fortuitous or the result of design.

Thus, not only did Congress express an intention merely 'to supplement the equitable principles applied by the courts,' but also condemned the 'assuming (of) an inconsistent position and then taking shelter behind the protective barrier of the statute of limitations'— this is precisely what petitioner is attempting to do— and declared that 'Such resort to the statute of limitations is a plain misuse of its fundamental purpose.'[10]

We hold that petitioner, having received tax benefits during 1957 through 1960 from the deduction of accruals of rate refunds, realized taxable income in 1961 when its liability to make the refunds terminated.

Decision will be entered until Rule 50.

All Citations

56 T.C. 82

Footnotes

1 Estimated date since the date of receipt is not indicated on the copy of the return in evidence.

1 Respondent has conceded that there is no deficiency for the year ending Sept. 30, 1963.

2 For the sake of simplicity, petitioner's fiscal years will usually be described by referring to the calendar year in which the particular fiscal year ends.

3 All section references are to the Internal Revenue Code of 1954, as in effect during the tax years in issue, unless otherwise noted.

SEC. 111. RECOVERY OF BAD DEBTS, PRIOR TAXES, and DELINQUENCY AMOUNTS.

(a) GENERAL Rule.— Gross income does not include income attributable to the recovery during the taxable year of a bad debt, prior tax, or delinquency amount, to the extent of the amount of the recovery exclusion with respect to such debt, tax, or amount.

(b) DEFINITIONS.— For purposes of subsection (a)—

(4) RECOVERY EXCLUSION.— The term 'recovery exclusion,' with respect to a bad debt, prior tax, or delinquency amount, means the amount, determined in accordance with regulations prescribed by the Secretary or his delegate, of the deductions or credits allowed, on account of such bad debt, prior tax, or delinquency amount, which did not result in a reduction of the taxpayer's tax under this subtitle * * *

4 The district chief of the field audit branch, Internal Revenue Service, called as a witness by petitioner, testified as follows with respect to this entry in the returns:

'Q. As an experienced auditor, simply looking at that entry on the return * * * , what would that mean to you?

'A. It would mean to me that the, that Mayfair Minerals made a refund in this amount as ordered by the FPC, Federal Power Commission.'

5 The statute of Limitations had already run on 1957 when the 1961 return was filed.

6 According to petitioner's accountants, this adjustment did not conform with generally accepted accounting principles.

7 Petitioner's basic policy with respect to this item was stated in a letter to its president, dated Dec. 6, 1961, in part as follows: 'Mayfair's management will not countenance any proposed course of action where there is even a remote possibility that IRS would allege fraud or conspiracy. Absent any such possibility, management plans to take all available steps to insure that Mayfair does not ultimately pay more taxes than are believed to be justly owned.'

8 There is testimony to the effect that respondent's agents attempted to review the returns of all taxpayers with assets in excess of $1 million, such as petitioner, within 20 months after they were filed. Had respondent's agents reviewed the 1961 return within that period, about 4 months would have remained before the statute of limitations expired on 1960. However, this was only a preliminary review to determine whether the return should be audited. The information relating to this item was so skillfully obscured in the 1961 return that the true facts as they related to the 1957-60 returns probably could not have been learned without an examination of petitioner's books and records.

9 No testimony was sought or elicited from respondent's representatives to establish the factual premise that they thought a disputed, contingent liability was deductible at the time they reviewed the returns for the years 1957 through 1960. To support its assertion of mutual mistake, petitioner relies upon a remark by resondent's counsel in his opening statement explaining one of his contentions, which we find it unnecessary to consider, i.e., that petitioner's failure to report the 1961 cancellation of the account payable for the rate refunds was a change of accounting method which required the Commissioner's approval. However, we understand this opening statement to mean that, for purposes of that argument, we could assume that the original reporting was correct. Respondent's other position— supported by a determination in the notice of deficiency and pleaded in the answer— is based on estoppel or the duty of consistency. In explaining this position in his opening statement, respondent's counsel stated that 'something in the nature of deceit was worked upon the government' and 'the entries as they were shown to the government on * * * (petitioner's 1957-60) return(s) were misleading.'

10 Many of the cases cited above applying quasi-estoppel or the duty of consistency were decided after the effective date of secs. 1311-1315 or their predecessors. See, e.g., Continental Oil Co. v. Jones, 177 F.2d 508 (C.A. 10, 1949), certiorari denied 339 U.S. 931 (1950); Johnson v. Commissioner, 162 F.2d 844 (C.A. 5, 1947), affirming in part 7 T.C. 465 (1946); Wichita Coca Cola Bottling Co. v. United States, 152 F.2d 6 (C.A.. 5, 1945); Commissioner v. Dallas Title & Guar. Co., 119 F.2d 211 (C.A. 5, 1941), modifying 40 B.T.A. 1022 (1939); Irving Bartel, 54 T.C. 25 (1970); C. H. Wentworth, 25 T.C. 1210 (1956), affd. 244 F.2d 874 (C.A. 9, 1957); Lloyd H. Faidley, 8 T.C. 1170 (1947).

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71 T.C. 226
United States Tax Court

SIDNEY W. ROSEN and LORRAINE S. ROSEN, PETITIONERS
v.
COMMISSIONER of INTERNAL REVENUE, RESPONDENT

Docket No. 5590-77.
|
Filed November 21, 1978.

Synopsis

T made an unrestricted gift of property to charity A in 1972, and claimed a charitable contribution deduction in respect thereof on T's 1972 income tax return which was apparently allowed. In 1973, A returned the property to T without consideration, although under no legal or other obligation to do so. Later that year, T made an unrestricted gift of the same property to charity B, and claimed a second charitable contribution deduction in respect of that gift on T's 1973 income tax return which was allowed. In 1974, B returned the property to T without consideration, although under no legal or other obligation to do so. Held, A and B did not make "gifts" within the meaning of sec. 102(a), I.R.C. 1954, when they returned the donated property to T. Held, further, T must, under the "tax benefit rule," include in gross income for 1973 and 1974 the fair market value of the returned property on the respective dates of its return, such fair market value in each instance being less than the amount deducted the previous year. Held, further, the amount includable in T's gross income in 1974 is not reduced below the fair market value of the property on the recovery date by virtue of demolition expenses subsequently incurred that year by T in respect of the property.

Attorneys and Law Firms

***226** Nestor M. Nicholas, for the petitioners.

John O. Tannenbaum, for the respondent.

OPINION

RAUM, Judge:

The Commissioner determined deficiencies in petitioners' Federal income tax as follows:

Year	*Deficiency*
1973..	$28,682.31
1974..	30,191.42

***227** Petitioners made gifts of property to charities in 1972 and 1973, and claimed charitable contributions deductions in respect thereof. Subsequently, in 1973 and 1974, the property was returned to them by the donees, and the principal issue presented is whether petitioners must include in their gross income, in those 2 years, the value of the returned property. The case was submitted without trial on the basis of a stipulation of facts.

Petitioners Sidney W. Rosen and Lorraine S. Rosen, husband and wife, resided in Fall River, Mass., at the time their petition herein was filed. They filed their joint Federal income tax returns for the years 1973 and 1974 with the Director, Internal Revenue Service Center, Andover, Mass.

Prior to December 20, 1972, petitioners were the owners of the land and buildings located on the southeasterly corner of High Street and Walnut Street, Fall River, Mass. (hereinafter the property). The property consisted of approximately 8,010 square feet of land on which was situated a three-story frame house containing five apartments and a two-car garage. On December 20, 1972, petitioners made a gift of the property to the city of Fall River, Mass. (the city), which accepted the gift at the time it was made. The value of the property, at the time the petitioners donated it to the city, was $51,250. As a result of the gift, the petitioners were entitled to a charitable contribution deduction, in the amount of $51,250, on their joint 1972 Federal income tax return. [1]

The gift to the city was made without any restrictions as to the use of the property and without imposing any obligations of any nature on the city. At the time the gift was accepted by the mayor of the city, the city officials contemplated using the property in connection with the city school department. The city council, however, argued that the school department budget was already excessive and that there was little reason to increase the budget by accepting property which would have to be adapted for school department use. The dispute between the city council ***228** and the mayor remained unresolved until April 1973, at which time it was agreed by the mayor and the city council that the property would be returned to the petitioners. Although the city was under no obligation whatsoever, legal or otherwise, to return the property to the petitioners, the property was transferred to the petitioners by the city on April 30, 1973. [2]

On June 20, 1973, the petitioners made a gift of the property, less a small portion retained for themselves, to the Union Hospital, Fall River, Mass. (the hospital). The value of the property transferred to the hospital by the petitioners, at the date of transfer, was $48,000, and the petitioners claimed and were allowed a charitable contribution deduction in that amount in respect of the gift of the property. [3]

The transfer by the petitioners to the hospital was made without any restrictions as to the use of the property and without imposing any obligation of any nature on the hospital. In 1974, the hospital found itself in financial difficulty and was unable to make use of the property. In addition, the building forming part of the property had remained vacant since its receipt by the hospital, and substantial damage had been done to the building by the weather and vandals. The building had deteriorated to the point where the board of trustees of the hospital felt it was becoming a liability and, accordingly, they voted on August 27, 1974, to transfer the property back to the petitioners without consideration. [4] The hospital was under no ***229** obligation, legal or otherwise, to return the property to the petitioners.

The parties have stipulated that the value of the property, at the time it was transferred to the petitioners by the hospital, was $25,000. In 1974, subsequent to the receipt of the property by the petitioners from the hospital, the petitioners expended $5,000 to demolish the building on the property.

The Commissioner determined that petitioners must include in gross income, on account of the return of the property to them by the city and later by the hospital, $52,990 in 1973 and $49,740 in 1974. The Commissioner now concedes that only $51,250 and $25,000 must be included in petitioners' gross income in 1973 and 1974, respectively, in respect of the return of the property by the city and the hospital. The petitioners claim, however, that they need include no amounts in their gross income in respect of the return of the property by either the city or the hospital. The Commissioner has not challenged the bona fides of any of the transactions, and the only question is whether petitioners must include in their gross income, in the years of the retransfers from the city and the hospital, the fair market value of the property returned. We hold that they are required to do so.

It has long been established that the receipt of money or property which might not otherwise be regarded as income may nevertheless constitute income within the statute (section 61, I.R.C. 1954, and corresponding provisions of prior law) if it represents the repayment, restoration, or return of an item which the taxpayer had deducted in an earlier year. The general concept has often been referred to as the “tax benefit rule.” [5]

The tax benefit rule has widespread applicability to a variety of different receipts. See 1 J. Mertens, Law of Federal Income Taxation, secs. 7.34-7.37(2) (1974 rev.). Familiar examples appear in cases involving the recovery of a bad debt which had been deducted on the returns of a prior year, e. g., ***230** Askin & Marine Co. v. Commissioner, 66 F.2d 776 (2d Cir.); Putnam Nat. Bank v. Commissioner, 50 F.2d 158 (5th Cir.); and in cases where excises or other taxes paid and deducted from gross income in a prior year are refunded in a later year, e. g., Rothensies v. Electric Battery Co., 329 U.S. 296, 298; Estate of Block v. Commissioner, 39 B.T.A. 338, affirmed sub nom. Union Trust Co. v. Commissioner, 111 F.2d 60 (7th Cir.), certiorari denied 311 U.S. 658. The principle has even been applied in appropriate cases to override specific statutory nonrecognition provisions, thus making taxable amounts otherwise excludable from income. See e. g., Tennessee Carolina Transportation, Inc. v. Commissioner, 65 T.C. 440, affirmed 582 F.2d 378, (6th Cir.) (sec. 336); Estate of Munter v. Commissioner, 63 T.C. 663 (sec. 337); McCamant v. Commissioner, 32 T.C. 824, 833-835 (sec. 22(b)(1)(A) of the 1939 Code, analogous to section 101(a)(1) of the 1954 Code). [6] Moreover, the so-called tax benefit rule has been explicitly recognized in section 111(a) of the Code in gross income in specified types of restorations. Thus, it provides that gross income does not include the recovery of a "bad debt, prior tax, or delinquency amount" to the extent of the "recovery exclusion" which is in substance defined (sec. 111(b) (4)) to mean the amount on account of which the item in question did not result in a reduction of taxes in the earlier year. [7]

There can be no serious challenge to the broad sweep of the tax benefit rule, and in considering its applicability here, we even find precedent for applying the rule in a case involving property once the subject of a charitable contribution deduction that is subsequently returned to the donor. In Alice Phelan Sullivan Corp. v. United States, 381 F.2d 399 (Ct.Cl.), there were returned to the taxpayer two parcels of real estate each of which ***231** it had previously donated and claimed as a charitable contribution deduction in a prior year. Each of the original gifts had been made subject to the condition that the property be used for a religious or educational purpose, and when the donee later determined not to use the gift, it was reconveyed to the taxpayer. The Court of Claims held not only that the recoupment properly was classified as income but also that the amount of reportable rates which were in effect at the time of the original gifts, provided only that the taxpayer had taken full benefit of the deductions available in the earlier years. See also Mason v. United States, 513 F.2d 25, 30 (7th Cir.). [8]

Petitioners do not challenge the correctness of the result in Alice Phelan Sullivan Corp., but rather seek to distinguish it. They correctly point out that in Alice Phelan Sullivan Corp., the subject property was returned to the taxpayer pursuant to a condition in the original gift that the property would be returned if it ceased to be used either for a religious or for an educational purpose. Here, by contrast, both of the petitioners' gifts were unconditional, and neither the city nor the hospital property back to the petitioners. From this petitioners argue that the property was returned to them by way of a "gift" from the city and the hospital excludable from income under section 102(a), [9] and that the tax benefit rule does not apply to receipts subject to section 102(a). We do not agree with the factual predicate to this argument.

As a factual matter, we cannot accept the contention that petitioners received "gifts" as the concept was defined in Commissioner v. Duberstein, 363 U.S. 278, 285-286, when the property was reconveyed to them. We think it clear that neither charitable donee transferred the property back to petitioners out of any detached or disinterested generosity; [10] they made the ***232** transfers because they found the property to be burdensome and because they desired to "undo" the original gift transactions by returning the property to the parties who had originally made the gifts to them. [11]

It would strain our credulity to conclude that the city and the hospital would have transferred the property to petitioners without consideration if they had originally purchased it from petitioners or had obtained it from some other source. The reconveyances to petitioners were not nontaxable "gifts" within the criteria set forth in Duberstein. We therefore need precludes application of the tax benefit rule to these transactions. [12]
Petitioners also contend that there has been no "recovery" within the meaning of the tax benefit rule because there has been no receipt of "amounts in respect of" the previously deducted charitable gifts. [13] Petitioners cite the absence of a legal obligation to return the property and urge us to conclude that the reconveyances were totally separate and independent transactions from the original gifts. We are unconvinced.

We agree with the limited proposition that the tax benefit rule requires a sufficient factual nexus between the event producing the tax benefit and the event constituting the recovery to justify viewing the latter event together with the former. See Dobson v. Commissioner, 320 U.S. 489, 502; Farr v. Commissioner, 11 T.C. 552, 567, affirmed sub nom. Sloane v. Commissioner, 188 F.2d 254 (6th Cir.); 1 J. Mertens, Law of Federal Income Taxation, sec. 7.37, at p. 125. See also ***233** Allen v. Trust Co. of Georgia, 180 F.2d 527 (5th Cir.); Continental Illinois National Bank v. Commissioner, 69 T.C. 357, 364-372. However, we have found that the purpose of the reconveyances was a desire by the donees to reverse the original gift transactions, and that the reconveyances without consideration would not have been made to petitioners were it not for the fact that they were the original donors of the property. The recoveries were far from the coincidental happenstances that petitioners would have us believe. This is especially true in light of the relatively short time periods between the original gifts and the reconveyances.

Nor can we agree, at least in cases where the return of property is not a "gift," that a legal obligation on the part of the transferor to return the property is always a sine qua non for application of the tax benefit rule. We think it sufficient to be a repayment, restoration, or return of property formerly belonging to the transferee that was the subject of a previous transaction producing a tax benefit, and that the transferee accept it for such purpose. See Bear Mill Manufacturing Co. v. Commissioner, 15 T.C. 703, 706-708; Excelsior Printing Co. v. Commissioner, 16 B.T.A. 886, 887-888. [14] This was the case in respect of the reconveyances by the city and the hospital—they were intended merely to reverse previous charitable donations. Under these circumstances, we see no reason to allow a windfall tax benefit based upon two charitable contributions deductions, particularly when, in the end, petitioners owned the very same property they tried to give away. Cf. Farr v. Commissioner, 11 T.C. at 567. The purposes of the tax benefit rule [15] are well served by requiring inclusion in gross income of the fair market value of the property at the times it was returned to petitioners.

In respect of the year 1974 petitioners contend that if they are required to include the receipt of the property in their gross income, the correct amount should be only $20,000, "computed as the fair market value of the property" when returned to them by the hospital ($25,000) minus $5,000 which they spent later ***234** that year to demolish the building. The Commissioner agrees that the amount to be included is to be measured by the $25,000 stipulated value rather than $49,740 which he had previously determined in his deficiency notice. However, he contests the reduction of the $25,000 amount by the subsequently incurred demolition expense. We agree that the $5,000 expenditure was an entirely separate item which may not be used to reduce the $25,000 stipulated value of the property at the time it was returned by the hospital in 1974. If petitioners are to have the benefit of that expense in 1974 they must point to some provision of the statute which gives them a deduction therefor. This they have not done, nor have they even articulated a theory upon which we might hold that they are entitled to a $5,000 deduction in 1974 for the demolition costs.

To the extent that petitioners may suggest that the demolition costs must be taken into account in fixing the fair market value of the property by reason of its vandalized condition, the point is wholly without merit on this record. The parties have already stipulated that the fair market value of the property on the date of its return in 1974 was $25,000, reflecting a reduction of almost 50 percent from its value the preceding year, and we must conclude on the materials before us that such stipulated fair market value has already fully taken into account the deteriorated state of the property. No further reduction in value is called for in the light of the stipulation of the parties. The amount properly includable in their 1974 gross income in respect of the hospital's return of the property to them is its stipulated fair market value at the time of the reconveyance, $25,000, unreduced by any subsequent demolition expenses incurred by them. [16]

Decision will be entered under Rule 155.

All Citations

71 T.C. 226

Footnotes

1 There is no indication in the record that such deduction was not taken or that it was disallowed in any part by the Commissioner.

2 The order of the city council in respect of the return of the property stated the following:

"ORDERED, that the Mayor be and he is hereby authorized to convey for no consideration to Sidney W. Rosen and Lorraine A. Rosen, the property located at the southeasterly corner of High and Walnut Streets, and be it further

"ORDERED, that this conveyance shall be subject to the restrictions that said Sidney W. Rosen and Lorraine A. Rosen reimburse the City of Fall River for all expenses incurred by the city for said property and assume liability for all outstanding bills or expenses for said property."

The deed conveying the property to petitioners recited that the transfer was a gift, and that there was no monetary consideration by the Rosens.

3 The $48,000 figure was stipulated by the parties. However, petitioners' 1973 return, which the parties have also stipulated, discloses that a total deduction of $49,740 was claimed, consisting of $48,000 for the real estate plus $1,740 for items of personal property located in the building, such as refrigerators, draperies, carpeting, and the like. No explanation of this discrepancy has been offered by petitioners.

4 The minutes of the board of trustees meeting state that the board voted "To return to Dr. and Mrs. Rosen the property on the southeast corner of High and Walnut Streets." The deed reconveying the property to petitioners and the certificate of the clerk of the hospital recorded with the deed both contained a recital that the purpose of the conveyance without consideration was to correct a "mistake of fact."

5 The rationale for the rule was set forth in Estate of Block v. Commissioner, 39 B.T.A. 338, 341, affirmed sub nom. Union Trust Co. v. Commissioner, 111 F.2d 60 (7th Cir.), certiorari denied 311 U.S. 658:

Income tax liability must be determined for annual periods on the basis of facts as they existed in each period. When recovery or some other event which is inconsistent with what has been done in the past occurs, adjustment must be made in reporting income for the year in which the change occurs."

See also Alice Phelan Sullivan Corp. v. Commissioner, 381 F.2d 399, 402 n. 2 (Ct.Cl.).

6 It has been held, however, in cases involving specific statutory nonrecognition provisions, that something must be "received" or that there must be an actual "recovery" in the subsequent year to justify inclusion of the previously deducted item in current gross income. See Nash v. United States, 398 U.S. 1; Estate of Schmidt v. Commissioner, 355 F.2d 111 (9th Cir.). This requirement is not a bar to the application of the tax benefit rule in this case because the property which was the subject of petitioners' gifts was in fact reconveyed to them in the years at issue.

7 Petitioners do not contend that the statutory "recovery exclusion" applies in this case. This limitation on the tax benefit rule in specified types of cases first appeared in 1942 (sec. 116 of the Revenue Act of 1942 adding par. (12) to sec. 22(b) of the 1939 Code). However, it was certainly not intended to deny the general applicability of the rule in other appropriate situations, cf., e. g., sec. 1.111-1(a), Income Tax Regs.; Dobson v. Commissioner, 320 U.S. 489, 506; California & Hawaiian Sugar Refining Corp. v. United States, 311 F.2d 235, 238-239 (Ct.Cl.).

8 Cf. Estate of Wasie v. Commissioner, T.C. Memo. 1977-323.

9 Sec. 102(a), I.R.C. 1954, provides:

SEC. 102. GIFTS AND INHERITANCES.

(a) GENERAL RULE.—Gross income does not include the value of property acquired by gift, bequest, devise, or inheritance.

10 The stipulation that neither of the charitable donees was under any obligation whatsoever to return the property does not necessarily establish that the transfers were gifts. Commissioner v. Duberstein, 363 U.S. 278, 285. Similarly, the fact that some of the supporting documentation may have referred to such transfers as "gifts" is not controlling. Commissioner v. Duberstein, supra at 286. Such terms was used obviously only in a descriptive sense to indicate the

absence of consideration, and not to establish that the criteria set forth in Duberstein had been satisfied so as to bring into play the provisions of sec. 102(a).

11 The city council of Fall River conditioned the return to the property on petitioners' reimbursement of all expenses incurred by the city for the property. The board of trustees of Union Hospital felt that the property was becoming a liability due to deterioration, and that reconveyance of the property was necessary to correct a "mistake of fact." These facts lead us to conclude that the charitable donees of the property made the reconveyances primarily to return to the original status before the gifts.

12 Petitioners' reliance on Reynolds v. Boos, 188 F.2d 322 (8th Cir.), and Cox v. Kraemer, 88 F.Supp. 835 (D. Conn.), is misplaced. Although neither case involved a recovery of property previously the subject of a charitable gift, both cases dealt with the applicability of the tax benefit rule to recoveries found to be gifts. Their factual conclusions on the gift issue appear doubtful in light of the criteria set forth in the subsequently decided Duberstein case. Finally, the question is one to be resolved by the trier of fact on the basis of the record in each case, see, e. g., Commissioner v. Duberstein, supra at 289, and we have no doubt on the record before us that the return of the property to petitioners by each original donee cannot fairly be found to constitute a "gift" within the meaning of sec. 102.

13 See sec. 1.111-1(a)(2), Income Tax Regs.

14 In Bear Mill Manufacturing Co. v. Commissioner, 15 T.C. 703, and Excelsior Printing Co. v. Commissioner, 16 B.T.A. 886, it was held that there was a taxable recovery of a previously deducted bad debt when a third party, not a party to the loan transaction, and not otherwise legally obligated to repay the debt, made a transfer of property to the creditor with the intention that the debt be satisfied, and the creditor accepted it for the purpose the transferor intended. It should be noted that in both cases we found that the transferor did not intend to make a gift to the creditor.

15 See n. 5 supra.

16 We do not consider the possible contention that proper application of the tax benefit rule would require earlier year by including in income of the later year the full amount previously deducted upon complete restoration of the identical property which gave rise to the deduction. Cf. Alice Phelan Sullivan Corp. v. Commissioner, 381 F.2d 399, 402 (Ct.Cl.). The Commissioner now seeks to include in income in this case only the fair market value of the property when it was returned, an amount that is smaller in each instance than the amount previously deducted. In such a case, the measure of the amount included is at least the fair market value of the property recovered. See Tennessee Carolina Transportation, Inc. v. Commissioner, 65 T.C. 440, 448, affirmed 582 F.2d 378 (6th Cir.); cf. Spitalny v. United States, 430 F.2d 195, 198 (9th Cir.). As set forth in our findings of fact, the parties have stipulated the "values" of the property at the times it was returned to petitioners, which we take to be fair market values.

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72 T.C. 807
United States Tax Court

ALLEN D. UNVERT and CATHERINE R. UNVERT, PETITIONERS
v.
COMMISSIONER of INTERNAL REVENUE, RESPONDENT

Docket No. 8690-76.
|
Filed August 8, 1979.

Synopsis

In his income tax return for 1969, petitioner deducted $54,500 as interest paid on indebtedness incurred to purchase real property. In 1972, the interest payment was refunded. After the statute of limitations on assessments for 1969 had run, respondent determined that the refund was taxable to petitioner in 1972. Held, in the light of all the facts, petitioner had a duty to treat the transaction consistently in both 1969 and 1972, and the interest refund is taxable in the latter year under the tax benefit rule.

Attorneys and Law Firms

***807** Donn Kemble and Joseph LaTorre, for the petitioners.

Kenneth G. Gordon, for the respondent.

Opinion

FEATHERSTON, Judge:

Respondent determined a deficiency of $44,405 in petitioners' Federal income tax for 1972. The issue for decision is whether $54,500 received in 1972 as a refund of prepaid interest which was claimed and allowed as a deduction in petitioners' 1969 income tax return is taxable in the later year.

***808** FINDINGS OF FACT

Petitioners Allen D. Unvert and Catherine R. Unvert, husband and wife,[1] were legal residents of Newport Beach, Calif., at the time their petition was filed. They filed their joint Federal income tax return for 1972 with the District Director of Internal Revenue for the District of Los Angeles, Fresno, Calif.

Petitioner Allen D. Unvert (petitioner) is a physician. In late 1969, concerned about the rate of taxation on the income from his medical practice, petitioner requested Walter P. Gribben (Gribben), an attorney, to suggest investments which would serve as tax shelters. Gribben referred petitioner to John B. Halverson (Halverson), an acquaintance of both men and a law school classmate of Gribben. In mid-December 1969, petitioner telephoned Halverson, then president of U.S. Financial Corp.,[2] and Halverson told petitioner he would make inquiries on the latter's behalf. Having heard nothing further from Halverson, petitioner again telephoned him on December 30, 1969. They agreed to meet the next day in San Diego to discuss an investment opportunity.

On the afternoon of December 31, 1969, petitioner met with Halverson as well as with Robert M. Walters, a founder and the chairman of the board of U.S. Financial Corp., and David G. Leaverton (Leaverton), house counsel. He was informed of an opportunity to purchase 16 condominium units in a large building owned by U.S. Financial Corp.; these units were identified on a list shown petitioner at the meeting. The representatives of U.S. Financial proposed that petitioner purchase the units on a contract of sale. The amount of the purchase price would be loaned petitioner by U.S. Financial.[3]

According to U.S. Financial, it was anticipated that most of the units would be sold during the following year. Sales prices were expected to be in an aggregate amount which would exceed the sales price to petitioner, thus enabling him to pay off the loan to U.S. Financial and to realize a profit as well.

***809** Petitioner was informed that by writing a check for prepaid interest on the loan, he would secure an interest deduction for 1969. Petitioner agreed to these terms. At the meeting, petitioner gave the others a personal check in the amount of $54,500 payable to U.S. Mortgage. On the check he indicated that the payment was to serve as prepaid interest on the loan of the purchase price of the condominiums. He was given a receipt for the payment.[4] Due to the late hour of the meeting, the representatives of U.S. Financial informed petitioner that the various documents related to the transaction could not be prepared until the following year. Petitioner made no objection and left the meeting with the belief that he had entered into a contract for the purchase of the condominium units.

During March 1970, petitioner became concerned that he had received no documentation of the condominiums purchase from U.S. Financial. He was reassured by Gribben that the documentation would be forthcoming and by John Leventis (Leventis), petitioner's accountant, that his check was adequate proof of the existence of the contract. To compute depreciation, Leventis telephoned U.S. Financial to confirm the purchase price. On his tax return for 1969, petitioner deducted as prepaid interest $54,500 and as depreciation on the units $1,239.58.

Having made several telephone calls to representatives of U.S. Financial to request the documents relating to the purchase, petitioner wrote Halverson a letter dated April 23, 1970, in which he expressed his concern at the delay in receiving documents "regarding the contractual relation we entered at the end of 1969." He asked for information and proposed a meeting to resolve possible difficulties. Under cover of a letter dated June 16, 1970, Leaverton forwarded to petitioner copies "of the proposed documentation." By a letter dated December 23, 1970, Gribben suggested that Halverson meet with petitioner about the "substantial amount of documentation remaining to be done."

When preparing his 1970 income tax return, petitioner was still concerned at his failure to receive documentation and an accounting of the 1969 transaction. By a letter dated March 24, 1971, he asked Halverson for information and indicated he would ***810** be willing to discuss any problems at a meeting. He informed Gribben of this letter by a letter dated the same day. After telephone calls made by petitioner and Leventis yielded no results, the two met with Halverson and Leaverton in mid-1971. At this meeting, petitioner was informed that the condominium units had not been sold and that U.S. Financial had not decided how to arrange the bill of sale.

By a letter dated August 9, 1971, Leaverton informed Gribben that:

> My client, Swan Constructors, Inc., hereby agrees to purchase your client Dr. Dale Unvert's position in the above-referenced condominium units on or before December 1, 1971 for the sum of $54,000 cash (less any cash theretofore received by Dr. Unvert by reason of such investment), upon the demand of Dr. Unvert.

In a letter to petitioner dated September 1, 1971, the controller of U.S. Financial, Gary L. Fitzgerald, enclosed a promissory note, a contract of sale and purchase, and a management agreement, which were designed to document the December 31, 1969, transaction. He requested that petitioner execute the documents and return them. He indicated that he would then return "the completely executed documents" to petitioner. In the letter, he refers to a letter written by Leaverton to Gribben, apparently that of August 9, 1971, which he terms a "letter of indemnification."

By a letter dated September 20, 1971, Gribben forwarded to Leaverton a promissory note in the amount of $50,000 and an executed copy of the management agreement, both of which were signed by petitioner. As he indicates in the letter, the promissory note is dated December 31, 1969; Gribben states that "it is clear that this Promissory Note evidenced part of the original purchase price." He mentions that he has asked petitioner to sign the contract of sale and purchase agreement, which petitioner "unfortunately neglected to sign." He further refers to Leaverton's statement in the August 9, 1971, letter that Swan Constructors, Inc., would purchase petitioner's interest in the condominiums.

In August or September 1971, petitioner and his accountant met with U.S. Financial's in-house accountant. When informed by the accountant that "the deal (would) be consummated" only if petitioner invested an additional $55,000, petitioner refused. At this point, petitioner asked Gribben to represent him in ***811** obtaining a refund of the original investment from U.S. Financial.

Petitioner believed until at least April 15, 1972, that he owned the condominiums. He also believed that during 1970 and 1971 some of the condominiums were leased under the management agreement and that some were sold and others substituted by U.S. Financial. On his 1970 and 1971 income tax returns, he deducted losses connected with the investment.

On or about May 1, 1972, following a series of contacts by Gribben in person, over the telephone, and by letter, which included a threat of legal action, petitioner received a personal check from Walters in the amount of petitioner's December 31, 1969, check. Petitioner informed Leventis of his receipt of the money.

On August 14, 1972, Revenue Agent Gerald Lenning (Lenning) contacted petitioner concerning an audit of petitioner's 1970 and 1971 income tax returns. October 11, 1972, Lenning met with Leventis with regard to the audit. At the meeting, Lenning gave Leventis a documented request for additional information about several items on the return, including petitioner's deductions related to U.S. Financial. Despite repeated requests for information, neither petitioner, Leventis, nor Gribben supplied any information to Lenning about the U.S. Financial transaction. Leventis supplied Lenning with information on other items.

On or about June 7, 1973, Lenning first obtained information on the U.S. Financial transaction from the San Diego Office of the Internal Revenue Service. On July 11, 1973, Lenning informed Leventis of his position that petitioner's purchase of the units was never completed. Leventis disagreed with Lenning. Petitioner's representatives did not comply with requests for more information on the transaction submitted by Lenning on July 23, 1973, July 30, 1973, September 28, 1973, and December 21, 1973.[5] In August 1973, Lenning issued to petitioner a revenue agent's report on or about October 15, 1973, petitioners filed their 1972 income tax return, on which they did not report the $54,500 received in 1972.

***812** OPINION

Because petitioner received a "tax benefit" from the deduction of the $54,500 as interest on his 1969 return, he is, in respondent's view, required to include that amount in his income for 1972, the year in which the deducted amount was refunded to him. Petitioner implicitly concedes that he would be required to include the refund in his 1972 income if the deducted amount in fact represented interest relating to a valid contract to purchase condominium units.[6] Since it subsequently became evident that the condominiums' purchase was never consummated, however, petitioner contends that the 1969 deduction was erroneous and that, consequently, the "tax benefit" rule does not apply. To support this position, petitioner relies mainly on Canelo v. Commissioner, 53 T.C. 217 (1969), affd. per curiam on other grounds 447 F.2d 484 (9th Cir. 1971), and Streckfus Steamers, Inc. v. Commissioner, 19 T.C. 1 (1952).

We hold for respondent.

Although each taxable period is separate and independent, there are situations in which the proper treatment of an item in one year cannot be resolved without reference to events in a prior year. See, e. g., Dobson v. Commissioner, 320 U.S. 489 (1943), rehearing denied 321 U.S. 231 (1944). When an amount is deducted from gross income in one year and recovered in a subsequent year, such amount is taxed in the later year if a tax benefit was realized from the deduction. Merchants Nat. Bank v. Commissioner, 199 F.2d 657, 659 (5th Cir. 1952), affg. 14 T.C. 1375 (1950); Putnam Nat. Bank v. Commissioner, 50 F.2d 158 (5th Cir. 1931), affg. 20 B.T.A. 45 (1930). The reason for this rule is clear, as explained in Estate of Block v. Commissioner, 39 B.T.A. 338, 341 (1939), affd. sub nom. Union Trust Co. v. Commissioner, 111 F.2d 60 (7th Cir. 1940), cert. denied 311 U.S. 658 (1940):[7]

> When recovery or some other event which is inconsistent with what has been done in the past occurs, adjustment must be made in reporting income for the ***813** year in which the change occurs. No other system would be practical in view of the statute of limitations the obvious administrative difficulties involved, and the lack of finality in income tax liability, which would result.

The instant case is a classic one. Petitioner deducted his 1969 payment to U.S. Financial Corp. as interest, thereby realizing a tax benefit. In 1972, the amount previously deducted was refunded to him. Under the tax benefit rule, the return to him of money which had been the subject of the income tax deduction in the prior year requires that the money be treated as income in the year of recovery.

We think petitioner's reading of Streckfus Steamers, Inc. v. Commissioner, supra, and Canelo v. Commissioner, supra, is too broad. In Streckfus Steamers, the taxpayer, on the accrual basis, claimed and was allowed on its 1940 return a deduction for Illinois sales tax; the taxpayer had not paid the tax and continued to contest it. After the Illinois court held the taxpayer was not liable for the tax, the Commissioner sought unsuccessfully to include in the taxpayer's 1943 gross income a sum equal to the 1940 deduction. Similarly, in Canelo, the taxpayers, members of a cash basis law partnership, deducted litigation expenses advanced under reimbursement agreements signed by their clients. The Court held that the advanced expenses were loans and were not deductible for years not barred by limitations. It refused to allow the Commissioner to include in current income reimbursements received by the taxpayers for advances made and deducted in earlier barred years. Because the deductions were improper when taken, the Court held that the tax benefit rule did not apply.

In those cases, the taxpayer did not switch the position taken in the year for which the deduction was allowed. The taxpayer in Streckfus Steamers claimed the deduction for 1940, and it was allowed by mutual mistake. After the Illinois court held the taxpayer did not owe the deducted tax and the Supreme Court clarified the law on timing of the deduction for contested liabilities, [8] the Commissioner switched his position and sought to include the deducted amount in income for a later year. Similarly, in Canelo, the taxpayer contended even at the time of ***814** trial, that the advanced legal expenses were deductible in the year in which they were incurred.

In contrast, petitioner claimed the $54,500 deduction on his 1969 return and thus declared that he had paid that amount as interest in 1969. The representation was accepted by the Internal Revenue Service as true, and the 1969 deduction was not disallowed. But now petitioner has shifted his position. He maintains that the payment was not interest, in effect claiming that the declaration in his 1969 return was untrue. Since the Internal Revenue Service did not notice his mistake before the statute of limitations expired, petitioner argues that no adjustment can be made with respect to the erroneously claimed interest deduction either for 1969, the year of the deduction, or for 1972, the year in which he received the refund. [9]

Because "it is no more right to allow a party to blow hot and cold as suits his interest in tax matters than in other relationships," courts have held a taxpayer to a duty of consistency in his tax treatment of related items. [10] Alamo Nat. Bank v. Commissioner, 95 F.2d 622, 623 (5th Cir. 1938), affg. 36 B.T.A. 402 (1937), cert. denied 304 U.S.577 (1938). The duty of consistency precludes a taxpayer who has received a tax benefit due to his treatment of an item in a year barred by the statute of limitations from claiming that the original treatment was incorrect and thus obtaining a tax advantage in a later year. Disapproving of such shift of position on the part of the taxpayer before it, the Fifth Circuit has observed (Johnson v. Commissioner, 162 F.2d 844, 846 (5th Cir. 1947)):

> This court has several times held that when a transaction and its tax consequences are thus projected into other tax years there is a duty of consistency as to its treatment, and one should be held to the

> consequences of the initial treatment, though inaccurate, when a correction throughout is impossible. (Emphasis added.)

This doctrine applies "even though all the technical elements of estoppel are not present." ***815** Continental Oil Co. v. Jones, 177 F.2d 508, 512 (10th Cir. 1949), cert. denied 339 U.S. 931 (1950). Accord, Orange Securities Corp. v. Commissioner, 131 F.2d 662, 663 (5th Cir. 1942). The Eighth Circuit has recently enumerated the prerequisites for application of the doctrine, also termed "quasi-estoppel," as follows (Beltzer v. United States, 495 F.2d 211, 212 (8th Cir. 1974)):

(1) the taxpayer has made a representation or reported an item for tax purposes in one year,

(2) the Commissioner has acquiesced in or relied on that fact for that year, and

(3) the taxpayer desires to change the representation, previously made, in a later year after the statute of limitations on assessments bars adjustments for the initial tax year.

See also Hess v. United States, 210 Ct.C1. 483, 537 F.2d 457, 463 (1976), cert. denied 430 U.S. 931 (1977), which applies the three elements laid out in Beltzer. [11]

Relying on this doctrine, certain cases have applied the tax benefit rule to a taxpayer who erroneously claimed a deduction in one year, recovered the amount of that deduction in a later year, and then shifted his position in the later year as to the controlling facts. See Askin & Marine Co. v. Commissioner, 66 F.2d 776, 778 (2d Cir. 1933), affg. 26 B.T.A. 409 (1932), and Commissioner v. Liberty Bank & Trust Co., 59 F.2d 320, 325 (6th Cir. 1932), revg. and remanding 14 B.T.A. 1428 (1929) (debts charged off as worthless in an earlier year and collected in a later year); Mayfair Minerals, Inc. v. Commissioner, 56 T.C. 82 (1971), affd. per curiam 456 F.2d 622 (5th Cir. 1972) (refunds ordered by Federal Power Commission deducted as accrued liabilities and order later rescinded); Faidley v. Commissioner, 8 T.C. 1170, 1173 (1947) (loss claimed in an earlier year and recovered from the estate of a guarantor in a later year).

In a number of other contexts, courts have refused taxpayers benefits from treating items in a manner inconsistent with that of barred years. E. g., ***816** Robinson v. Commissioner, 181 F.2d 17 (5th Cir. 1950), affg. 12 T.C. 246 (1949) (amount erroneously deducted in barred year could not be deducted in later year); Wichita Coca-Cola Bottling Co. v. United States, 152 F.2d 6 (5th Cir. 1945), cert. denied 327 U.S. 806 (1946) (income omitted in barred year taxed in later year); Bothwell v. Commissioner, 77 F.2d 35 (10th Cir. 1935), affg. 27 B.T.A. 1351 (1933) (failure to report fair market value of property received as compensation prevented use of such value as basis); Griffith v. United States, an unreported case (N.D. Tex. 1971, 27 AFTR 2d 754, 71-1 USTC par. 9280)Tex. 1971, 27 AFTR 2d 754, 71-1 USTC par. 9280) (value of property reported on estate tax return by taxpayer as administratrix held basis for computing gain on disposition).

Petitioner acknowledges this line of cases but argues that they apply only to those he deems "bad guys" he maintains that his behavior has been innocent. We are not persuaded by this argument. [12] The cases cited by petitioner do not support his position that a taxpayer who innocently misrepresented a fact in a barred year may freely switch his position to achieve a tax advantage in a later year. These cases rely in part on other factors, such as the availability of the true facts to the Commissioner during the period before the statute of limitations ran. Ross v. Commissioner, 169 F.2d 483, 495-496 (1st Cir. 1948), revg. a Memorandum Opinion of this Court; Studebaker-Packard Corp. v. United States, an unreported case (N.D. Ind. 1961, 8 AFTR 2d 5058, 61-2 USTC par. 9551). Another case notes, in addition to this factor, that the erroneous deduction at issue resulted from a mistake of law. Crosley Corp. v. United States, 229 F.2d 376, 381 (6th Cir. 1956). It is well settled that estoppel does not apply to mistakes of law (see United States v. S. F. Scott & Sons, 69 F.2d 728 (1st Cir. 1943)), but before a mistake of law can occur both parties must know the facts. Mayfair Minerals, Inc. v. Commissioner, 56 T.C. at 93.

Other cases are inapposite in that they involve a change of position not by the taxpayer but by the Commissioner. Commissioner v. Schuyler, 196 F.2d 85 (2d Cir. 1952), affg. a Memorandum ***817** Opinion of this Court; Twitchco, Inc. v. United States, 348 F.Supp. 330 (M.D. Ala. 1972). In another, the Commissioner apparently did not rely on the doctrine of quasi-estoppel. B. C. Cook & Sons, Inc. v. Commissioner, 59 T.C. 516 (1972). In the final case upon which petitioner relies, the taxpayer did not switch his position after an earlier year was barred but rather urged that an erroneous deduction be allowed for the year at issue on the grounds that the Commissioner could later rely on the tax benefit rule and include the amount in income. LaCroix v. Commissioner, 61 T.C. 471 (1974).

Even assuming the duty of consistency or quasi-estoppel does not apply to the innocent, we are not persuaded by petitioner's protestations of what he terms his "pure heart." He claims his belief that the 1969 transaction constituted a valid contract lasted until after April 15, 1973, when the statute of limitations for 1969 expired. He was shaken in this belief, he asserts, only in August 1973, when he read Lenning's report which stated that the sale of the condominiums was never completed. Upon receiving the May 1972 check for $54,500, petitioner, according to his varying accounts, either did not think of the tax consequences, or believed that the check represented part of the sale price to Swan Constructors, Inc., and that it would therefore be reported on his 1972 return, or continued to believe that he still owned the condominiums. He explains his failure to report the amount on his 1972 income tax return as due to his realization, after the statute of limitations for his 1969 return had run but before he filed his 1972 return on October 15, 1973, that he had not in fact owned the condominiums.

We find petitioner's statements inconsistent, both internally and with his contemporaneous actions. We find it incredible that upon merely reading Lenning's report, petitioner would abandon his long-held belief that the 1969 transaction constituted a valid contract. As one of the parties involved, he had knowledge of facts which Lenning lacked. Moreover, at the time petitioner now claims he realized there had been no contract, Leventis was disputing this finding with Lenning. Petitioner failed to include the $54,500 amount on his 1972 return, an action consistent only with the very position advanced by Lenning which petitioner and his representatives were then disputing.

As to his view of the May 1972 Check, we are unable to determine among his spate of accounts what petitioner did in ***818** fact think. We note, however, that the view that the refund was a sale, one which petitioner concededly did not advance on his 1972 return, appears unreasonable. At one point, he states that he viewed the check as carrying out the August 1971 offer to buy his position in the condominiums. Yet the offer was made months earlier and there is nothing to indicate that the May 1972 transaction was intended to carry out that offer. Moreover, his instructions to Gribben "to get * * * (the) money back" are inconsistent with a theory of sale.

In light of petitioner's repeated earlier references to his belief in the existence of a contract and the lack of evidence that the 1969 payment was a deposit, we think petitioner was attempting to retrieve not a deposit but rather an amount paid for which petitioner had belatedly discovered that a contract might not exist. If petitioner believed no contract existed in May 1972, he was under the duty prescribed by section 1.461-1(a)(3)(i), Income Tax Reg., to file an amended return. Even if he was unaware of this duty, he was aware of the audit of his 1970 and 1971 returns. Yet his representatives repeatedly withheld from Lenning information in regard to the U.S. Financial Corp. transaction. A taxpayer may be charged with responsibility for actions involving his income tax returns which he has entrusted to his accountant. Bartel v. Commissioner, 54 T.C. 25, 30-31 (1970). Therefore, even if petitioner was innocent at the time of filing the 1969 return, we think his actions from at least August 1972 to April 15, 1973, when the 3-year statute of limitations ran on the assessment of a deficiency for 1969, constituted wrongful misleading silence as to the treatment of the condominiums transaction on his 1969 return.

To reflect the foregoing,

Decision will be entered for the respondent.

All Citations

72 T.C. 807

Footnotes

1 Petitioners were married in 1972.

2 Petitioners have asked us to take judicial notice under rule 201, Federal Rules of Evidence, of several newspaper articles concerning U.S. Financial Corp. In our view, these articles, set out in appendix I to petitioner's brief, contain no material relevant to the U.S. Financial Corp. transaction at issue here. Accordingly, we decline to take judicial notice of them.

3 Apparently, related companies were to be involved in aspects of the transaction—Swan Constructors, Inc., for the most part refer to U.S. Financial rather than to the other companies.

4 The parties have stipulated that petitioner was given a receipt. At trial, without objection, petitioner testified that he was given no receipt and that he believed the canceled check would serve as one.

5 By September 1973, Leventis was no longer serving as petitioner's accountant. Later contacts were with petitioner's attorney, Donn Kemble, and new accountant, Pete Helsley.

6 Apparently, as late as 1975, petitioner contended that the transaction was a valid purchase. It is stipulated that a notice of deficiency was issued on Mar. 18, 1975, to petitioner, denying claimed losses for 1970 and 1971 in connection with this transaction, and that a Tax Court case was instituted. Subsequent to the filing of the answer in that case, petitioner conceded that respondent had correctly denied those deductions.

7 While the tax benefit rule had its genesis in court decisions, it is now implicitly codified in sec. 111, I.R.C. 1954, relating to recovery exclusions. West Seattle National Bank of Seattle v. Commissioner, 288 F.2d 47, 48-49 (9th Cir. 1961), affg. 33 T.C. 341 (1959).

8 Security Mills Co. v. Commissioner, 321 U.S. 281 (1944); Dixie Pine Co. v. Commissioner, 320 U.S. 516 (1944).

9 Although the record is not entirely clear on this point, the refund could be interpreted as constituting a rescission of a valid contract. If so, the initial deduction was not erroneous and the tax benefit rule would clearly apply.

10 On Jan. 2, 1979, respondent filed a motion for leave to file amended answer to conform the pleadings to the proof, under Rule 41(b), Tax Court Rules of Practice and Procedure. The motion requested leave to amend the pleadings to reflect the doctrine of quasi-estoppel or duty of consistency. Upon due consideration, we find that the issue has been tried by the consent of the parties. Accordingly, we have granted respondent's motion to amend the pleadings.

11 In contrast, for the more stringent requirements of "pure" estoppel to apply (United States v. S.F. Scott & Sons, 69 F.2d 728, 732 (1st Cir. 1934)—

> "(1) there must be false representation or wrongful misleading silence. (2) The error must originate in a statement of fact and not in an opinion or a statement of law. (3) The person claiming the benefits of estoppel most be ignorant of the true facts, and (4) be adversely affected by the acts or statements of the person against whom an estoppel is claimed."

Accord, Tide Water Oil Co. v. Commissioner 29 B.T.A. 1208, 1218-1219 (1934).

12 In Mayfair Minerals, Inc. v. Commissioner, 56 T.C. 82, 91 (1971), affd. per curiam 456 F.2d 622 (5th Cir. 1972), we stated that Canelo v. Commissioner, 53 T.C. 217 (1969), affd. per curiam 447 F.2d 484 (9th Cir. 1971), and Streckfus Steamers, Inc. v. Commissioner, 19 T.C. 1 (1952)—
"are clearly inapposite where the taxpayer, either deliberately or unintentionally, misleads the Commissioner through erroneous representations of fact in his returns, and the Commissioner, consequently, allows the statute of limitations to run on adjustments of taxable income on the misleading returns." (Emphasis added.)

tob of a fair trial. Benson's approach to witness Nesbo on the eve of trial is far more troubling. It was not done at the instance of the prosecution, however, and we have little doubt that if the case is retried, adequate precautions will be taken to minimize the effect of the past and to prevent its recurrence.

CONCLUSION

For the reasons discussed above, the conviction is REVERSED.

Dorothy SCHWARTZ ROJAS, Schwartz Farms, Inc., and Estate of Charles R. Schwartz, Deceased, Bank of America, National Trust and Savings Association, Administrator, Petitioners–Appellees,

v.

COMMISSIONER OF INTERNAL REVENUE, Respondent–Appellant.

Dorothy SCHWARTZ ROJAS, Petitioner–Appellant,

v.

COMMISSIONER OF INTERNAL REVENUE, Respondent–Appellee.

SCHWARTZ FARMS, INC., Estate of Charles R. Schwartz, Deceased, et al., Petitioners–Appellants,

v.

COMMISSIONER OF INTERNAL REVENUE, Respondent–Appellee.

Nos. 88–7521, 89–70027 and 89–70028.

United States Court of Appeals, Ninth Circuit.

Argued and Submitted March 12, 1990.
Decided April 26, 1990.

Taxpayer petitioned for review of Commissioner of Internal Revenue's determination of deficiencies in income of now dissolved corporation. The Court of Appeals, Sneed, Circuit Judge, held that tax benefit rule did not extend to allow Government to recapture value of deductions for cultivation and operating expenses incurred during final year of corporation's farming operations.

Affirmed.

1. Internal Revenue 4678

Protective cross appeal by successful taxpayers was permissible once initial appeal by Commissioner of Internal Revenue was filed, raising the possibility of reversal. 26 U.S.C.A. § 7482(a).

2. Internal Revenue 3138

Tax benefit rule did not extend to allow Government to recapture value of deductions for cultivation and operating expenses incurred during final year of taxpayer corporation's farming operations, although unharvested crops for which expenses were incurred eventually were transferred to corporation's sole shareholder during liquidation and Government contended that tax result obtained by technical compliance with Internal Revenue Code was improper because it converted corporate ordinary income into shareholder capital gain. 26 U.S.C.A. § 162(a).

3. Internal Revenue 4713

Tax Court did not abuse its discretion in determining that facts concerning postliquidation disposition of taxpayer's assets were relevant in determining whether taxpayer was liable for deficiencies in income taxes; evidence of sale of distributed crops by taxpayer after liquidation arguably contributed to assertion of Commissioner of Internal Revenue that taxpayer was liable for deficiencies.

Gary R. Allen, John A. Dudeck, Jr., Tax Div., Dept. of Justice, Washington, D.C., for respondent-appellant-cross-appellee.

Robert L. Sullivan, Jr., Fresno, Cal., for petitioners-appellees-cross-appellants.

Craig A. Houghton, Baker, Manock & Jensen, Fresno, Cal., for petitioner-appellee-cross-appellant.

Appeal from the United States Tax Court.

Before SNEED, FARRIS and FERNANDEZ, Circuit Judges.

SNEED, Circuit Judge:

The Commissioner of Internal Revenue (the Commissioner) determined deficiencies in the income taxes of Schwartz Farms, Inc. (Schwartz Farms), a dissolved corporation. The Commissioner further asserted that Schwartz Farms' primary shareholders, Dorothy Schwartz Rojas and her deceased husband's estate (collectively referred to as "the taxpayer"), were liable for the alleged deficiencies. The taxpayer petitioned the Tax Court for a review of the Commissioner's determination. The Tax Court decided in favor of the taxpayer. The Commissioner appeals the Tax Court's decision and the taxpayer cross-appeals on an evidentiary matter. We affirm.

I.

FACTS AND PROCEEDINGS BELOW

The facts have been stipulated. Dorothy and Charles Schwartz were the primary shareholders of Schwartz Farms, Inc., a closely held corporation engaged in farming row crops. Following Charles Schwartz's death on April 6, 1976, Dorothy Schwartz (now Dorothy Schwartz Rojas) elected to subject her community property interest in Schwartz Farms to administration in her husband's estate. On October 1, 1976, Schwartz Farms adopted a plan of complete liquidation under 26 U.S.C. § 337 (1976).[1] Various liquidation distributions to shareholders were made over the next three years.

In the 1976 liquidation distribution, Schwartz Farms transferred to the taxpayer all of its "operating assets," comprising in part both harvested and unharvested crops. The taxpayer realized a long-term capital gain of $681,514 upon receipt of the operating assets, representing the difference between the fair market value of all the assets distributed and the income tax basis of Schwartz Farms' stock in the taxpayer's hands. The operating assets acquired a fair market value basis in the hands of the taxpayer under 26 U.S.C. § 334(a) (1976).

Schwartz Farms filed its final income tax return for the fiscal year ending January 31, 1977. On that return, Schwartz Farms deducted all of the cultivation and operating expenses incurred during its final year of operation. Schwartz Farms was a cash basis taxpayer and thus could properly deduct its business expenses as they were incurred, under 26 U.S.C. § 162(a) (1976). Of the total value of section 162(a) deductions that Schwartz Farms took on its final tax return, $909,904 is in dispute. This is the cost of producing unharvested crops that eventually were transferred to the taxpayer during liquidation.

The Commissioner conceded that all of Schwartz Farms' cultivation expenses deducted under section 162(a) were incurred in the ordinary course of business. Accordingly, the Commissioner did not seek to disallow the $909,904 in section 162(a) deductions taken for production of unharvested crops. Instead, the Commissioner, after abandoning accrual accounting and assignment of income theories, sought to recapture the value of these deductions through application of the tax benefit rule. The Tax Court rejected the Commissioner's request to apply the tax benefit rule in this case and decided in favor of the taxpayer. The Commissioner appeals.

The Cross-Appeal

The stipulation of facts reserved to either party the right to object to such facts on the grounds of materiality or relevancy. The stipulation is incorporated into the Tax Court opinion.

The Tax Court overruled the taxpayer's objection to the relevancy of certain stipulated facts concerning the disposition of assets transferred to Charles Schwartz's

1. We apply the tax laws that were in effect when the events of this case took place.

estate after the liquidation distribution. The taxpayer appeals from the Tax Court's determination that the challenged facts are admissible as evidence. On appeal to this court, the Commissioner asserts that post-liquidation events are relevant to the central question of whether the tax benefit rule requires a restoration to income of the value of Schwartz Farms' earlier deduction.

II.

JURISDICTION

[1] This court has jurisdiction under 26 U.S.C. § 7482(a) (1982). The Commissioner disputes this court's jurisdiction to hear the taxpayer's cross-appeal on the ground that a successful party has no rights of appeal from an entirely favorable judgment. *See Public Serv. Comm'n v. Brashear Freight Lines, Inc.*, 306 U.S. 204, 206, 59 S.Ct. 480, 481, 83 L.Ed. 608 (1939). Yet, a protective cross-appeal is permissible once an initial appeal has been filed, raising the possibility of reversal. *Bryant v. Technical Research Co.*, 654 F.2d 1337, 1341–42 (9th Cir.1981). Therefore, we have jurisdiction over the cross-appeal.

III.

STANDARDS OF REVIEW

We review de novo the applicability of tax benefit principles to the stipulated facts. *See Stern v. Commissioner*, 747 F.2d 555, 557 (9th Cir.1984) ("The Tax Court's application of law to undisputed facts ... is reviewable de novo."). Abuse of discretion is the proper standard with respect to the issue raised by the cross-appeal. *See Sochin v. Commissioner*, 843 F.2d 351, 355 (9th Cir.), *cert. denied*, — U.S. ——, 109 S.Ct. 72, 102 L.Ed.2d 49 (1988).

IV.

ANALYSIS

[2] The Commissioner does not dispute that the taxpayer's actions were in technical compliance with all relevant Internal Revenue Code sections. No such section requires the result the Commissioner seeks. Rather, the Commissioner argues that the tax result obtained is improper because in essence it converts corporate ordinary income into shareholder capital gain. Specifically, the Commissioner argues that Schwartz Farms should have to recognize as income $909,904, the value of the section 162(a) business deductions it took for producing unharvested crops that eventually were distributed to the taxpayer during liquidation. Had this been done, Schwartz Farms and the taxpayer would have had taxable gain as ordinary income and capital gains respectively. The Commissioner asserts further that the taxpayer is liable for Schwartz Farms' alleged income tax deficiency since the taxpayer was Schwartz Farms' primary shareholder and the transferee of its unharvested crops.

Because the taxpayer engineered its windfall without violating the letter of any section of the Code, the Commissioner is forced to seek to recapture the $909,904 of unrecognized income through application of the tax benefit rule. Essentially, the tax benefit rule is used by courts to adjust income and deduction inconsistencies between tax years.[2] The consolidated cases of *Hillsboro Nat'l Bank v. Commissioner* and *United States v. Bliss Dairy, Inc.*, 460 U.S. 370, 103 S.Ct. 1134, 75 L.Ed.2d 130 (1983), represent the Supreme Court's latest analysis of the tax benefit rule.

In *Bliss Dairy*, the Supreme Court applied the tax benefit rule to require a dairy farm to recognize as income the value of business deductions it had taken during the previous year for cattle feed that ultimately was not fed to cattle but distributed to shareholders during the farm's liquidation. The Court stated that the premise of a section 162(a) business deduction is that the item or service acquired will be consumed in the course of a trade or business. *Id.* at 395, 103 S.Ct. at 1149. Accordingly, the

2. *See United States v. Bliss Dairy, Inc.*, 460 U.S. 370, 387–88 n. 22, 103 S.Ct. 1134, 1145 n. 22, 75 L.Ed.2d 130 (quoting Lassen, *The Tax Benefit Rule and Related Problems*, 20 Taxes 473 (1942)).

Court held that the farm's liquidation distribution of unconsumed feed was "fundamentally inconsistent" with the premise on which the deduction of the feed was based. *Id.* at 383, 103 S.Ct. at 1143; *see also id.* at 395, 103 S.Ct. at 1149. The Court applied the tax benefit rule to remedy the inconsistency, requiring the farm to recognize as income the value of the deduction taken for unconsumed feed distributed during liquidation. *Id.* at 396, 103 S.Ct. at 1149. By the same token, the tax benefit rule did *not* require the farm to recognize as income the value of deductions taken for feed that was actually consumed prior to liquidation. *Id.*

The Commissioner argues that *Bliss Dairy* requires application of the tax benefit rule because Schwartz Farms' liquidation distribution of unharvested crops, whose cultivation cost had been fully deducted, was fundamentally inconsistent with the premise on which those deductions were based. The *Bliss Dairy* facts, however, differ clearly from the facts at hand. Schwartz Farms actually consumed all of its seed, fertilizer, and other deducted cultivation assets prior to liquidation; none of the deducted assets were distributed to shareholders in an unused or unconsumed form. The Commissioner argues that crops are merely the physical transformation of the expensed cultivation assets; only a sale of the crop avoids the "inconsistency" of which *Bliss Dairy* spoke. A liquidation distribution of unharvested crops is, according to the Commissioner, equivalent to the distribution of unconsumed feed in *Bliss Dairy*.

The Commissioner argues that consumption in a business context necessarily involves the ultimate production of income. Schwartz Farms' cultivation expenses of $909,904 did not produce income by the farm because the crops were distributed to the taxpayer prior to harvest. Therefore, reasons the Commissioner, Schwartz Farms' liquidation distribution of unharvested crops was fundamentally inconsistent with the premise on which deduction of the unsold crops' cultivation cost was based.

We decline to extend *Bliss Dairy* in this manner. To do so would extend the tax benefit rule well beyond the parameters outlined in *Bliss Dairy*. We share the Tax Court's reluctance to go beyond the facts of *Bliss Dairy*. We also subscribe to its description set forth in the margin of the consequences of doing so.[3]

The problem this case presents, the conversion of ordinary income into capital gain, is not unusual. The recapture of excess depreciation deductions provided for by 26 U.S.C. § 1245 (1988) addresses a very similar problem in a different context. The corporate liquidation and basis provisions of the Code also contribute to the problem. Courts should be hesitant to create sweeping rules which are addressed to the numerous variations of a problem and which, because of their breadth and the absence of sharply defined limits, inevitably must be modified by Congress to fix more precisely their reach. We doubt that Congress requires any such instruction from us.

3. The issue here is more than a semantic difference between the respondent and petitioners over the meaning of the word "consumed." Respondent's application of the tax-benefit rule in this case is a significant expansion of the rule and, in our view, goes far beyond its intended scope. Under respondent's formulation, every business deduction under section 162 would be "cancelled out" if an unforeseen event, not just a corporate liquidation, frustrated the sale of any products which would otherwise have been completed and sold. In this case, it is particularly significant that respondent seeks to recapture deductions for general and administrative overhead and equipment maintenance costs. Under the respondent's formulation of the rule, therefore, every taxpayer, regardless of its method of accounting, would be required to precisely allocate and recapture all of its business deductions attributable to the production of products every time an unforeseen event frustrated their sale. The respondent's formulation goes beyond "rough transactional parity." Such an expansive recapture rule is not contemplated by either the holding of *Bliss Dairy*, which is limited to recapture of the deduction for the costs of assets which were themselves distributed in the liquidation, or by the spirit of the case, which referred to the tax-benefit rule as a "limited rule." 460 U.S. at 389, 103 S.Ct. at 1146. Respondent has cited no authority which suggests that we should go beyond the holding of the Supreme Court in *Bliss Dairy*.

Rojas v. Commissioner, 90 T.C. 1090, 1103–04 (1988).

The Taxpayer's Cross-Appeal

[3] The taxpayer appeals the Tax Court's determination that facts concerning the post-liquidation disposition of Schwartz Farms' assets are relevant. That determination was not an abuse of discretion. Evidence of the sale of distributed crops by the taxpayer after liquidation arguably contributed to the Commissioner's assertion that the taxpayer is liable for deficiencies in Schwartz Farms' income taxes.

AFFIRMED.

Marlene EBERLE, et al., Plaintiffs,

and

Robert Kiser, Plaintiff–Appellant,

v.

CITY OF ANAHEIM; Anaheim Police Department; P. Shepard; Hagenson; Monsoor, et al., Defendants–Appellees.

No. 88–6125.

United States Court of Appeals, Ninth Circuit.

Argued and Submitted March 8, 1990.

Decided April 26, 1990.

Spectator at professional football game brought action against police officers alleging violation of his civil rights by officers' arresting him without probable cause and using excessive force in effecting arrest. The United States District Court for the Central District of California, Alicemarie H. Stotler, J., entered judgment in favor of police officers. Spectator appealed. The Court of Appeals, David R. Thompson, Circuit Judge, held that: (1) encounter between police officer and spectator was not an arrest but was nothing more than investigatory detention, and (2) police officer's use of fingerhold on spectator was objectively reasonable.

Affirmed.

1. Federal Courts ⇨617

Spectator at football game could not raise on appeal of civil rights action issue that his arrest at football game violated his First Amendment right to free speech where he did not include that claim, or any issue pertaining to it, in initial pretrial order, and almost three years after pretrial order was entered and 15 days before trial, he sought to add the omitted First Amendment issue, and district court denied motion to amend. U.S.C.A. Const.Amend. 1.

2. Federal Courts ⇨915

Plaintiff waived issue on appeal of civil rights action that district court abused its discretion by refusing to permit him to amend pretrial order to include First Amendment issue where plaintiff did not raise argument in his opening brief. U.S.C.A. Const.Amend. 1.

3. Arrest ⇨63.5(5)

Police officers had reasonable justification for detaining spectator at football game; third parties informed officers that spectator was causing disturbance in the stands which could lead to fight and they observed spectator acting in manner which, in their opinion, constituted crime of disturbing the peace under California law.

4. Arrest ⇨63.5(7)

Police officers' seizure of spectator at football game was no more than investigatory detention and did not constitute arrest for which probable cause was required; there was evidence that reasonable innocent person in spectator's circumstances would have felt free to leave after brief questioning by officers and officers forcibly took spectator to stadium security office because they felt unsafe because of large crowd that had gathered in concourse area where they had been questioning spectator.

5. Arrest ⇨63.5(7)

Police officers' use of force in questioning spectator at football game did not personalty which becomes an improvement to real property 'constructs' an 'improvement to real property' ". *Sonnier,* 909 S.W.2d at 478. Next, the court considered whether "when personalty is installed and used on one piece of land for over ten years, and then is removed and reinstalled on another property by the initial purchaser, whether the ten-year repose period starts again upon the substantial completion of the personalty's reinstallation." *Id.*

The court answered the first question in the negative. They held that only one who "alter[s] realty by constructing additions or annexing personalty to it" benefits from the statute of repose. *Id.* at 482. One who does "no more than manufacture personalty that is later transformed by third parties into an improvement" is not protected by the statute of repose. *Id.* The court went on to say that "Chisholm is only the manufacturer of personalty. As such it cannot claim the protection of section 16.009 of the Texas Civil Practice and Remedies Code because it did not 'construct ... an improvement to real property.' " *Id.* at 483.

The court likewise answered the second question in the negative. "The statute of repose governing the annexation at Sugar Land is not revivified by any activity occurring at another construction site. The subsequent annexation at Ramsey created a new ten-year repose period protecting those who annexed the personalty to the realty there...." *Id.*

CONCLUSION

[1, 2] Chisholm did not "construct ... an improvement to real property." Therefore, it does not receive the protection of Texas' statute of repose. In addition, when the tomato chopper was moved to Ramsey III in 1985, a new repose period began to run. Because Chisholm could not be protected by the statute of repose, the judgment of the district court is REVERSED and the case is remanded to the district court for proceedings consistent with this opinion and the opinion of the Supreme Court of Texas.

The district court granted summary judgment in favor of defendant Unipunch Products, Inc. In his initial brief, Sonnier expressly waived any appeal of that order. Therefore, the summary judgment in favor of Unipunch Products, Inc. is AFFIRMED.

The Director, Employees Workers' Compensation Division, State of Texas, ("Director") intervened in this case at the district court level. A take-nothing judgment was entered against the Director. Because the Director did not file a notice of appeal in this case, he is not properly before this court.

HUGHES & LUCE, L.L.P., Alan J. Bogdanow, Tax Matters Partner, Petitioners–Appellants,

v.

COMMISSIONER OF INTERNAL REVENUE, Respondent–Appellee.

No. 95–60036.

United States Court of Appeals, Fifth Circuit.

Nov. 15, 1995.

Law firm challenged adjustment to its taxable income based upon determination that out-of-pocket service costs it advanced to third parties on behalf of clients represented nondeductible loans. The United States Tax Court, 1994 WL 604047, entered judgment for Commissioner of Internal Revenue (CIR), finding that law firm was required to treat previously deducted service costs as income upon being reimbursed by clients, and law firm appealed. The Court of Appeals, Wiener, Circuit Judge, held that: (1) tax benefit rule was not subject to erroneous deduction exception, and (2) tax benefit rule required inclusion of reimbursements in income.

Affirmed.

1. Internal Revenue ⚷4705, 4730

In reviewing decisions of tax court, same standards are applied as are used in reviewing decision of district court: questions of law are reviewed de novo; findings of fact are reviewed for clear error.

2. Internal Revenue ⚷3138

Tax benefit rule was adopted in equitable effort to mitigate some inflexibilities of annual accounting system, upon which federal income tax is based, by approximating results that would be produced in system based on transactional rather than annual accounting.

3. Internal Revenue ⚷3138

Tax benefit rule includes amount in income in current year to extent that: amount was deducted in year prior to current year, deduction resulted in tax benefit, event occurs in current year that is fundamentally inconsistent with premises on which deduction was originally based, and nonrecognition provision of Internal Revenue Code does not prevent inclusion of gross income.

4. Internal Revenue ⚷3138

Under tax benefit rule for including amount deducted in previous year in taxpayer's current year's income, event is fundamentally inconsistent with premises on which tax deduction was originally based if event would have foreclosed deduction had it occurred in year of deduction.

5. Internal Revenue ⚷3138

Tax benefit rule, pursuant to which amount deducted in previous year will be included in taxpayer's current year's income, is not subject to erroneous deduction exception, pursuant to which it would apply only when original deduction was proper.

6. Internal Revenue ⚷3138

Law firm's actual recoveries, in subsequent tax years, of out-of-pocket service costs, previously paid to third parties on behalf of clients, were fundamentally inconsistent with premises on which law firm took income tax deductions for prior tax year, thus invoking tax benefit rule to include reimbursements in law firm's subsequent years' income following determination that such service costs were nondeductible loans, as actual recoveries would have foreclosed deduction had they occurred in same year as disbursements.

Vester T. Hughes, Jr., J. Gregory Taylor, David Hernandez, Hughes & Luce, L.L.P., Dallas, TX, Jay Howell Hebert, Dallas, TX, for petitioners-appellants.

Gary R. Allen, U.S. Department of Justice, Tax Division, Appellate Section, Washington, DC, Gilbert S. Rothenberg, Richard Bradshaw Farber, Thomas J. Clark, U.S. Dept. of Justice, Tax Div., Washington, DC, for C.I.R.

Appeal from a Decision of the United States Tax Court.

Before REAVLEY, JOLLY and WIENER, Circuit Judges.

WIENER, Circuit Judge.

This federal income tax case finds a law firm appealing from an adverse judgment rendered by the United States Tax Court. The underlying dispute arose when, during the course of an audit, the Internal Revenue Service (IRS) determined that "Service Costs" deducted by Hughes & Luce, L.L.P. should be treated as nondeductible loans to clients. The instant controversy concerns the collateral issue of the proper tax treatment of currently-received reimbursements of "Service Costs" previously deducted by the law firm as expenses in earlier tax years. The Tax Court upheld the IRS's adjustment to Hughes & Luce's then-current taxable income, holding that the *duty of consistency* requires Hughes & Luce to recognize income for these reimbursements. The Tax Court declined to apply the *tax benefit rule,* however, relying on the so-called "erroneous deduction exception." Agreeing with every other circuit court that has addressed the erroneous deduction exception, we conclude that it should be rejected, and that the judgment of the Tax Court should be affirmed but on the basis of the tax benefit rule.

I

FACTS AND PROCEEDINGS

Hughes & Luce, L.L.P. is a Texas general partnership engaged in the practice of law. It commenced doing business on November 1, 1976. Hughes & Luce uses the cash receipts and disbursements method of accounting for income tax purposes and files its tax returns on a calendar year basis.

Although the terms of an engagement differ from client to client, Hughes & Luce customarily bills clients separately for out-of-pocket costs paid to third parties for expenses incurred in connection with the firm's representation of those clients. These costs include expenses for court costs, filing fees, expert witness fees, travel and meals, long-distance telephone charges, delivery services, and the like ("Service Costs").

On its income tax returns for the years 1976 through 1989, Hughes & Luce deducted Service Costs as ordinary and necessary business expenses in the year in which the expense was paid. Reimbursements of these costs were included in its ordinary income in the year received. Often the reimbursements were received in a taxable year subsequent to the year in which the Service Costs had been deducted as business expenses.

On March 30, 1992, the IRS began an audit of Hughes & Luce's timely filed 1989 tax return. During the course of this audit, the IRS challenged Hughes & Luce's treatment of the Service Costs. The IRS contended that the firm's payments for Service Costs should be treated as loans to clients. Accordingly, the Service Costs should be neither deductible when paid nor includible in income when reimbursed. For purposes of this case, Hughes & Luce concedes that the Service Costs are properly treated as loans to clients for taxable year 1989 and following.

For the taxable year 1989, Hughes & Luce had deducted Service Costs in the amount of $2,367,535.[1] Reimbursements totaling $2,398,825 were included in income for this same year. Of the total reimbursements, $1,908,509 was attributable to Service Costs paid and deducted in 1989. The remainder of $490,766 was attributable to Service Costs paid and deducted in years prior to 1989.[2] It is these latter reimbursements that are at issue in this case. As the statute of limitations had expired for the years prior to 1989, the IRS was precluded from making an adjustment to those years to disallow the deduction of these Service Costs.

Hughes & Luce essentially contends that none of the reimbursements received in 1989 are taxable income because the IRS determined them to be loan repayments, and loan repayments are not ordinarily includible in income. The IRS counters that the reimbursements received in 1989 but attributable to costs advanced and deducted as expenses in years prior to 1989 are includible in taxable income for 1989 under either (1) the tax benefit rule or (2) the duty of consistency, which is also known as the doctrine of quasi-estoppel. On June 1, 1993, the IRS sent Hughes & Luce a Notice of Final Partnership Administrative Adjustment for its 1989 tax year, reflecting an adjustment to its taxable income of $422,457.[3]

Hughes & Luce filed a petition in the Tax Court challenging the IRS's determination. The Tax Court held that, as the deductions for Service Costs in years prior to 1989 were improper, the tax benefit rule was inapplica-

1. The majority of these Service Costs were described on Hughes & Luce's income tax return as "Other Rebillable Expenses," and the remainder was interspersed among eighteen other categories of expenses.

2. The parties have stipulated to the amounts above. As acknowledged by the Tax Court, the $450 discrepancy between the total reimbursements and the components thereof is immaterial for purposes of our decision.

3. The adjustment was calculated as follows:

Service Costs deducted but not reimbursed as of December 31, 1988		$490,766
Service Costs deducted in 1989	$2,367,535	
Service Costs reimbursed in 1989	(2,398,825)	(31,290)
Less: Bad debt deduction		(37,019)
Adjustment to Hughes & Luce's taxable income for 1989		$422,457

ble under the so-called "erroneous deduction exception." The court went on to hold, however, that Hughes & Luce was required to include the amount in issue in its income under the duty of consistency. Hughes & Luce now appeals that decision.

II

ANALYSIS

A. Standard of Review

[1] In reviewing decisions of the Tax Court we apply the same standards used in reviewing a decision of the district court: Questions of law are reviewed de novo; findings of fact are reviewed for clear error.[4]

B. Tax Benefit Rule

[2] The federal income tax is based on an annual accounting system, which is "a practical necessity if [it] is to produce revenue ascertainable and payable at regular intervals."[5] Strict adherence to an annual accounting period, however, may create transactional inequities.[6] The tax benefit rule was adopted in an equitable effort to mitigate some of the inflexibilities of the annual accounting system by approximating the results that would be produced in a system based on transactional rather than annual accounting.[7]

[3, 4] The tax benefit rule includes an amount in income in the current year to the extent that: (1) the amount was deducted in a year prior to the current year, (2) the deduction resulted in a tax benefit, (3) an event occurs in the current year that is fundamentally inconsistent with the premises on which the deduction was originally based, and (4) a nonrecognition provision of the Internal Revenue Code does not prevent the inclusion of gross income.[8] An event is fundamentally inconsistent with the premises on which the deduction was originally based if that event would have foreclosed the deduction had it occurred in the year of the deduction.[9]

[5] The Tax Court held that application of the tax benefit rule was improper in this case because of the "erroneous deduction exception." That exception provides that the tax benefit rule applies only when the original deduction was proper.[10] Because the disbursement of a loan (i.e., Service Cost) is not a proper deduction, the Tax Court concluded that the tax benefit rule did not require Hughes & Luce to include the amount in issue in its 1989 taxable income.

In its opinion, the Tax Court noted candidly that the erroneous deduction exception has been criticized or rejected by many Courts of Appeals.[11] The Tax Court nevertheless applied this exception in the instant case because we had not squarely addressed this issue. We do so now and join the other circuits in rejecting the erroneous deduction exception.

The rationale underlying the erroneous deduction exception was explained by the Tax Court in *Canelo* as follows:

> We realize that [the taxpayers] herein have received a windfall through the improper deductions. But the statute of limitations requires eventual repose. The "tax

4. *Estate of Hudgins v. Commissioner,* 57 F.3d 1393, 1396 (5th Cir.1995).

5. *Hillsboro Nat'l Bank v. Commissioner,* 460 U.S. 370, 377, 103 S.Ct. 1134, 1140, 75 L.Ed.2d 130 (1983) (citing *Burnet v. Sanford & Brooks Co.,* 282 U.S. 359, 365, 51 S.Ct. 150, 152, 75 L.Ed. 383 (1931)).

6. *Id.*

7. *Id.* 460 U.S. at 377, 381, 103 S.Ct. at 1140, 1142.

8. *Id.* at 383–84, 103 S.Ct. at 1143; *Frederick v. Commissioner,* 101 T.C. 35, 41, 1993 WL 270985 (1993).

9. *Hillsboro,* 460 U.S. at 383–84, 103 S.Ct. at 1143.

10. *See Canelo v. Commissioner,* 53 T.C. 217, 226, 1969 WL 1662 (1969), *aff'd on other grounds,* 447 F.2d 484 (9th Cir.1971).

11. *See Unvert v. Commissioner,* 656 F.2d 483, 485–86 (9th Cir.1981), *cert. denied,* 456 U.S. 961, 102 S.Ct. 2036, 72 L.Ed.2d 484 (1982); *Union Trust Co. v. Commissioner,* 111 F.2d 60, 61 (7th Cir.), *cert. denied,* 311 U.S. 658, 61 S.Ct. 12, 85 L.Ed. 421 (1940); *Kahn v. Commissioner,* 108 F.2d 748, 749 (2d Cir.1940); *Commissioner v. Liberty Bank & Trust Co.,* 59 F.2d 320, 325 (6th Cir.1932).

> benefit" rule disturbs that repose only if [the IRS] had no cause to question the initial deduction, that is, if the deduction was proper at the time it was taken. Here the deduction was improper, and [the IRS] should have challenged it before the years prior to 1960 were closed by the statute of limitations.[12]

Like the other Courts of Appeals before us, we are not persuaded by this reasoning or by the arguments advanced by Hughes & Luce in support of this exception.

As other courts have observed, the inclusion of the reimbursements in income does not *reopen* the tax liability for the prior years—albeit the result is much the same—and does not implicate the statute of limitations.[13] The only taxable year affected by application of the tax benefit rule is the year in which the reimbursements are received, which year must be open for the rule to apply at all. That these reimbursements are properly treated as loan repayments does not prevent their taxation when, as here, the loan disbursements were erroneously deducted in a prior year as an expense. The tax benefit rule requires taxation because of a previously created tax benefit, regardless of an item's inherent characteristics (i.e., whether repayment of a loan or recovery of a deductible expense) and regardless of whether the original deduction was proper or improper.[14] We also agree with the court in *Unvert* that the erroneous deduction exception is poor public policy in that it rewards the taking of improper tax deductions. We therefore reject the erroneous deduction exception and conclude that the tax benefit rule applies regardless of the propriety of the original deduction.

Hughes & Luce argues that the Supreme Court's decision in *Hillsboro National Bank v. Commissioner* effectively overruled prior cases that rejected or criticized the erroneous deduction exception. Selectively pointing to language and examples in that case, Hughes & Luce asserts that *Hillsboro* leaves no doubt that the tax benefit rule can be applied only when the original deduction was proper. We disagree, finding this to be a strained interpretation of *Hillsboro.*

At issue in *Hillsboro* was whether the tax benefit rule was limited to situations in which a taxpayer recovers an amount previously deducted or, alternatively, whether it also applies when an event in a later year is fundamentally inconsistent with the premise on which the deduction was claimed.[15] Neither the propriety of the original deductions nor the validity of the erroneous deduction exception was ever in question in *Hillsboro.* Thus, we are unpersuaded by this argument.

[6] Hughes & Luce also contends that there is no fundamentally inconsistent event in this case because the very nature of "rebillable expenses" is that reimbursement of such expenses is expected. Thus, Hughes & Luce insists, it is improper to invoke the tax benefit rule. This argument misses the mark. In holding that a fundamentally inconsistent event is a requirement to invoke the tax benefit rule, the Supreme Court in *Hillsboro* expanded that rule by refusing to limit it to situations involving an actual recovery. The actual recoveries by Hughes & Luce of the Service Costs at issue plainly are fundamentally inconsistent events in that they would have foreclosed the deduction had they occurred in the same year as the disbursements.[16]

C. Duty of Consistency

As we affirm the Tax Court on the basis that the tax benefit rule requires Hughes & Luce to include the amount at issue in its 1989 taxable income, we need not and therefore do not consider the Tax Court's holding that this same result is required under the duty of consistency. This should not be construed as either agreeing with or rejecting the Tax Court's treatment of that matter.

12. *Canelo v. Commissioner,* 53 T.C. 217, 226–27, 1969 WL 1662 (1969), *aff'd on other grounds,* 447 F.2d 484 (9th Cir.1971).

13. *Dobson v. Commissioner,* 320 U.S. 489, 493, 64 S.Ct. 239, 242, 88 L.Ed. 248 (1943); *Unvert v. Commissioner,* 656 F.2d 483, 485–86 (9th Cir. 1981), *cert. denied,* 456 U.S. 961, 102 S.Ct. 2036, 72 L.Ed.2d 484 (1982).

14. *Unvert,* 656 F.2d at 486.

15. *Hillsboro,* 460 U.S. at 381, 103 S.Ct. at 1142.

16. *See Hillsboro,* 460 U.S. at 383–84, 103 S.Ct. at 1143.

III

CONCLUSION

For the foregoing reasons, we reject the erroneous deduction exception and conclude that the tax benefit rule applies regardless of the propriety of the original deduction. We therefore affirm the Tax Court's judgment, albeit we do so on the basis of the tax benefit rule rather than on the reason expressed by the Tax Court.

AFFIRMED.

Glen ROBERTSON and Cheryl Robertson, Individually and as Heirs at Law of Jonathan P. Robertson, Plaintiffs–Appellants,

v.

PLANO CITY OF TEXAS, et al., Defendants–Appellees.

No. 94–41229.

United States Court of Appeals, Fifth Circuit.

Nov. 15, 1995.

Burglary suspect's parents brought § 1983 action against city, police chief, and police officers to recover for suspect's suicide after he was erroneously admonished about adult penalties for car burglary. The United States District Court for the Eastern District of Texas, Paul N. Brown, J., dismissed for failure to state claim. Parents appealed. The Court of Appeals, Rhesa Hawkins Barksdale, Circuit Judge, held that: (1) suspect was never under arrest, and (2) erroneous admonition about adult penalties did not violate substantive due process.

Affirmed.

1. Federal Courts ⇨817

Although leave to amend complaint should be granted liberally, its denial is reviewed only for abuse of discretion.

2. Federal Courts ⇨624

Plaintiffs' objection that they did not drop request to replead was reviewable only for plain error since it was raised for first time on appeal; if district court incorrectly characterized or misunderstood plaintiffs' position on amending complaint, they should have requested reconsideration. Fed.Rules Civ.Proc.Rules 59(e), 60(d), 28 U.S.C.A.

3. Federal Courts ⇨624

Court of Appeals lacked basis for finding error in district court's finding that plaintiffs did not wish to replead, and, thus, finding could not have been plain error; plaintiffs offered affidavit from attorney present at management conference, but affidavit was not part of record.

4. Federal Courts ⇨621

Possibility that finding on question of fact could rise to level of obvious error required to meet standard for plain error is remote.

5. Federal Courts ⇨776

Dismissal for failure to state claim is reviewed de novo. Fed.Rules Civ.Proc.Rule 12(b)(6), 28 U.S.C.A.

6. Arrest ⇨68(4)

Police officers' encounter with minor suspect in his home was not "seizure" under Fourth Amendment; suspect was not placed under arrest, and police officers did not display weapons, touch suspect, or use language leading him to believe that his freedom would be restrained if he attempted to leave. U.S.C.A. Const.Amend. 4.

See publication Words and Phrases for other judicial constructions and definitions.

7. Constitutional Law ⇨253(1)

Municipal Corporations ⇨747(3)

Police officers' erroneous admonition about adult penalties for car burglary to which 16–year-old minor had confessed did not violate substantive due process rights of minor who committed suicide; officers told minor that offense carried possibility of $10,000 fine and imprisonment, but juvenile had as a switchman for about 7 years and when injured was well under the age for retirement. His work was satisfactory. Neither his age nor his physical condition contributed to cause his injury.

In Minneapolis, etc., R. Co. v. Rock, supra, this Court held that one who obtained employment as a switchman for an interstate carrier by railroad by fraudulently evading the company's rule requiring applicants to submit to a physical examination and who suffered injury in the course of employment in interstate transportation, while the company remained unaware of the deception, was not as of right an employee within the meaning, or entitled to the protection, of the Federal Employers' Liability Act, and could not maintain an action for injury under that statute.

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*Rock was an imposter. He applied for work under his true name and was rejected upon examination because his physical condition was found unacceptable under the carrier's reasonable rule and practice. Later, representing that he had not theretofore made application, he applied again, but under a different name, and procured another man to impersonate him and in his place to submit to the required physical examination. And, by means of the surgeon's report upon that man's condition, Rock deceived the company, and thereby secured the employment in which, about a year later, he suffered injury. The court said (page 414 of 279 U. S., 49 S. Ct. 363, 365): "The deception * * set at naught the carrier's reasonable rule and practice established to promote the safety of employees and to protect commerce. It was directly opposed to the public interest, because calculated to embarrass and hinder the carrier in the performance of its duties and to defeat important purposes sought to be advanced by the act. * * * [Page 415 of 279 U. S., 49 S. Ct. 363, 365.] While his physical condition was not a cause of his injuries, it did have direct relation to the propriety of admitting him to such employment. It was at all times his duty to disclose his identity and physical condition to petitioner. His failure so to do was a continuing wrong in the nature of a cheat. The misrepresentation and injury may not be regarded as unrelated contemporary facts. As a result of his concealment his status was at all times wrongful, a fraud upon the petitioner, and a peril to its patrons and its other employees. Right to recover may not justly or reasonably be rested on a foundation so abhorrent to public policy."

Here, defendant could not have regarded the difference between plaintiff's actual age and that stated in his application as having any material bearing upon the physical condition it required. The arbitrators did not find, and the evidence does not show, that

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plaintiff's false state*ment of his age substantially affected the examining surgeon's conclusion that he was in good health and acceptable physical condition, or that, if he had given his real age, the surgeon would have found otherwise. Indeed the surgeon's testimony shows that, save in exceptional cases, defendant, in accordance with its established rules, permits its switchmen to continue in the service until they are 65 years old without any physical examination after they are employed. Plaintiff's physical condition was not shown to be such as to make his employment inconsistent with the defendant's proper policy or its reasonable rules to insure discharge of its duty to select fit employees. The evidence indicates that, under its own interpretation of rule 22 together with the schedule constituting the agreement between defendant and its switchmen, defendant, after the final acceptance of plaintiff's application, was not free to discharge him on account of the false statement as to his age.

It is clear that the facts found, when taken in connection with those shown by uncontradicted evidence, are not sufficient to bring this case within the rule applied in Minneapolis, etc., R. Co. v. Rock, supra, or the reasons upon which that decision rests.

Judgment affirmed.

286 U. S. 417

NORTH AMERICAN OIL CONSOLIDATED v. BURNET, Commissioner of Internal Revenue.

No. 575.

Argued April 20, 21, 1932.
Decided May 23, 1932.

1. Internal revenue 🔑7(34).

Income earned from property in litigation and impounded by receiver pending outcome of suit *held* not taxable to receiver (Revenue Act 1916, § 13 (c).

Income earned from property in litigation and impounded by receiver pending outcome of suit to determine beneficial ownership was not taxable to receiver under Revenue Act 1916, § 13 (c), 39 Stat. 756, 771, because receiver was in possession of only a part of the properties operated by the taxpayer corporation.

2. Internal revenue 🔑25.

Statutory provisions relating to tax returns by receivers *held* applicable only to receivers in charge of entire property or business of corporation (Revenue Act 1916, § 13 (c); Revenue Act 1918, § 239).

3. Internal revenue ⚷7(4).

Income earned in 1916, but impounded by receiver pending outcome of litigation involving right thereto, *held* not taxable as income of 1916.

Among properties operated by taxpayer corporation in 1916 was a section of oil land, the legal title to which stood in the name of the United States. The government, claiming also the beneficial ownership of the property, instituted a suit to oust the taxpayer corporation from possession, and in 1916 secured the appointment of a receiver to operate the property and to hold the net income thereof. In 1917 a final decree was entered dismissing the government's bill, and the money was paid over, in that year, to the taxpayer corporation. The government took an appeal, without supersedeas, to the Circuit Court of Appeals, which in 1920 affirmed the decree, and an appeal to the Supreme Court was dismissed in 1922 pursuant to stipulation.

4. Internal revenue ⚷7(4).

Income earned in 1916, but impounded by receiver pending outcome of litigation, and actually paid over to taxpayer in 1917, *held* taxable as income of 1917.

On Certiorari to the United States Circuit Court of Appeals for the Ninth Circuit.

Proceedings by David Burnet, Commissioner of Internal Revenue, to review a decision of the United States Board of Tax Appeals with relation to a deficiency tax of the North American Oil Consolidated, a corporation, for income and profits taxes for the year 1917. To review an order of the Circuit Court of Appeals [50 F.(2d) 752], reversing the order of the Board of Tax Appeals, the taxpayer brings certiorari.

Order affirmed.

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*Mr. Herbert W. Clark, of San Francisco, Cal., for petitioner.

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*The Attorney General and Mr. G. A. Youngquist, Asst. Atty. Gen., for respondent.

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*Mr. Justice BRANDEIS delivered the opinion of the Court.

The question for decision is whether the sum of $171,979.22, received by the North American Oil Consolidated in 1917, was taxable to it as income of that year.

The money was paid to the company under the following circumstances: Among many properties operated by it in 1916 was a section of oil land, the legal title to which stood in the name of the United States. Prior to that year, the government, claiming also the

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beneficial *ownership, had instituted a suit to oust the company from possession; and on February 2, 1916, it secured the appointment of a receiver to operate the property, or supervise its operations, and to hold the net income thereof. The money paid to the company in 1917 represented the net profits which had been earned from that property in 1916 during the receivership. The money was paid to the receiver as earned. After entry by the District Court in 1917 of the final decree dismissing the bill, the money was paid, in that year, by the receiver to the company. United States v. North American Oil Consolidated, 242 F. 723. The government took an appeal (without supersedeas) to the Circuit Court of Appeals. In 1920, that court affirmed the decree. 264 F. 336. In 1922, a further appeal to this Court was dismissed by stipulation. 258 U. S. 633, 42 S. Ct. 315, 66 L. Ed. 802.

The income earned from the property in 1916 had been entered on the books of the company as its income. It had not been included in its original return of income for 1916; but it was included in an amended return for that year which was filed in 1918. Upon auditing the company's income and profits tax returns for 1917, the Commissioner of Internal Revenue determined a deficiency based on other items. The company appealed to the Board of Tax Appeals. There, in 1927, the Commissioner prayed that the deficiency already claimed should be increased so as to include a tax on the amount paid by the receiver to the company in 1917. The Board held that the profits were taxable to the receiver as income of 1916; and hence made no finding whether the company's accounts were kept on the cash receipts and disbursements basis or on the accrual basis. 12 B. T. A. 68. The Circuit Court of Appeals held that the profits were taxable to the company as income of 1917, regardless of whether the company's returns were made on

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the cash or on the *accrual basis. 50 F.(2d) 752. This Court granted a writ of certiorari. 284 U. S. 614, 52 S. Ct. 208, 76 L. Ed. —.

It is conceded that the net profits earned by the property during the receivership constituted income. The company contends that they should have been reported by the receiver for taxation in 1916; that, if not returnable by him, they should have been returned by the company for 1916, because they constitute income of the company accrued in that year; and that, if not taxable as income of the company for 1916, they were taxable to it as income for 1922, since the litigation was not finally terminated in its favor until 1922.

[1, 2] First. The income earned in 1916 and impounded by the receiver in that year was not taxable to him, because he was the receiver of only a part of the properties operated by the company. Under section 13 (c) of the Revenue Act of 1916,[1] receivers who "are operating the property or business of corporations" were obliged to make returns "of net income as and for such corporations," and "any income tax due" was to be "assessed and collected in the same manner as if assessed directly against the organizations of whose businesses or properties they have custody and control." The phraseology of this section was adopted without change in the Revenue Act of 1918, 40 Stat. 1057, 1081, c. 18, § 239. The regulations of the Treasury De-
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partment have consistently construed *these statutes as applying only to receivers in charge of the entire property or business of a corporation; and in all other cases have required the corporations themselves to report their income. Treas. Regs. 33, arts. 26, 209; Treas. Regs. 45, arts. 424, 622. That construction is clearly correct. The language of the section contemplates a substitution of the receiver for the corporation; and there can be such substitution only when the receiver is in complete control of the properties and business of the corporation. Moreover, there is no provision for the consolidation of the return of a receiver of part of a corporation's property or business with the return of the corporation itself. It may not be assumed that Congress intended to require the filing of two separate returns for the same year, each covering only a part of the corporate income, without making provision for consolidation so that the tax could be based upon the income as a whole.

[1] Act of September 8, 1916, 39 Stat. 756, 771, c. 463: "In cases wherein receivers, trustees in bankruptcy, or assignees are operating the property or business of corporations * * * subject to tax imposed by this title, such receivers, trustees, or assignees shall make returns of net income as and for such corporations * * * in the same manner and form as such organizations are hereinbefore required to make returns, and any income tax due on the basis of such returns made by receivers, trustees, or assignees shall be assessed and collected in the same manner as if assessed directly against the organizations of whose businesses or properties they have custody and control."

[3] Second. The net profits were not taxable to the company as income of 1916. For the company was not required in 1916 to report as income an amount which it might never receive. See Burnet v. Logan, 283 U. S. 404, 413, 51 S. Ct. 550, 75 L. Ed. 1143. Compare Lucas v. American Code Co., 280 U. S. 445, 452, 50 S. Ct. 202, 74 L. Ed. 538; Burnet v. Sanford & Brooks Co., 282 U. S. 359, 363, 51 S. Ct. 150, 75 L. Ed. 383. There was no constructive receipt of the profits by the company in that year, because at no time during the year was there a right in the company to demand that the receiver pay over the money. Throughout 1916 it was uncertain who would be declared entitled to the profits. It was not until 1917, when the District Court entered a final decree vacating the receivership and dismissing the bill, that the company became entitled to receive the money. Nor is it material, for the purposes of this case, whether the company's return was filed on the cash receipts and disbursements basis, or on the accrual basis. In
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neither event was it taxable in 1916 on *account of income which it had not yet received and which it might never receive.

[4] Third. The net profits earned by the property in 1916 were not income of the year 1922—the year in which the litigation with the government was finally terminated. They became income of the company in 1917, when it first became entitled to them and when it actually received them. If a taxpayer receives earnings under a claim of right and without restriction as to its disposition, he has received income which he is required to return, even though it may still be claimed that he is not entitled to retain the money, and even though he may still be adjudged liable to restore its equivalent. See Board v. Commissioner of Internal Revenue (C. C. A.) 51 F.(2d) 73, 75, 76. Compare United States v. S. S. White Dental Manufacturing Co., 274 U. S. 398, 403, 47 S. Ct. 598, 71 L. Ed. 1120. 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. Compare Lucas v. American Code Co., supra.

Affirmed.

think it advisable that we adhere to the procedure followed in Herb v. Pitcairn, 1945, 324 U.S. 117, 65 S.Ct. 459, 89 L.Ed 789.

[3] We will continue the cause for such period as will enable counsel for the petitioner, with all convenient speed, to apply to the appropriate California courts for certificate or other expression, to show whether the judgments herein rest on adequate and independent state grounds or whether decision of the federal question was necessary to the judgments rendered. Cf. Loftus v. People of State of Illinois, 1948, 334 U.S. 804, 68 S.Ct. 1212, 92 L.Ed. 1737; State of Indiana ex rel. Anderson v. Brand, 1938, 303 U.S. 95, 58 S.Ct. 443, 82 L.Ed. 685.

Cause continued.

340 U.S. 590

UNITED STATES v. LEWIS.

No. 347.

Argued March 2, 1951.

Decided March 26, 1951.

Rehearing Denied April 30, 1951.

See 341 U.S. 923, 71 S.Ct. 741.

Ellis R. Lewis sued the United States of America for a refund of an alleged overpayment of his 1944 income tax. The United States Court of Claims, Madden, J., 91 F. Supp. 1017, held that plaintiff was entitled to the refund sought, and the United States brought certiorari. The United States Supreme Court, Mr. Justice Black, held that since the taxpayer had received the bonus, upon which he paid taxes in 1944, under a claim of right and without restriction as to its disposition, he was not entitled to a refund in respect to that portion of the bonus which he had subsequently, in 1946, been required to repay to his employer under compulsion of state court's judgment finding that bonus had been improperly computed.

Reversed.

Mr. Justice Douglas dissented.

1. Internal revenue 314

Where taxpayer receives earnings under claim of right and without restriction as to its disposition, he has received income which he is required to include on his income tax return, even though it may still be claimed that he is not entitled to retain money, and even though he may still be adjudged liable to restore its equivalent. 26 U.S.C.A. §§ 41, 42, 322(b).

2. Internal revenue 1967

Where taxpayer had received bonus from employer in 1944 and paid income tax for that year on basis of such bonus, and subsequently, in 1946, state court had directed taxpayer to repay employer part of that bonus, because it had been improperly computed, taxpayer was not entitled to refund of difference between tax payable in 1944 if bonus had been computed correctly and amount of tax actually paid, in view of fact that until his payment of judgment to his employer in 1946, taxpayer had at all times claimed and used the full amount of the bonus unconditionally as his own. 26 U.S.C.A. §§ 41, 42, 322(b).

Mr. Ellis N. Slack, Washington, D. C., for petitioner.

Mr. Sigmund W. David, Chicago, Ill., for respondent.

Mr. Justice BLACK delivered the opinion of the Court.

Respondent Lewis brought this action in the Court of Claims seeking a refund of an alleged overpayment of his 1944 income tax. The facts found by the Court of Claims are: In his 1944 income tax return, respondent reported about $22,000 which he had received that year as an employee's bonus. As a result of subsequent litigation in a state court, however, it was decided that respondent's bonus had been improperly computed; under compulsion of the state court's judgment he returned approximately $11,000 to his employer. Until payment

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of the judgment in 1946, respondent

had at all times claimed and used the full $22,000 unconditionally as his own, in the good faith though "mistaken" belief that he was entitled to the whole bonus.

On the foregoing facts the Government's position is that respondent's 1944 tax should not be recomputed, but that respondent should have deducted the $11,000 as a loss in his 1946 tax return. See G.C.M. 16730, XV–1 Cum. Bull. 179 (1936). The Court of Claims, however, relying on its own case, Greenwald v. United States, 57 F. Supp. 569, 102 Ct.Cl. 272, held that the excess bonus received "under a mistake of fact" was not income in 1944 and ordered a refund based on a recalculation of that year's tax. 91 F.Supp. 1017, 1022, 117 Ct. Cl. 336. We granted certiorari, 340 U.S. 903, 71 S.Ct. 279, because this holding conflicted with many decisions of the courts of appeals, see, e. g., Haberkorn v. United States, 6 Cir., 173 F.2d 587, and with principles announced in North American Oil Consolidated v. Burnet, 286 U.S. 417, 52 S. Ct. 613, 76 L.Ed. 1197.

[1, 2] In the North American Oil case we said: "If a taxpayer receives earnings under a claim of right and without restriction as to its disposition, he has received income which he is required to return, even though it may still be claimed that he is not entitled to retain the money, and even though he may still be adjudged liable to restore its equivalent." 286 U.S. at 424, 52 S.Ct. at page 615, 76 L.Ed. 1197. Nothing in this language permits an exception merely because a taxpayer is "mistaken" as to the validity of his claim. Nor has the "claim of right" doctrine been impaired, as the Court of Claims stated, by Freuler v. Helvering, 291 U.S. 35, 54 S.Ct. 308, 78 L.Ed. 634, or Com'r v. Wilcox, 327 U.S. 404, 66 S.Ct. 546, 90 L.Ed. 752. The Freuler case involved an entirely different section of the Internal Revenue Code, and its holding is inapplicable here. 291 U.S. at 43, 54 S.Ct. at page 311, 78 L.Ed. 634. And in Com'r v. Wilcox, supra, we held that receipts from embezzlement did not constitute income, distinguishing North American Oil on the ground

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that an embezzler asserts no "bona fide legal or equitable claim". 327 U.S. at 408, 66 S.Ct. at page 549, 90 L.Ed. 752.

Income taxes must be paid on income received (or accrued) during an annual accounting period. Cf. I.R.C. §§ 41, 42, 26 U.S.C.A. §§ 41, 42; and see Burnet v. Sanford & Brooks Co., 282 U.S. 359, 363, 51 S.Ct. 150, 151, 75 L.Ed. 383. 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. See cases collected in 2 Mertens, Law of Federal Income Taxation, § 12.103. 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.[1]

Reversed.

Mr. Justice DOUGLAS (dissenting).

The question in this case is not whether the bonus had to be included in 1944 income for purposes of the tax. Plainly it should have been because the taxpayer claimed it as of right. Some years later, however, it was judicially determined that he had no claim to the bonus. The question is whether he may then get back the tax which he paid on the money.

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

1. It has been suggested that it would be more "equitable" to reopen respondent's 1944 tax return. While the suggestion might work to the advantage of this taxpayer, it could not be adopted as a general solution because, in many cases, the three-year statute of limitations would preclude recovery. I.R.C. § 322(b), 26 U.S.C.A. § 322(b).

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.

340 U.S. 616
UNITED STATES v. MOORE et al.
No. 344.

Argued and Submitted Feb. 28–March 1, 1951.

Decided March 26, 1951.

Rehearing Denied April 30, 1951.
See 341 U.S. 923, 71 S.Ct. 740.

Action by the United States of America against Warren V. Moore and Mrs. Warren V. Moore, under the Housing and Rent Act of 1947, as amended, § 1 et seq., 50 U.S.C.A. Appendix, § 1881 et seq., for damages, for violations of the Act and restitution of overceiling rentals collected. The United States Court of Appeals for the Fifth Circuit, 182 F.2d 332, reversed a judgment of the United States District Court for the Northern District of Texas allowing statutory damages of $50 for a wilful violation and ordering restitution to be made to tenant of all overcharges received, and the plaintiff brought certiorari. The Supreme Court, Mr. Justice Clark, held that landlords could be ordered to make restitution of overceiling rentals, notwithstanding that a prohibitory injunction was not required because the defense-rental area in which premises was located was de-controlled after the violation but before the Government brought the action.

Judgment of Court of Appeals reversed and cause remanded with directions.

Mr. Chief Justice Vinson, Mr. Justice Douglas, Mr. Justice Black and Mr. Justice Frankfurter, dissented.

1. Landlord and tenant ⚷200(1½)
War and national defense ⚷222

Where after alleged violations but before Government brought action under Housing and Rent Act for damages and for injunction against further violations and for restitution, defense-rental area in which premises was located was decontrolled, landlords could be ordered to make restitution of overceiling rentals, independently of injunctive relief, as an "other order", within provision in Act permitting the court to grant a permanent or temporary injunction, restraining order, or other order. Housing and Rent Act of 1947, §§ 1 et seq., 204(j) (3), 205, 206(b), as amended, 50 U.S.C.A.Appendix, §§ 1881 et seq., 1894(j) (3), 1895, 1896(b).

See publication Words and Phrases, for other judicial constructions and definitions of "Other Order".

2. Landlord and tenant ⚷200(1½)
War and national defense ⚷206

Termination of rent control in defense-rental area in which premises was located did not end legal effect of provisions of Housing and Rent Act under which action was instituted by Housing Expediter against landlords for damages, injunction against further violations of the Act and for restitution of rent overcharges. Housing and Rent Act of 1947, §§ 1 et seq., 204(f), (j) (3), 205, 206(b), as amended, 50 U.S.C.A.Appendix, §§ 1881 et seq., 1894(f), (j) (3), 1895, 1896(b).

3. Federal civil procedure ⚷2044

Where no demand for jury trial was made by defendants as required by Federal Rules of Civil Procedure, any right to jury trial was waived, and defendants' contention that trial of proceeding as an action for equitable relief denied their constitutional right to jury trial would be denied. Fed.Rules Civ.Proc. rule 38, 28 U.S.C.A.

Mr. James L. Morrisson, Washington, D. C., for petitioner.

Mr. Frank Cusack, Dallas, Tex., for respondents.

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Mr. Justice CLARK delivered the opinion of the Court.

The United States brings this action under the Housing and Rent Act of 1947, as

394 U.S. 678

UNITED STATES, Petitioner,
v.
SKELLY OIL COMPANY.
No. 280.

Argued Jan. 15, 1969.
Decided April 21, 1969.
Rehearing Denied June 2, 1969.
See 395 U.S. 941, 89 S.Ct. 1992.

Taxpayer brought action against the United States for refund of federal income taxes paid. The United States District Court for the Northern District of Oklahoma, 255 F.Supp. 228, rendered judgment adverse to the taxpayer, and the taxpayer appealed. The Court of Appeals for the Tenth Circuit, 392 F.2d 128, reversed the judgment of the District Court. On certiorari, the Supreme Court, Mr. Justice Marshall, held that where taxpayer overcharged customers for natural gas for certain years, and during those years was allowed a 27½% depletion allowance for income tax purposes, and subsequently taxpayer was required to refund overcharge, deduction allowable in year of repayment was required to be reduced by percentage depletion allowance claimed and allowed in years of receipt as result of inclusion of later-refunded items in taxpayer's gross income for those years.

Judgment of Court of Appeals reversed, and case remanded to Court of Appeals with instructions that it be returned to District Court for reentry of original District Court judgment.

Mr. Justice Douglas, Mr. Justice Stewart, and Mr. Justice Harlan dissented.

1. Internal Revenue ⚷328

Under "claim-of-right doctrine" if taxpayer receives earnings under claim of right and without restriction as to its disposition, he has received income which he is required to return for income tax purposes, even though it may still be claimed that he is not entitled to retain the money, and even though he may still be adjudged liable to restore its equivalent.

See publication Words and Phrases for other judicial constructions and definitions.

2. Internal Revenue ⚷504

Section of Internal Revenue Code dealing with computation of tax where taxpayer restores substantial amount held under claim of right was enacted to alleviate some of the inequities which Congress felt existed under the claim-of-right doctrine. 26 U.S.C.A. (I.R.C.1954) § 1341.

3. Internal Revenue ⚷503

In case of accrual-basis taxpayer, legislative history of section of Internal Revenue Code dealing with computation of tax where taxpayer restores substantial amount held under claim of right makes it clear that deduction is allowable at proper time for accrual. 26 U.S.C.A. (I.R.C.1954) § 1341.

4. Internal Revenue ⚷281, 1297

Congress, in enacting section of Internal Revenue Code dealing with computation of tax where taxpayer restores substantial amount held under claim of right, did not intend to tamper with underlying claim-of-right doctrine, but only provided an alternative for certain cases in which new approach favored taxpayer. 26 U.S.C.A. (I.R.C.1954) § 1341.

5. Internal Revenue ⚷1297

Under (a)(1) of section 1341 of Internal Revenue Code dealing with computation of tax where taxpayer restores substantial amount held under claim of right, words "deduction" and "item" are not necessarily required to be equal in amount. 26 U.S.C.A. (I.R.C.1954) § 1341(a) (1).

6. Internal Revenue ⚷1297

When section 1341(a) (4) of the Internal Revenue Code dealing with computation of tax where taxpayer restores substantial amount held under claim of right speaks of the tax computed with such "deduction" it is referring to the "deduction" mentioned in (a)(2) of that section. 26 U.S.C.A. (I.R.C.1954) § 1341(a) (2, 4).

7. Internal Revenue ⚷1297

The "deduction" under (a)(4) of section 1341 of the Internal Revenue Code dealing with computation of tax where taxpayer restores substantial amount held under claim of right must be determined, not by any mechanical equation with the "item" originally included in gross income under that section, but by reference to applicable sections of the Internal Revenue Code and the case law developed under those sections. 26 U.S.C.A. (I.R.C.1954) § 1341(a) (4).

8. Internal Revenue ⚷1292

The Internal Revenue Code should not be interpreted to allow taxpayer the practical equivalent of double deduction for income tax purposes.

9. Internal Revenue ⚷1297

Where taxpayer overcharged customers for natural gas for certain years, and during those years was allowed a 27½% depletion allowance for income tax purposes, and subsequently taxpayer was required to refund overcharge, deduction allowable in year of repayment was required to be reduced by percentage depletion allowance claimed and allowed in years of receipt as result of inclusion of later-refunded items in taxpayer's gross income for those years. 26 U.S.C.A. (I.R.C.1954) § 1341(a) (4).

10. Internal Revenue ⚷1332

Under annual accounting system dictated by Internal Revenue Code, each year's income tax must be definitely calculable at end of tax year.

11. Internal Revenue ⚷262

It is essence of any system of taxation that it should produce revenue ascertainable and payable to the government at regular intervals.

12. Internal Revenue ⚷1292

In cases arising under the claim-of-right doctrine, emphasis on annual accounting period normally requires that income tax consequences of a receipt should not determine size of deduction allowable in year of repayment, and there is no requirement that deduction save taxpayer the exact amount of taxes he paid because of inclusion of the item in income for a prior year.

13. Internal Revenue ⚷1297

Annual accounting concept does not require Supreme Court to close its eyes to what happened in prior years in applying section of Internal Revenue Code in dealing with computation of tax where taxpayer restores substantial amount held under claim of right, and, for instance, prior year may be examined to determine whether repayment gives rise to regular loss or capital loss. 26 U.S.C.A. (I.R.C.1954) § 1341.

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Sol. Gen. Erwin N. Griswold, for petitioner.

Robert J. Casey, New York City, for respondent.

Mr. Justice MARSHALL delivered the opinion of the Court.

During its tax year ending December 31, 1958, respondent refunded $505,536.54 to two of its customers for overcharges during the six preceding years. Respondent, an Oklahoma producer of natural gas, had set its prices during the earlier years in accordance with a minimum price order of the Oklahoma Corporation Commission. After that order was vacated as a result of a decision of this Court, Michigan Wisconsin Pipe Line Co. v. Corporation Comm. of Oklahoma, 355 U.S. 425, 78 S.Ct. 409, 2 L.Ed.2d 412 (1958), respondent found it necessary to settle a number of claims filed by its customers; the repayments in question represent settlements of two of those claims. Since respondent had claimed an unrestricted right to its sales receipts during the years 1952 through 1957, it had included the $505,536.54 in its gross income in those years. The amount was also included in respondent's "gross income from the property" as defined in § 613 of the Internal Revenue Code of 1954, the section which allows taxpayers to deduct a fixed percentage of certain receipts to compensate for the depletion of natural resources from which they derive income. Allowable percentage depletion for receipts from oil and gas wells is fixed at 27½% of the "gross income from the property." Since respondent

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claimed and the Commissioner allowed percentage depletion deductions during these years, 27½% of the receipts in question was added to the depletion allowances to which respondent would otherwise have been entitled. Accordingly, the actual increase in respondent's taxable income attributable to the receipts in question was not $505,536.54, but only $366,513.99. Yet, when respondent made its refunds in 1958, it attempted to deduct the full $505,536.54. The Commissioner objected and assessed a deficiency. Respondent paid and, after its claim for a refund had been disallowed, began the present suit. The Government won in the District Court, 255 F.Supp. 228 (D.C.N.D.Okl.1966), but the Court of Appeals for the Tenth Circuit reversed, 392 F.2d 128 (1968). Upon petition by the Government, we granted certiorari, 393 U.S. 820, 89 S.Ct. 121, 21 L.Ed.2d 92 (1968), to consider whether the Court of Appeals decision had allowed respondent "the practical equivalent of double deduction," Charles Ilfeld Co. v. Hernandez, 292 U.S. 62, 68, 54 S.Ct. 596, 598, 78 L.Ed. 1127 (1934), in conflict with past decisions of this Court and sound principles of tax law. We reverse.

I.

[1] The present problem is an outgrowth of the so-called "claim-of-right" doctrine. Mr. Justice Brandeis, speaking for a unanimous Court in North American Oil Consolidated v. Burnet, 286 U.S. 417, 424, 52 S.Ct. 613, 615, 76 L.Ed. 1197 (1932), gave that doctrine its classic formulation. "If a taxpayer receives earnings under a claim of right and without restriction as to its disposition, he has received income which he is required to return, even though it may still be claimed that he is not entitled to retain the money, and even though he may still be adjudged liable to restore its equivalent." Should it later appear that the taxpayer was not entitled to keep the money, Mr. Justice Brandeis explained, he would be entitled to a deduction in the year of repayment; the taxes due for the year of receipt would

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not be affected. This approach was dictated by Congress' adoption of an annual accounting system as an integral part of the tax code. See Burnet v. Sanford & Brooks Co., 282 U.S. 359, 365–366, 51 S.Ct. 150, 152, 75 L.Ed. 383 (1931). Of course, the tax benefit from the deduction in the year of repayment might differ from the increase in taxes attributable to the receipt; for example, tax rates might have changed, or the taxpayer might be in a different tax "bracket." See Healy v. Commissioner of Internal Revenue, 345 U.S. 278, 284–285, 73 S.Ct. 671, 675, 97 L.Ed. 1007 (1953). But as the doctrine was originally formulated, these discrepancies were accepted as an unavoidable consequence of the annual accounting system.

[2–4] Section 1341 of the 1954 Code was enacted to alleviate some of the inequities which Congress felt existed in this area.[1] See H.R.Rep. No. 1337, 83d

1. Section 1341(a) provides:

"If—

"(1) an item was included in gross income for a prior taxable year (or years) because it appeared that the taxpayer had an unrestricted right to such item;

"(2) a deduction is allowable for the taxable year because it was established after the close of such prior taxable year

Cong., 2d Sess., 682 86–87 (1954); S.Rep. No. 1622, 83d Cong., 2d Sess., 118–119 (1954), U.S.Code Cong. & Admin.News, p. 4629. As an alternative to the deduction in the year of repayment [2] which prior law allowed, § 1341(a) (5) permits certain taxpayers to recompute their taxes for the year of receipt. Whenever § 1341(a) (5) applies, taxes for the current year are to be reduced by the amount taxes were increased in the year or years of receipt because the disputed items were included in gross income. Nevertheless, it is clear that Congress did not intend to tamper with the underlying claim-of-right doctrine; it only provided an alternative for certain cases in which the new approach favored the taxpayer. When the new approach was not advantageous to the taxpayer, the old law was to apply under § 1341(a) (4).

In this case, the parties have stipulated that § 1341(a) (5) does not apply. Accordingly, as the courts below recognized, respondent's taxes must be computed under § 1341(a) (4) and thus, in effect, without regard to the special relief Congress provided through the enactment of § 1341. Nevertheless, respondent argues, and the Court of Appeals seems to have held, that the language used in § 1341 requires that respondent be allowed a deduction for the full amount it refunded to its customers. We think the section has no such significance.

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[5–7] In describing the situations in which the section applies, § 1341(a) (2) talks of cases in which "a deduction is allowable for the taxable year because it was established after the close of [the year or years of receipt] that the taxpayer did not have an unrestricted right to such item * * *." The "item" referred to is first mentioned in § 1341(a) (1); it is the item included in gross income in the year of receipt. The section does not imply in any way that the "deduction" and the "item" must necessarily be equal in amount. In fact, the use of the words "a deduction" and the placement of § 1341 in subchapter Q—the subchapter dealing largely with side effects of the annual accounting system—make it clear that it is necessary to refer to other portions of the Code to discover how much of a deduction is allowable. The regulations promulgated under the section make the necessity for such a cross-reference clear. Treas.Reg. on Income Tax (1954 Code) § 1.1341–1 (26 CFR § 1.1341–1). Therefore, when § 1341(a) (4)—the subsection applicable here—speaks of "the tax * * * computed with such deduction," it is referring to the deduction mentioned in § 1341(a) (2); and that deduction must

(or years) that the taxpayer did not have an unrestricted right to such item or to a portion of such item; and

"(3) the amount of such deduction exceeds $3,000,

"then the tax imposed by this chapter for the taxable year shall be the lesser of the following:

"(4) the tax for the taxable year computed with such deduction; or

"(5) an amount equal to—

"(A) the tax for the taxable year computed without such deduction, minus

"(B) the decrease in tax under this chapter (or the corresponding provisions of prior revenue laws) for the prior taxable year (or years) which would result solely from the exclusion of such item (or portion thereof) from gross income for such prior taxable year (or years).

"For purposes of paragraph (5) (B), the corresponding provisions of the Internal Revenue Code of 1939 shall be chapter 1 of such code (other than subchapter E, relating to self-employment income) and subchapter E of chapter 2 of such code."

Section 1341(b) (2) contains an exclusion covering certain cases involving sales of stock in trade or inventory. However, because of special treatment given refunds made by regulated public utilities, both parties agree that § 1341(b) (2) is inapplicable to this case and that, accordingly, § 1341(a) applies.

2. In the case of an accrual-basis taxpayer, the legislative history makes it clear that the deduction is allowable at the proper time for accrual. H.R.Rep. No. 1337, 83 Cong., 2d Sess., A294 (1954); S.Rep.

be determined, not by any mechanical equation with the "item" originally included in gross income, but by reference to the applicable sections of the Code and the case law developed under those sections.

II.

[8, 9] There is some dispute between the parties about whether the refunds in question are deductible as losses under § 165 of the 1954 Code or as business expenses under § 162.[3] Although in some situations the distinction may have relevance, cf. Equitable Life Ins. Co. of

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Iowa v. United States, 340 F.2d 9 (C.A. 8th Cir. 1965), we do not think it makes any difference here. In either case, the Code should not be interpreted to allow respondent "the practical equivalent of double deduction," Charles Ilfeld Co. v. Hernandez, 292 U.S. 62, 68, 54 S.Ct. 596, 598, 78 L.Ed. 1127 (1934), absent a clear declaration of intent by Congress. See United States v. Ludey, 274 U.S. 295, 47 S.Ct. 608, 71 L.Ed. 1054 (1927). Accordingly, to avoid that result in this case, the deduction allowable in the year of repayment must be reduced by the percentage depletion allowance which respondent claimed and the Commissioner allowed in the years of receipt as a result of the inclusion of the later-refunded items in respondent's "gross income from the property" in those years. Any other approach would allow respondent a total of $1.27½ in deductions for every $1 refunded to its customers.

[10–12] Under the annual accounting system dictated by the Code, each year's tax must be definitively calculable at the end of the tax year. "It is the essence of any system of taxation that it should produce revenue ascertainable, and payable to the government, at regular intervals." Burnet v. Sanford & Brooks Co., *supra,* 282 U.S. at 365, 51 S.Ct. at 152. In cases arising under the claim-of-right doctrine, this emphasis on the annual accounting period normally requires that the tax consequences of a receipt should not determine the size of the deduction allowable in the year of repayment. There is no requirement that the deduction save the taxpayer the exact amount of taxes he paid because of the inclusion of the item in income for a prior year. See Healy v. Commissioner of Internal Revenue, *supra.*

[13] Nevertheless, the annual accounting concept does not require us to close our eyes to what happened in prior years. For instance, it is well settled that the prior year may be examined to determine whether the repayment gives rise to a regular loss or a capital loss. Arrowsmith

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v. Commissioner of Internal Revenue, 344 U.S. 6, 73 S.Ct. 71, 97 L.Ed. 6 (1952). The rationale for the *Arrowsmith* rule is easy to see; if money was taxed at a special lower rate when received, the taxpayer would be accorded an unfair tax windfall if repayments were generally deductible from receipts taxable at the higher rate applicable to ordinary income. The Court in *Arrowsmith* was unwilling to infer that Congress intended such a result.

This case is really no different.[4] In essence, oil and gas producers are taxed

No. 1622, 83d Cong., 2d Sess., 451–452 (1954).

3. The Commissioner has long recognized that a deduction under some section is allowable. G.C.M. 16730, XV–1 Cum. Bull. 179 (1936).

4. The analogy would be even more striking if in *Arrowsmith* the individual taxpayers had not utilized the alternative tax for capital gains, as they were permitted to do by what is now § 1201 of the 1954 Code. Where the 25% alternative tax is not used, individual taxpayers are taxed at ordinary rates on 50% of their capital gains. See § 1202. In such a situation, the rule of the *Arrowsmith* case prevents taxpayers from deducting 100% of an item refunded when they were taxed on only 50% of it when it was received. Although *Arrowsmith* prevents this inequitable result by treating the repayment as a capital loss, rather than by disallowing 50% of the deduction, the policy behind the decision is applicable in this case. Here it would be inequitable

on only 72½% of their "gross income from the property" whenever they claim percentage depletion. The remainder of their oil and gas receipts is in reality tax exempt. We cannot believe that Congress intended to give taxpayers a deduction for refunding money that was not taxed when received. Cf. O'Meara v. Commissioner, 8 T.C. 622, 634–635 (1947). Accordingly, Arrowsmith teaches that the full amount of the repayment cannot, in the circumstances of this case, be allowed as a deduction.

This result does no violence to the annual accounting system. Here, as in *Arrowsmith*, the earlier returns are not being reopened. And no attempt is being made to require the tax savings from the deduction to equal the

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tax consequences of the receipts in prior years.[5] In addition, the approach here adopted will affect only a few cases. The percentage depletion allowance is quite unusual; unlike most other deductions provided by the Code, it allows a fixed portion of gross income to go untaxed. As a result, the depletion allowance increases in years when disputed amounts are received under claim of right; there is no corresponding decrease in the allowance because of later deductions for repayments.[6] Therefore, if a deduction for 100% of the repayments were allowed, every time money is received and later repaid the taxpayer would make a profit equivalent to the taxes on 27½% of the amount refunded. In other situations when the taxes on a receipt do not equal the tax benefits of a repayment, either the taxpayer or the Government may, depending on circumstances, be the beneficiary. Here, the taxpayer always wins and the Government always loses. We cannot believe that Congress would have intended such an inequitable result.

The parties have stipulated that respondent is entitled to a judgment for $20,932.64 plus statutory interest for

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claims unrelated to the matter in controversy here; the District Court entered a judgment for that amount. Accordingly, the judgment of the Court of Appeals is reversed and the case is remanded to that court with instructions that it be returned to the District Court for re-entry of the original District Court judgment.

Reversed and remanded.

Mr. Justice DOUGLAS, dissenting.

I share Mr. Justice STEWART'S views as to this case and add only a word.

If we sat in chancery reviewing tax cases, much of what the Court says would have appeal. But we do not sit to do equity in tax cases; that is one of Congress' main concerns.

The search for equity in the tax laws is wondrous and elusive. As Edmond Cahn said: "[T]hose only are equal whom the law has elected to equalize." E. Cahn, The Sense of Injustice 14 (1949).

Percentage depletion had its roots in granting a reward to men who go into undeveloped territory in search of oil and gas. But today it is granted anyone who

to allow a 100% deduction when only 72½% was taxed on receipt.

5. Compare the analogous approach utilized under the "tax benefit" rule. Alice Phelan Sullivan Corp. v. United States, 381 F.2d 399, 180 Ct.Cl. 659 (1967); see Internal Revenue Code of 1954 § 111. In keeping with the analogy, the Commissioner has indicated that the Government will only seek to reduce the deduction in the year of repayment to the extent that the depletion allowance attributable to the receipt directly or indirectly reduced taxable income. Proposed Treas.Reg. § 1.613–2(c) (8), 33 Fed.Reg. 10702–10703 (1968).

6. The 10% standard deduction mentioned in Mr. Justice STEWART'S dissent, *post*, at 1389–1390, differs in that it allows as a deduction a percentage of adjusted gross income, rather than of gross income. See § 141; cf. §§ 170, 213. As a result, repayments may in certain cases cause a decrease in the 10% standard deduction allowable in the year of repayment, assuming that the repayment is of the character to be deducted in calculating adjusted gross income. See § 62.

has an interest in oil or gas; the beneficiary need not live the life of the oil wildcatter or bear his risks to obtain the benefits of percentage depletion.

When it comes to capital gains what "equities" are to be applied? Is it fair that earned income pay a heavier tax?

A son who spends $1,000 on his destitute father does not get the same tax benefit as he who pays a like sum to his alma mater. Louis Eisenstein pursues example after example of so-called inequities in tax laws in his book The Ideologies of Taxation (1961). For example, the profits on the sale of unbred pigs are taxable as ordinary income, while the profits on the sale of pigs once bred

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are taxable as capital gains. *Id.*, 174. The same is true of turkeys but not of chickens, even though "a bred chicken and a bred turkey are similarly situated. Each has feathers and two legs." *Ibid.*

Treasury recently noted numerous basic inequities resulting in preferred tax treatment for some people's dollars. Tax Reform Studies and Proposals, U. S. Treasury Dept., Joint Publication of House Committee on Ways and Means and Senate Committee on Finance, 91st Cong., 1st Sess., pt. 1, pp. 13, 17 (Comm. Print 1969).

Apart from certain aspects of percentage depletion were the reduced taxation on long-term capital gains and the exclusion of interest on state and local government bonds. The examples are legion. The Tax Reform study gives an unusual example:

> "An individual had a total income of $1,284,718 of which $1,210,426 was in capital gains, the remaining $74,292 from wages, dividends, and interest. He excluded one-half of his capital gains, which he is allowed to do under present law, thereby reducing his present law (adjusted gross) income to $679,405 (after allowing for the $100 dividend exclusion). From this income he subtracted all his personal deductions, which amounted to $676,419 and which included $587,693 for interest on funds borrowed presumably for the purpose of purchasing the securities on which the capital gains were earned. As a result, after allowing $1,200 of personal exemptions his taxable income was reduced to $1,786 and he paid a tax of $274. His overall tax rate, therefore, was about two-hundredths of one percent." *Id.*, at 15.

This was made possible by using a taxpayer's deductions only against that part of his income which is subject to the tax, ignoring the excluded part.

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Tax laws are indeed arbitrary; the lines they draw are the products of pressures inside the Congress with compromises carrying the day.

The Court of Appeals held that the "item" here in question was properly included in "gross income" prior to 1958 and was an allowable "deduction" in 1958 because the taxpayer did not have "an unrestricted right" to a "portion of such item," and that the amount of such deduction exceeds $3,000—all as provided in § 1341.[1] Skelly Oil Co. v. United States, 10 Cir., 392 F.2d 128, 131.

1. Section 1341 reads as follows:
(a) General rule. If—
"(1) an item was included in gross income for a prior taxable year (or years) because it appeared that the taxpayer had an unrestricted right to such item;
"(2) a deduction is allowable for the taxable year because it was established after the close of such prior taxable year (or years) that the taxpayer did not have an unrestricted right to such item or to a portion of such item; and
"(3) the amount of such deduction exceeds $3,000,
"then the tax imposed by this chapter for the taxable year shall be the lesser of the following:
"(4) the tax for the taxable year computed with such deduction; or
"(5) an amount equal to—
"(A) the tax for the taxable year computed without such deduction, minus
"(B) the decrease in tax * * * for the prior taxable year * * * which

There is no irregularity on the face of the return. There is no conflict with any decision of any other Court of Appeals. We are asked, however, to put a gloss on the statute that Treasury desires. I would adhere to the construction given by the Court of Appeals leaving to Congress the correction of any inequities in the tax scheme.

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The Congress many years ago created the Joint Committee on Internal Revenue Taxation, which is a standing committee. 26 U.S.C. §§ 8001–8005, 8021–8023. One of its statutory mandates is "[t]o investigate the operation and effects of the Federal system of internal revenue taxes." *Id.*, § 8022.

In that connection a recent report states:

> "[T]he Joint Committee staff has in recent years been used as a committee liaison with the Treasury Department in working on tax proposals for the committee. The staff aids the two tax committees in explaining provisions, in writing committee reports, and in aiding in the drafting of bills."

The Joint Committee makes regular reports to Congress for revision of the tax laws. Inequities that arise as a result of interpretations that are given existing laws either at the administrative or judicial level can be quickly corrected by this agency of oversight.[2]

Treasury unhappily has developed the habit of jockeying in the courts, testing one theory against another. In California, it may take one position and in Massachusetts the opposite position, the issue in each being the same. The hope is that conflicts over litigious and important issues will develop and the case will be brought here.[3]

If we were trained in the art and science of taxation, we might serve a useful function. But taxation is a

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specialty in which we have only sporadic and no continuous experience. It has been said that one of our decisions is like a "lightning bolt" that "illuminates only a very small portion of the landscape," leaving a darkness that later decisions do not remove. R. Paul, Studies in Federal Taxation 249–250 (3d series 1940). Our contributions, if such they can be called, are dubious indeed, for the Joint Committee can and does rewrite the Code frequently.

It is therefore the rare tax case[4] we should consider, except the even rarer constitutional case. The present case has no constitutional overtones; the taxpayer followed the words of the tax law literally, using no new or strained construction of words to find a tax advantage; there is no conflict between this case and any other decision. The Solicitor General only claims that the result reached by the Court of Appeals does not fit the neat logic which he finds in a group of related tax cases.

would result solely from the exclusion of such item * * * from gross income for such prior taxable year * * *."

2. Perhaps the most egregious error that we made in my time (one for which I take partial blame), was Helvering v. Hallock, 309 U.S. 106, 60 S.Ct. 444, 84 L.Ed. 604, an opinion for the Court, written by Mr. Justice Frankfurter that overruled Helvering v. St. Louis Trust Co., 296 U.S. 39, 56 S.Ct. 74, 80 L.Ed. 29, and Becker v. St. Louis Union Trust Co., 296 U.S. 48, 56 S.Ct. 78, 80 L.Ed. 35. This is one classic example of the type of problem which should be left to the Joint Committee.

3. For a classic example see R. Paul, Studies in Federal Taxation 449–450 (3d series 1940).

4. The validity of Regulations and the effect of re-enactment of a statutory provision on them present distinct questions. Helvering v. Wilshire Oil Co., 308 U.S. 90, 60 S.Ct. 18, 84 L.Ed. 101; Commissioner of Internal Revenue v. South Texas Lumber Co., 333 U.S. 496, 68 S.Ct. 695, 92 L.Ed. 831; Commissioner of Internal Revenue v. Stidger, 386 U.S. 287, 87 S.Ct. 1065, 18 L.Ed.2d 53.

An account of the cost, confusion, and inequity in tax administration that ensues while everyone waits for a conflict among the Circuits (which takes at least 10 years) is related in Griswold, The Need for a Court of Tax Appeals, 57 Harv.L.Rev. 1153 (1944). The role we presently play was stated as follows:

"Our present system of tax adjudication inevitably leaves nearly every question uncertain during the entire period while it must be dealt with, usually in thousands of instances, by the administrative officers. And yet that is just the period when there should be an authoritative rule if the system is to work smoothly, effectively, speedily, fairly, and

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without discrimination. Under our present system delay and discrimination are typical and inevitable." *Id.*, at 1161.

In absence of an unmistakably clear conflict among the Circuits, I would abide by the opinions of the Courts of Appeals in tax cases and leave to the Joint Committee whether the gloss which Treasury now tries to put on the statute is or is not desirable.

Mr. Justice STEWART, with whom Mr. Justice DOUGLAS and Mr. Justice HARLAN join, dissenting.

The Court today denies the respondent a tax benefit fairly provided by the Code for no other discernible reasons than that, under the statute as written, "the taxpayer always wins and the Government always loses,"[1] and that "the approach here adopted will affect only a few cases." *Ante*, at 1384. But we are not free, even in a few cases, to abandon settled principles of annual accounting and statutory construction merely to avoid what the Court thinks Congress might consider an "inequitable result."[2]

"[T]he rule that general equitable considerations do not control the measure of deductions or tax benefits cuts both ways. It is as applicable to the

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Government as to the taxpayer. Congress may be strict or lavish in its allowance of deductions or tax benefits. The formula it writes may be arbitrary and harsh in its applications. But where the benefit claimed by the taxpayer is fairly within the statutory language and the construction sought is in harmony with the statute as an organic whole, the benefits will not be withheld from the taxpayer though they represent an unexpected windfall." Lewyt Corp. v. Commissioner of Internal Revenue, 349 U.S. 237, 240, 75 S.Ct. 736, 738, 99 L.Ed. 1029.

From any natural reading of § 1341, it is apparent that Congress believed the "deduction" in § 1341 (a) (2) would be

1. Section 1341, of course, is designed precisely to create a situation where "the taxpayer always wins and the Government always loses." Strict adherence to annual accounting and the claim-of-right doctrine before 1954 sometimes benefited the taxpayer, sometimes the Government. Section 1341 retains those principles where they benefit the taxpayer but allow recomputation of the taxes of a prior year if that method would result in a greater tax saving.

2. Judicial assumptions that Congress did not intend liberal benefits for taxpayers are particularly suspect in the area of percentage depletion, perhaps the most generous business deduction in the Code. And Congress had the recipients of percentage depletion specifically in mind when it drafted § 1341. The House bill excluded from the coverage of § 1341 all refunds relating to inventory sales. The Senate Committee promptly removed refunds by regulated utilities from this exclusion with the following remarks:

"Your committee's bill provides that the exclusion of refunds pertaining to inventory sales will not exclude from the benefits of this section refunds made by a regulated public utility where the refunds are required to be made by the regulatory body, such as the Federal Power Commission. It is made clear, for example, that refunds of charges for the sale of natural gas under rates approved temporarily would be eligible for the benefits of this section." S.Rep. No. 1622, 83d Cong., 2d Sess., 118 (1954).

in the amount of the "item" described in § 1341 (a) (1). If that understanding is not manifest from the face of the statute and the legislative history,[3] it is the unavoidable inference from a study of the pre-1954 law which 694 the Court concedes § 1341 (a) (4) was intended to codify. In every case in this area previously decided by the Court the amount deductible in the year of repayment was considered to be exactly the same as the amount of the previously included item. In two of the cases most sharply in congressional focus in 1954, the Government had conceded without hesitation that the taxpayers were "entitled to a deduction for a loss in the year of repayment of the amount earlier included in income." Healy v. Commissioner of Internal Revenue, 345 U.S. 278, 284, 73 S.Ct. 671, 675, 97 L.Ed. 1007. See also United States v. Lewis, 340 U.S. 590, 591, 71 S.Ct. 522, 523, 95 L.Ed. 560. That has been the express position of the Treasury since at least 1936,[4] and the Court today has not cited a single instance of deviation from that understanding.

The Court says that § 1341 is not alone controlling and that "it is necessary to refer to other portions of the Code to discover how much of a deduction is allowable." 695 *Ante*, at 1382. I agree that § 1341 must be considered in the context of the Internal Revenue Code as an "organic whole." But no other provisions of the Code in any manner bolster the Court's argument. The Court assumes, quite correctly, that either § 162 or § 165 does permit a deduction for the refund. But it does not, and cannot, suggest that either of those sections—or any other statutory provision—limits the amount of the deduction for the undeniable loss of profits in the full amount of the repayment. Instead the Court assumes a broad equitable authority to weed out tax benefits which it calls "double deductions"—a characterization wholly inapposite to the facts of this case.

In prior decisions disallowing what truly were "double deductions," the Court has relied on evident statutory indications, not just its own view of the equities, that Congress intended to pre-

3. The House and Senate Reports give no indication that Congress thought the deduction would be other than the amount of the item included in gross income for the prior year. They refer to the amount of the deduction and of the item interchangeably.

"If the taxpayer included an item in gross income in one taxable year, and in a subsequent taxable year he becomes entitled to a deduction because the item or a portion thereof is no longer subject to his unrestricted use, and the amount of the deduction is in excess of $3,000, the tax for the subsequent year is reduced by either the tax attributable to the deduction or the decrease in the tax for the prior year attributable to the removal of the item, whichever is greater. Under the rule of the *Lewis* case (340 U.S. 590, 71 S.Ct. 522 [95 L.Ed. 560] (1951)), the taxpayer is entitled to a deduction only in the year of repayment.

"In the case of a cash-basis taxpayer, in order to be entitled to a deduction in the later year, the amount must be repaid. However, in the case of an accrual-basis taxpayer, if the item was accrued but never received, the section applies when the deduction accrues in the later year although there is, of course, no amount to be repaid." S.Rep. No. 1622, *supra*, n. 2, at 451.
See also H.R.Rep. No. 1337, 83d Cong., 2d Sess., A294 (1954).

4. See G. C. M. 16730, XV–1 Cum.Bull. 179, 181 (1936):
"In the instant case the taxpayer received the income under a claim of right and without restriction as to its disposition. On authority of the cases cited herein, this office is of the opinion that the profits in question should not be eliminated from the taxpayer's gross income for the years 1928 and 1929 [the years of inclusion], *but that the taxpayer is entitled to a deduction, for the year in which paid, of the amount of the profits paid* * * *." (Emphasis supplied.)
See also 2 J. Mertens, Law of Federal Income Taxation § 12.106a, p. 431 (P. Zimet & J. Stanley rev. ed. 1967).

clude the second deduction. In those cases the taxpayers sought to benefit twice from the same statutory deduction.[5] In this case, by contrast, 696 the respondent had taken two different deductions accorded by Congress for distinct purposes. In the years 1952 through 1957 it deducted the proper amounts for depletion—a deduction which is allowed by Congress "on the theory that the extraction of minerals gradually exhausts the capital investment in the mineral deposit," and which is "designed to permit a recoupment of the owner's capital investment in the minerals so that when the minerals are exhausted, the owner's capital is unimpaired." Commissioner of Internal Revenue v. Southwest Exploration Co., 350 U.S. 308, 312, 76 S.Ct. 395, 397, 100 L.Ed. 347. The respondent's 1958 deduction was granted by Congress for the entirely different reason that the refund of previously reported income constituted a loss, or business expense. In purpose and effect the deductions are wholly unrelated, and each is sustainable on its own merits. Certainly it cannot be said either that the respondent did not in fact exhaust the capital assets for which the deductions were allowed in 1952 through 1957 or that it did not suffer a business loss by the 1958 repayment.

The sole nexus between these distinct transactions on which the Court constructs its "double deduction" theory is that the depletion deductions were computed as a percentage of gross income from the property. But this fact cannot distinguish percentage depletion from any other deduction. If the respondent had elected to take cost depletion in 1952 through 1957, for example, there would also have been a portion of the gross income in those years—perhaps less than 27½%, perhaps more—which was not included in taxable income. Whether a deduction is computed as a fixed percentage of income or 697 in some other manner, it always reduces by some percentage the income which is ultimately taxed. There are other deductions, of course, whose amount is a function of a certain percentage of the taxpayer's income. With respect to the individual taxpayer, the standard 10% deduction, § 141, and those for charitable contributions, § 170, and medical expenses, § 213, are doubtless the most frequent. Under the Court's ruling today, any taxpayer who repays money included in gross income in a prior year in which he also took one of the above mentioned deductions will have to reduce his refund deduction by that portion of the previous year's deduction attributable to the included in-

5. Charles Ilfeld Co. v. Hernandez, 292 U.S. 62, 54 S.Ct. 596, 78 L.Ed. 1127, and United States v. Ludey, 274 U.S. 295, 47 S.Ct. 608, 71 L.Ed. 1054, both involved situations in which the taxpayer tried to take the same deduction twice. In *Ilfeld* the taxpayer had taken deductions, through consolidated returns, for the annual losses of its subsidiaries; when the subsidiaries' assets were sold and the companies dissolved, the parent taxpayer sought to take deductions for losses of its investment in the subsidiaries. As the Court held, "The allowance claimed would permit [the parent] twice to use the subsidiaries' losses for the reduction of its taxable income," a double deduction that "nothing in the Act * * * purports to authorize * * *." 292 U.S., at 68, 54 S.Ct., at 598. In *Ludey* the taxpayer had taken deductions for depletion of his mining properties; but when the properties were sold in the taxable year in question, the taxpayer did not, in computing the gain from the sale, adjust the basis of the property to reflect the depletion deductions. The Court held that depletion allowances, like those for depreciation, are granted in recognition of the fact that the asset is disappearing year by year. When it is disposed of, therefore, "the thing then sold is not the whole thing originally acquired. The amount of the depreciation must be deducted from the original cost of the whole in order to determine the cost of that disposed of in the final sale of properties. Any other construction would permit a double deduction for the loss of the same capital assets." 274 U.S., at 301, 47 S.Ct., at 610.

come. Surely this result contravenes the purpose of the annual accounting concept to prevent recomputations of the prior year's tax.

The Court says today that there can be no deduction "for refunding money that was not taxed when received." *Ante*, at 1384. This means nothing less than that, whenever a taxpayer seeks to deduct a refund of money received as income under a claim of right in a prior year, the deduction must be reduced by the percentage of gross income in that prior year which, for whatever reason, was not also taxable income. Otherwise there will be precisely the same kind of so-called "double deduction" as the Court finds in this case.

It is clear that the Court has wrought a major transformation of the deduction which has heretofore been allowed and which Congress recognized in § 1341(a)(4). That deduction is permitted because, in the words of § 1341, the item "was included in *gross* income for a prior taxable year" (emphasis added), not because it was included in *taxable* income. It is no answer to say that the "annual accounting concept does not require us to close our eyes to what happened in prior years."

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Ante, at 1383. Of course we must look to the prior years to ascertain the amounts included in gross income and the nature of that income as it bears on the provision under which it is deductible in the year of repayment. Arrowsmith v. Commissioner of Internal Revenue, 344 U.S. 6, 73 S.Ct. 71, 97 L.Ed. 6.[6] But the very purpose of the annual accounting concept is to preclude adjustments in the amount of the deduction to reflect the tax consequences of the item's inclusion in the prior year.

"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, and would violate the spirit of the annual accounting system. This basic principle cannot be changed simply because it is of advantage to a taxpayer or to the Government in a particular case that a different rule be followed." Healy v. Commissioner of Internal Revenue, 345 U.S. 278, 284–285, 73 S.Ct. 671, 675.

One of the major factors, in addition to changes in tax rates and brackets, that determine who will benefit from adherence to the annual accounting principles embodied in § 1341(a)(4) is the extent to which the taxpayer had deductions in the prior or subsequent taxable years to offset gross income. And it is no less inconsistent

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with annual accounting principles to pare down the allowable loss deduction in the year of repayment because of other deductions in the year of inclusion than because of a lower tax rate or bracket in that year.

Because I cannot agree that the Court's equitable sensibilities empower it to depart from the sound principles of tax accounting specifically endorsed by Congress in § 1341, I respectfully dissent.

6. As the Court recognizes, *ante*, at 1383, n. 4, the Court in *Arrowsmith* did not hold that the amount of the deduction in the year of repayment would be reduced because in the year of inclusion the money had been taxed at a lower rate or had been offset by deductions. It held merely that the losses fell within the definition of "capital losses" contained in the sections authorizing deductions for the repayment. The Court does not in this case point to any comparable statutory provision affecting the nature or amount of the deduction for the refund.

subdivisions (a), (b), or (c). This Court granted certiorari, 282 U. S. *835, 51 S. Ct. 179, 75 L. Ed. —, January 5, 1931, the government acquiescing because of the importance of the question and the conflict of the decision below with one of the Court of Appeals for the First Circuit where, however, the point was neither discussed, Simmons Co. v. Commissioner, 33 F.(2d) 75, nor raised in the petition for certiorari, which was denied 280 U. S. 588, 50 S. Ct. 37, 74 L. Ed. 221.[2]

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[1, 2] Petitioner contends that under (d) the parties may stipulate for review in any circuit court of appeals. In view of the rule of the statutes that venue of the federal courts generally turns upon the geographical location of the parties and is never within their exclusive control, it would require plain language in this statute to support an unlimited choice. But the words of (d)—"the Circuit Court of Appeals for the circuit"—seem to refer, not to the court of appeals for any circuit, but to some particular circuit court of appeals previously described, necessarily that one which could have entertained the petition, under (a), (b) or (c), in the absence of an agreement under (d). Only such a construction comports with the statement of the House Committee on Ways and Means, that the provisions now in § 1002 "* * * prevent undue burden upon those circuits embracing States in which a vast number of corporations are organized." House Reports, 69th Congress, 1st Session, Vol. 1, Report No. 1, p. 19. An unlimited choice might overburden a circuit court of appeals, whose docket was *already overcrowded, with petitions for review with respect to which it could have had no venue under the other subdivisions of section 1002.

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The Senate Committee on Finance, in proposing the addition of (d) to section 1002, stated that the purpose was to permit parties "* * * to stipulate the court to which the review will be taken, in order that any doubt as to the proper court may be removed * * *" Senate Reports, 69th Congress, 1st Session, Vol. 1, Report No. 52, p. 36. See also, to the same effect, the conference report in House Reports, supra, Report No. 356, p. 54. Whatever solution (d) may afford for the difficulties in those cases when doubts arise as to the proper circuit for review under (a), (b), or (c), here petitioner had its principal office in California and filed its return there, so that under (b) the venue could properly be laid only in the Court of Appeals for the Ninth Circuit. Hence the parties' right of choice by stipulation under (d) was restricted to that court or the Court of Appeals of the District of Columbia.

Section 1003 (a) confers jurisdiction to review decisions of the Board of Tax Appeals on circuit courts of appeals and the Court of Appeals of the District of Columbia. Section 1002 is entitled "Venue." Even if the effect of this distinction is to define venue but not to restrict the jurisdiction of the court below, it was not bound to exercise jurisdiction in the face of (d), which authorized the parties to control the venue only by stipulation conforming to its terms. See Kansas City Ry. Co. v. United States, 282 U. S. 760, 51 S. Ct. 304, 75 L. Ed. 684, decided February 25, 1931. The restriction on the power of the parties to stipulate as to venue would be meaningless if they could waive it without the consent of the court.

Affirmed.

[2] The Court of Appeals for the Second Circuit has twice assumed jurisdiction in cases like the present one, without discussion. Greylock Mills v. Commissioner, 31 F.(2d) 655; Fowler v. Commissioner, 42 F.(2d) 837. In the latter case, certiorari was denied, but review was not sought on the question of venue. 282 U. S. 897, 51 S. Ct. 182, 75 L. Ed. —, January 12, 1931. The only other case discussing the question accords with the present. Spring Canyon Coal Co. v. Commissioner, 38 F.(2d) 764 (C. C. A. 8th).

(283 U. S. 404)

BURNET, Commissioner of Internal Revenue v. LOGAN.

SAME v. BRUCE.

Nos. 521, 522.

Argued April 29, 1931.

Decided May 18, 1931.

1. Internal revenue ⚷7(11).

Taxpayer, selling stock in consideration of annual payments contingent on iron ore received, *held* entitled to return of capital investment before paying income tax based on conjectural market value of annual payments (Revenue Act 1916, § 2; Revenue Act 1918, c. 18).

It appeared that taxpayer, together with all other owners of stock in company which, by virtue of stock ownership in a mining company, was entitled to a certain percentage of all iron ore removed, sold her shares to a steel manufacturer, who made a cash payment and agreed to pay annually thereafter a specified amount for each ton of ore received, and that market value of agreement to pay annual amounts could not be determined with fair certainty, and that there was no need for attempting to do so, since, after taxpayer had received payments sufficient to recoup her capital investment, that is, value of her shares on March 1, 1913, annual payments thereafter, if any, could be readily apportioned, and taxed, as profit.

2. **Internal revenue ⚷7(19).**

Ordinarily, income taxpayer may not deduct from gross receipts supposed loss represented by his outstanding note.

3. **Internal revenue ⚷7(11, 19).**

Generally, income tax law affects only realized losses or gains, and promise to pay indeterminate sums is not necessarily taxable "income."

[Ed. Note.—For other definitions of "Income," see Words and Phrases.]

4. **Internal revenue ⚷7(8).**

Where promisee bequeathed annual payments under contract with steel manufacturer contingent on iron ore received, payments to legatee did not constitute taxable "income" until they equaled value of bequest as appraised for federal estate tax (Revenue Act 1916, § 2; Revenue Act 1918, c. 18).

It appeared that promisee had sold certain stock to a steel manufacturer in consideration of cash payment and manufacturer's agreement to pay specified sum annually thereafter for each ton of ore received by virtue of stock ownership; that promisee bequeathed one-half of her interest in payments, if any, to be made thereafter; and that value of interest thus bequeathed was assumed, for purposes of federal estate tax, to be designated amount, and transfer thereof was taxed on basis of such amount.

On Writs of Certiorari to the United States Circuit Court of Appeals for the Second Circuit.

Petitions by Edith Andrews Logan and by Julia Andrews Bruce, opposed by the Commissioner of Internal Revenue, to review orders of the United States Board of Tax Appeals affirming determination of deficiencies in certain income taxes. The Circuit Court of Appeals reversed the order in each case [42 F.(2d) 193, 42 F.(2d) 197, respectively], and David Burnet, Commissioner of Internal Revenue, brings certiorari.

Affirmed.

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*The Attorney General and Mr. G. A. Youngquist, Asst. Atty. Gen., for petitioner.

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*Messrs. John Enrietto, of Washington, D. C., and Herbert C. Smyth, of New York City, for respondent Logan.

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*Mr. Raymond B. Goodell, of New York City, for respondent Bruce.

Mr. Justice McREYNOLDS delivered the opinion of the Court.

These causes present the same questions. One opinion, stating the essential circumstances disclosed in No. 521, will suffice for both.

Prior to March, 1913, and until March 11, 1916, respondent, Mrs. Logan, owned 250 of the 4,000 capital shares issued by the Andrews & Hitchcock Iron Company. It held 12 per cent. of the stock of the Mahoning Ore & Steel Company, an operating concern. In 1895 the latter corporation procured a lease for 97 years upon the "Mahoning" mine and since then has regularly taken therefrom large, but varying, quantities of iron ore—in 1913, 1,515,428 tons; in 1914, 1,212,287 tons; in 1915, 2,311,940 tons; in 1919, 1,217,167 tons; in 1921, 303,020 tons; in 1923, 3,029,865 tons. The lease contract did not require production of either maximum or minimum tonnage or any definite payments. Through an agreement of stockholders (steel manufacturers), the Mahoning Company is obligated to apportion extracted ore among them according to their holdings.

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*On March 11, 1916, the owners of all the shares in Andrews & Hitchcock Company sold them to Youngstown Sheet & Tube Company, which thus acquired, among other things, 12 per cent. of the Mahoning Company's stock and the right to receive the same percentage of ore thereafter taken from the leased mine.

For the shares so acquired, the Youngstown Company paid the holders $2,200,000 in money, and agreed to pay annually thereafter for distribution among them 60 cents for each ton of ore apportioned to it. Of this cash Mrs. Logan received 250/4000—$137,500; and she became entitled to the same fraction of any annual payment thereafter made by the purchaser under the terms of sale.

Mrs. Logan's mother had long owned 1,100 shares of the Andrews & Hitchcock Company. She died in 1917, leaving to the daughter one-half of her interest in payments thereafter made by the Youngstown Company. This bequest was appraised for federal estate tax purposes at $277,164.50.

During 1917, 1918, 1919, and 1920 the Youngstown Company paid large sums under the agreement. Out of these respondent received on account of her 250 shares $9,900 in 1917; $11,250 in 1918; $8,995.50 in 1919; $5,444.30 in 1920—$35,589.80. By reason of the interest from her mother's estate, she received $19,790.10 in 1919, and $11,977.49 in 1920.

Reports of income for 1918, 1919, and 1920 were made by Mrs. Logan upon the basis of cash receipts and disbursements. They in-

cluded no part of what she had obtained from annual payments by the Youngstown Company. She maintains that until the total amount actually received by her from the sale of her shares equals their value on March 1, 1913, no taxable income will arise from the transaction. Also that, until she actually receives by reason of the right be-
*411
queathed to her a sum equal to its *appraised value, there will be no taxable income therefrom.

On March 1, 1913, the value of the 250 shares then held by Mrs. Logan exceeded $173,089.80—the total of all sums actually received by her prior to 1921 from their sale ($137,500 cash in 1916, plus four annual payments amounting to $35,589.80). That value also exceeded original cost of the shares. The amount received on the interest devised by her mother was less than its valuation for estate taxation; also less than the value when acquired by Mrs. Logan.

The Commissioner ruled that the obligation of the Youngstown Company to pay 60 cents per ton had a fair market value of $1,942,111.46 on March 11, 1916; that this value should be treated as so much cash, and the sale of the stock regarded as a closed transaction with no profit in 1916. He also used this valuation as the basis for apportioning subsequent annual receipts between income and return of capital. His calculations, based upon estimates and assumptions, are too intricate for brief statement.[1] He made deficiency assessments according to the view just stated, and the Board of Tax Appeals approved the result.

[1] In the brief for petitioner the following appears: The fair market value of the Youngstown contract on March 11, 1916, was found by the Commissioner to be $1,942,111.46. This was based upon an estimate that the ore reserves at the Mahoning mine amounted to 82,858,535 tons; that all such ore would be mined; that 12 per cent. (or 9,942,564.2 tons) would be delivered to the Youngstown Company. The total amount to be received by all the vendors of stock would then be $5,965,814.52 at the rate of 60 cents per ton. The Commissioner's figure for the fair market value on March 11, 1916, was the then worth of $5,965,814.52, upon the assumption that the amount was to be received in equal annual installments during 45 years, discounted at 6 per cent., with a provision for a sinking fund at 4 per cent. For lack of evidence to the contrary, this value was approved by the Board. The value of the $\frac{55}{4000}$ interest which each acquired by bequest was fixed at $277,164.50 for purposes of federal estate tax at the time of the mother's death.

During the years here involved, the Youngstown Company made payments in accordance with the terms of the contract, and respondents respectively received sums proportionate to the interests in the contract which they acquired by exchange of property and by bequest.

The Board held that respondents' receipts from the contract, during the years in question, represented "gross income"; that respondents should be allowed to deduct from said gross income a reasonable allowance for exhaustion of their contract interests; and that the balance of the receipts should be regarded as taxable income.

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*The Circuit Court of Appeals held that, in the circumstances, it was impossible to determine with fair certainty the market value of the agreement by the Youngstown Company to pay 60 cents per ton. Also that respondent was entitled to the return of her capital—the value of 250 shares on March 1, 1913, and the assessed value of the interest derived from her mother—before she could be charged with any taxable income. As this had not in fact been returned, there was no taxable income.

We agree with the result reached by the Circuit Court of Appeals.

[1] The 1916 transaction was a sale of stock—not an exchange of property. We are not dealing with royalties or deductions from gross income because of depletion of mining property. Nor does the situation demand that an effort be made to place according to the best available data some approximate value upon the contract for future payments. This probably was necessary in order to assess the mother's estate. As annual payments on account of extracted ore come in, they can be readily apportioned first as return of capital and later as profit. The liability for income tax ultimately can be fairly determined without resort to mere esti-
*413
mates, assumptions, and speculation. *When the profit, if any, is actually realized, the taxpayer will be required to respond. The consideration for the sale was $2,200,000 in cash and the promise of future money payments wholly contingent upon facts and circumstances not possible to foretell with anything like fair certainty. The promise was in no proper sense equivalent to cash. It had no ascertainable fair market value. The transaction was not a closed one. Respondent might never recoup her capital investment from payments only conditionally promised. Prior to 1921, all receipts from the sale of her shares amounted to less than their value on March 1, 1913. She properly demanded the return of her capital investment before assessment of any taxable profit based on conjecture.

[2, 3] "In order to determine whether there has been gain or loss, and the amount of the gain if any, we must withdraw from the gross proceeds an amount sufficient to restore the capital value that existed at the commencement of the period under consideration." Doyle v. Mitchell Bros. Co., 247 U. S. 179, 184, 185, 38 S. Ct. 467, 469, 62 L. Ed. 1054. Revenue Act 1916, § 2, 39 Stat. 757, 758; Revenue Act 1918, c. 18, 40 Stat. 1057. Ordinarily, at least, a taxpayer may not deduct from gross receipts a supposed loss which in fact is represented by his outstanding note. Eckert v. Burnet, 283 U. S. 140, 51 S. Ct. 373, 75 L. Ed. 911 (April 13,

1931). And, conversely, a promise to pay indeterminate sums of money is not necessarily taxable income. "Generally speaking, the income tax law is concerned only with realized losses, as with realized gains." Lucas v. American Code Co., 280 U. S. 445, 449, 50 S. Ct. 202, 203, 74 L. Ed. 538.

[4] From her mother's estate, Mrs. Logan obtained the right to share in possible proceeds of a contract thereafter to pay indefinite sums. The value of this was assumed to be $277,164.50, and its transfer was so taxed. Some valuation—speculative or otherwise—was necessary in order to close the estate. It may never yield as much, it may *414 *yield more. If a sum equal to the value thus ascertained had been invested in an annuity contract, payments thereunder would have been free from income tax until the owner had recouped his capital investment. We think a like rule should be applied here. The statute definitely excepts bequests from receipts which go to make up taxable income. See Burnet, Commissioner, v. Whitehouse, 283 U. S. 148, 51 S. Ct. 374, 75 L. Ed. 916 (April 13, 1931).

The judgments below are affirmed.

(283 U. S. 380)

ATCHISON, T. & S. F. RY. CO. v. RAILROAD COMMISSION OF STATE OF CALIFORNIA et al.

LOS ANGELES & S. L. R. CO. v. SAME.

SOUTHERN PAC. CO. et al. v. SAME.

Nos. 470–472.

Argued April 23, 24, 1931.
Decided May 18, 1931.

1. Courts ⚷394(3).

Decision of state court is conclusive so far as its constitutional provisions and laws are concerned.

2. Commerce ⚷10.

Congress in matter of regulating interstate commerce may circumscribe its regulation and occupy limited field.

3. Commerce ⚷10.

Intention of Congress to supersede state authority over matters pertaining to interstate commerce not covered by federal legislation should not be implied unless act of Congress fairly interpreted conflicts with state law.

4. Commerce ⚷58.

Order of state railroad commission requiring construction of union passenger station *held* not repugnant to constitutional provision conferring upon Congress power to regulate interstate commerce.

5. Commerce ⚷58.

Order of state railroad commission requiring construction of union passenger station *held* not in conflict with powers vested by Congress in Interstate Commerce Commission (Interstate Commerce Act § 1 (18–21), as amended by Transportation Act § 402, 49 USCA § 1 (18–21).

6. Railroads ⚷58.

Application to Interstate Commerce Commission for certificate approving construction of proposed union station and relocation of connecting tracks *held* properly made by city in which proposed station would be located (Interstate Commerce Act § 1 (18–21), as amended by Transportation Act § 402, 49 USCA § 1 (18–21).

In various proceedings to compel railroads to construct union station in city, it was *held* that relocation of tracks which was incidental to the proposed union station, required a certificate of approval of the Interstate Commerce Commission under Interstate Commerce Act § 1 (18–21), as amended by Transportation Act § 402, 41 Stat. 476–478, 49 USCA § 1 (18–21). After state railroad commission made order requiring construction of such union station, the city made application to the Interstate Commerce Commission for a certificate of approval for relocation of tracks and making of necessary connections and extensions.

7. Railroads ⚷58.

Railroads may be compelled by state legislation to establish stations at proper places for convenience of patrons.

8. Railroads ⚷9(1).

Power to regulate railroad cannot be exercised so as to unnecessarily or arbitrarily trammel or interfere with operation of railroad properties and business.

9. Railroads ⚷9(1).

In determining validity of regulation governing operation of railroad, question is whether, under facts disclosed, regulation is essentially unreasonable.

10. Railroads ⚷9(1).

In determining whether regulation governing operation of railroad is reasonable, Court in the observance of law suggest corrective legislation. See e. g., United States v. Heinszen & Co., 206 U.S. 370, 27 S.Ct. 742, 51 L.Ed. 1098.

Mr. Justice DOUGLAS, dissenting.

This decision gives a capricious twist to the law. One would assume from a reading of the opinion in Wong Yang Sung v. McGrath, 339 U.S. 33, 70 S.Ct. 445, 94 L.Ed. 616, that the failure of a federal agency to use the type of examiner prescribed by Congress in the Administrative Procedure Act, 60 Stat. 237, 5 U.S.C. § 1001 et seq., 5 U.S.C.A. § 1001 et seq., vitiated the proceedings whether objection was raised or not. The Congress decided
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to separate the judicial functions of examiners from the investigative and prosecuting functions. It required the separation in cases involving property interests as well as those involving personal liberty. It condemned as unfair a practice which had grown up of allowing one man to be the police officer, the prosecutor, and the judge.

Violation of that requirement led the Court in Wong Yang Sung's case to issue a writ of habeas corpus to save an alien from deportation where the hearing examiner did not meet the requirements of the Administrative Procedure Act. That was a collateral attack on the administrative proceeding, successfully made even though no objection to the examiner was raised at the hearing.*

The objection raised in the present case likewise was not made at the hearing; but it was made before review of the order had beeen completed. It would seem, therefore, that reversal of this administrative order would follow *a fortiori* from Wong Yang Sung's case.

No one knows how the commingling of police, prosecutor and judicial functions in one person may affect a particular decision. In some situations it might make no difference; in others it might subtly corrupt the administrative process. The only important consideration for us is that Congress has condemned the practice; and we as supervisors of the federal system should see to it that the law is enforced, not selectively but in all cases coming before us.

Of course, an agency that flouts the mandate for fair examiners does not lose jurisdiction of the case. Even habeas corpus is no longer restricted to the testing of "jurisdiction" in the historic sense. See Johnson v. Zerbst, 304 U.S. 458, 467, 58 S.Ct. 1019, 1024, 82 L.Ed. 1461; Bowen v. Johnston, 306 U.S.
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19, 24, 59 S.Ct. 442, 444, 83 L.Ed. 455. But the action of the Commission in the present case created an error that permeates the entire proceeding. It is error that goes to the very vitals of the case. I would therefore set aside the order and send the case back for a hearing that meets the statutory standards of fairness. I would make the rule of Wong Yang Sung's case good for more than the day and the occasion.

344 U.S. 6

ARROWSMITH et al. v. COMMISSIONER OF INTERNAL REVENUE.

No. 51.

Argued Oct. 24, 1952.

Decided Nov. 10, 1952.

Rehearing Denied Dec. 8, 1952.
See 344 U.S. 900, 73 S.Ct. 273.

Proceedings to review decision of Tax Court, 15 T.C. 876, which classified a loss to taxpayers as ordinary business loss. The Court of Appeals for the Second Circuit reversed, treating the loss as a capital loss, 193 F.2d 734, and the taxpayers brought certiorari. The United States Supreme Court, Mr. Justice Black, held that where stockholders, who, over the years, had liquidated corporation and reported profit therefrom as capital gain, subsequently, as transferees

* And the alien in that case, like the respondent here, was represented by counsel in the administrative proceedings.

of the assets of the corporation, were required to pay a judgment rendered against the corporation, their loss therefrom was reportable in the year in which it was incurred as a capital loss and not as an ordinary business loss.

Affirmed.

Mr. Justice Douglas and Mr. Justice Jackson dissented.

1. Internal Revenue 🔑612, 667

Where stockholders, who, over the years, had liquidated corporation and reported profit therefrom as capital gain, subsequently, as transferees of the assets of the corporation, were required to pay a judgment rendered against the corporation, their loss therefrom was reportable in the year in which it was incurred as a capital loss and not as an ordinary business loss. 26 U.S.C.A. §§ 23(g), 115(c), 117(b), (d)(2), (e), 311(a).

2. Internal Revenue 🔑612, 667

Where stockholders liquidated corporation between years 1937 and 1940 and reported profit therefrom as capital gain but suffered loss in 1944, as transferees of assets of corporation, by way of judgment against corporation, consideration of all the 1937 to 1944 liquidation transaction events in order to properly classify the nature of the 1944 loss for tax purposes did not breach the principle that each taxable year is a separate unit for tax accounting purposes. 26 U.S.C.A. §§ 23(g), 115(c), 117(b), (d)(2), (e), 311(a).

3. Internal Revenue 🔑612

Where transferee of assets of corporation, who had reported profits from liquidation thereof as capital gain, was subjected to a judgment against the corporation as a transferee of the assets thereof and jointly with corporation for breach of fiduciary relationship to judgment creditor, but paid only half of judgment while other transferee of assets paid other half, such payment was reportable as a capital loss and not as an ordinary business loss, notwithstanding the individual judgment. 26 U.S.C.A. §§ 23(g), 115(c), 117(b), (d)(2), (e), 311(a).

Mr. George R. Sherriff, New York City, for petitioners.

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Helen Goodner, Washington, D. C., for respondent.

Mr. Justice BLACK delivered the opinion of the Court.

This is an income tax controversy growing out of the following facts as shown by findings of the Tax Court. In 1937 two taxpayers, petitioners here, decided to liquidate and divide the proceeds of a corporation in which they had equal stock ownership.* Partial distributions made in 1937, 1938, and 1939 were followed by a final one in 1940. Petitioners reported the profits obtained from this transaction, classifying them as capital gains. They thereby paid less income tax than would have been required had the income been attributed to ordinary business transactions for profit. About the propriety of these 1937–1940 returns, there is no dispute. But in 1944 a judgment was rendered against the old corporation and against Frederick R. Bauer, individually. The two taxpayers were required to and did pay the judgment for the corporation, of whose assets they were transferees. See Phillips-Jones Corp. v. Parmley, 302 U.S. 233, 235–236, 58 S.Ct. 197, 198, 82 L.Ed. 221. Cf. I.R.C. § 311(a), 26 U.S.C.A. § 311(a). Classifying the loss as an ordinary business one, each took a tax deduction for 100% of the amount paid. Treatment of the loss as a capital one would have allowed deduction of a much smaller amount. See I.R.C. § 117(b), (d)(2) and (e), 26 U.S.C.A. § 117(b), (d)(2), (e). The Commissioner

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viewed the 1944 payment as part of the original liquidation transaction requiring classification as a capital loss, just as the taxpayers had treated

* At dissolution the corporate stock was owned by Frederick P. Bauer and the executor of Davenport Pogue's estate. The parties here now are Pogue's widow, Bauer's widow, and the executor of Bauer's estate.

the original dividends as capital gains. Disagreeing with the Commissioner the Tax Court classified the 1944 payment as an ordinary business loss. 15 T.C. 876. Disagreeing with the Tax Court the Court of Appeals reversed, treating the loss as "capital." 2 Cir., 193 F.2d 734. This latter holding conflicts with the Third Circuit's holding in Commissioner of Internal Revenue v. Switlik, 184 F.2d 299. Because of this conflict, we granted certiorari. 343 U.S. 976, 72 S.Ct. 1075.

[1] I.R.C. § 23(g), 26 U.S.C.A. § 23(g), treats losses from sales or exchanges of capital assets as "capital losses" and I.R.C. § 115(c), 26 U.S.C.A. § 115(c), requires that liquidation distributions be treated as exchanges. The losses here fall squarely within the definition of "capital losses" contained in these sections. Taxpayers were required to pay the judgment because of liability imposed on them as transferees of liquidation distribution assets. And it is plain that their liability as transferees was not based on any ordinary business transaction of theirs apart from the liquidation proceedings. It is not even denied that had this judgment been paid after liquidation, but during the year 1940, the losses would have been properly treated as capital ones. For payment during 1940 would simply have reduced the amount of capital gains taxpayers received during that year.

[2] It is contended, however, that this payment which would have been a capital transaction in 1940 was transformed into an ordinary business transaction in 1944 because of the well-established principle that each taxable year is a separate unit for tax accounting purposes. United States v. Lewis, 340 U.S. 590, 71 S.Ct. 522, 95 L.Ed. 560; North American Oil Consolidated v. Burnet, 286 U.S. 417, 52 S.Ct. 613, 76 L.Ed. 1197. But this principle is not breached by considering all the 1937–1944 liquidation transaction events in order properly to classify the nature **9** 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.

[3] The petitioner Bauer's executor presents an argument for reversal which applies to Bauer alone. He was liable not only by reason of being a transferee of the corporate assets. He was also held liable jointly with the original corporation, on findings that he had secretly profited because of a breach of his fiduciary relationship to the judgment creditor. Trounstine v. Bauer, Pogue & Co., D.C., 44 F.Supp. 767, 773; Id., 2 Cir., 144 F.2d 379, 382. The judgment was against both Bauer and the corporation. For this reason it is contended that the nature of Bauer's tax deduction should be considered on the basis of his liability as an individual who sustained a loss in an ordinary business transaction for profit. We agree with the Court of Appeals that this contention should not be sustained. While there was a liability against him in both capacities, the individual judgment against him was for the whole amount. His payment of only half the judgment indicates that both he and the other transferee were paying in their capacities as such. We see no reason for giving Bauer a preferred tax position.

Affirmed.

Mr. Justice DOUGLAS, dissenting.

I agree with Mr. Justice JACKSON that these losses should be treated as ordinary, not capital, losses. There were no capital transactions in the year in which the losses were suffered. Those 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. See United States v. Lewis, 340 U.S. 590, 71 S.Ct. 522, 95 L.Ed. 560. I have not felt, as my dissent in the Lewis case indicates, that the law made that an inexorable **10** principle. But if it is the law, we should require observance of it—not merely by taxpayers but by the government as well. We should force each year to stand on its own footing, whoever may gain or lose from it in a particular case. We impeach that principle when we treat this year's losses as if they diminished last year's gains.

Mr. Justice JACKSON, whom Mr. Justice FRANKFURTER joins, dissenting.

This problem arises only because the judgment was rendered in a taxable year subsequent to the liquidation.

Had the liability of the transferor-corporation been reduced to judgment during the taxable year in which liquidation occurred, or prior thereto, this problem, under the tax laws, would not arise. The amount of the judgment rendered against the corporation would have decreased the amount it had available for distribution which would have reduced the liquidating dividends proportionately and diminished the capital gains taxes assessed against the stockholders. Probably it would also have decreased the corporation's own taxable income.

Congress might have allowed, under such circumstances, tax returns of the prior year to be reopened or readjusted so as to give the same tax results as would have obtained had the liability become known prior to liquidation. Such a solution is foreclosed to us and the alternatives left are to regard the judgment liability fastened by operation of law on the transferee as an ordinary loss for the year of adjudication or to regard it as a capital loss for such year.

This Court simplifies the choice to one of reading the English language, and declares that the losses here come "squarely within" the definition of capital losses contained within two sections of the Internal Revenue

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Code. What seems so clear to this Court was not seen at all by the Tax Court, in this case or in earlier consideration of the same issue; nor was it grasped by the Court of Appeals for the Third Circuit. Commissioner of Internal Revenue v. Switlik, 1950, 184 F.2d 299.

I find little aid in the choice of alternatives from arguments based on equities. One enables the taxpayer to deduct the amount of the judgment against his ordinary income which might be taxed as high as 87%, while if the liability had been assessed against the corporation prior to liquidation it would have reduced his capital gain which was taxable at only 25% (now 26%). The consequence may readily be characterized as a windfall (regarding a windfall as anything that is left to a taxpayer after the collector has finished with him).

On the other hand, adoption of the contrary alternative may penalize the taxpayer because of two factors: (1) since capital losses are deductible only against capital gains, plus $1,000, a taxpayer having no net capital gains in the ensuing five years would have no opportunity to deduct anything beyond $5,000; and (2) had the liability been discharged by the corporation, a portion of it would probably in effect have been paid by the Government, since the corporation could have taken it as a deduction, while here the total liability comes out of the pockets of the stockholders.

Solicitude for the revenues is a plausible but treacherous basis upon which to decide a particular tax case. A victory may have implications which in future cases will cost the Treasury more than a defeat. This might be such a case, for anything I know. Suppose that subsequent to liquidation it is found that a corporation has undisclosed claims instead of liabilities and that under applicable state law they may be prosecuted for the benefit of the stockholders. The logic of the Court's decision here, if adhered to, would result in a lesser return to the

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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?

Where the statute is so indecisive and the importance of a particular holding lies in its rational and harmonious relation to the general scheme of the tax law, I think great deference is due the twice-expressed judgment of the Tax Court. In spite of the gelding of Dobson v. Commissioner, 320 U.S. 489, 64 S.Ct. 239, 88 L.Ed. 248, by the recent revision of the Judicial Code, Act of

June 25, 1948, § 36, 62 Stat. 991–992, 26 U.S.C.A. § 1141(a), I still think the Tax Court is a more competent and steady influence toward a systematic body of tax law than our sporadic omnipotence in a field beset with invisible boomerangs. I should reverse, in reliance upon the Tax Court's judgment more, perhaps, than my own.

344 U.S. 13
SANFORD v. KEPNER.
No. 46.

Argued Oct. 24, 1952.

Decided Nov. 10, 1952.

Proceedings on a bill in equity brought to obtain review of the action of the Patent Office in an interference proceeding between the parties in which the Board of Interference Examiners of the Patent Office awarded priority of invention of the subject matter in issue to the defendant. The United States District Court for the Middle District of Pennsylvania, Follmer, J., 99 F.Supp. 221, dismissed the action, and plaintiff appealed. The United States Court of Appeals for the Third Circuit, Hastie, Circuit Judge, 195 F. 2d 387, affirmed, and plaintiff brought certiorari. The United States Supreme Court, Mr. Justice Black, held that since the issue as to priority of invention had been decided against plaintiff, the District Court had not been required to consider and adjudicate the question raised by plaintiff as to the patentability of the defendant's device.

Affirmed.

1. Courts 🔑383(1)

United States Supreme Court would grant certiorari where circuits had different views concerning duty of district courts to consider and adjudicate questions of invention and patentability when parties urge them in proceedings under statute authorizing aggrieved party to bring bill in equity to obtain patent after an adverse determination in interference proceedings on issue of priority. 35 U.S.C.A. § 63.

2. Patents 🔑114.1, 114.15

The purpose of the statutory provision for bringing bill in equity after adverse determination in interference proceeding on priority issue, is to give judicial remedy to applicant who has been finally denied patent because of Patent Office decision against him and in favor of his adversary on question of priority, and when trial court decides the factual issue of priority against him, and thus affirms refusal of patent by Patent Office, he has obtained full remedy statute gives him; and only if he wins on priority issue may he proceed under further provisions of statute permitting court to authorize issuance of patent. 35 U.S.C.A. § 63.

3. Patents 🔑114.15

Under statute giving aggrieved applicant right to bring bill in equity to obtain patent after adverse determination in interference proceeding on priority issue, there can be no adjudication in favor of issuance of patent unless alleged invention is a patentable one. 35 U.S.C.A §§ 52, 63.

4. Patents 🔑114.15

Where priority of invention was decided against plaintiff in proceedings under statute authorizing bringing of bill in equity by applicant denied patent because of determination in favor of his adversary in interference proceeding on question of priority, District Court was not required to adjudicate question, sought to be raised by plaintiff, with regard to patentability of defendant's device. 35 U.S.C.A. §§ 52, 63.

Mr. J. Preston Swecker, Washington, D. C., for petitioner.

Mr. Hugh M. Morris, Wilmington, Del., for respondent.

Mr. Justice BLACK delivered the opinion of the Court.

[1–4] Claiming he was the original and sole inventor of a mechanical device, the

Law 5267: Tax Accounting
Reading #6

Code: §§ 1001(a), (b); 453(a), (b), (c), (d), (f), (j); 453B(a), (b).
Regulations: § 1.453-9(a), (b).
Temp. Regulations: § 15a.453-1(a), (b), (d).

Problems:

1. Lisa, a cash method taxpayer, owns Blackacre in fee simple. Her adjusted basis in Blackacre is $20,000. On December 31, 2019, when Blackacre's fair market value is $100,000, she sells it to Bart on the following terms: $10,000 in cash as a down payment; and Bart's promissory note for $90,000. The note calls for Bart to make equal annual installments of $10,000 each for the next nine years, with the first installment due in one year. Bart also agrees to pay with each annual payment 10% interest on the unpaid balance at the end of each year. Assume this interest rate meets the imputed interest requirements. Lisa is in the 15% capital gains tax bracket.

(a) What is Lisa's gain or loss?
(b) What problems may Lisa face if she has to pay the entire tax liability in the year of sale?
(c) Is the transaction an installment sale? If so, how much gain is recognized and when? How are the annual interest payments treated?
(d) What if the note given by Bart were due on demand?
(e) What if Lisa, after receiving the $10,000 down payment but before collecting any payments on the non-demand promissory note, sells the note for $85,000?

2. Review Burnet v. Logan, 283 U.S. 404 (1931). Assume that Mrs. Logan owned all the shares in a mining company with a basis in the stock of $173,000. In 1916, she sold her shares for $137,500 in cash and future payments based on production from the mine. The production payments called for the purchaser to pay 60 cents for each ton of ore extracted. Mrs. Logan received production payments of $20,000 in 1917, $15,500 in 1918, $19,000 in 1919, and $10,000 in 1920. An appraiser estimated that the present discounted value of the production payments in 1916 was approximately $105,000, with an expected payout period of 45 years.

(a) From Mrs. Logan's viewpoint, which is the better outcome: (i) closed transaction treatment using the installment sale method; or (ii) a finding that the amount realized lacks an ascertainable fair market value?
(b) Does § 453(j)(2) overrule Logan? Note that as of 1916, the installment sale method had not yet been enacted, and there was no special treatment for capital gains.
(c) What was the purchaser's basis in the shares acquired from Mrs. Logan?

is this so as to Chase National Bank. As the District Court noted, 61 F.Supp. at page 152, its counsel recommended and had full knowledge of the agreement; and Chase had knowledge of the subsequent dividend distributions, to which it did not demur. At this late stage, it is equitably estopped from raising any objection to the validity of the liens on the basis of the operation of the plan which it proposed. Cf. Merchants' Nat. Bank of New York v. Sexton, 228 U.S. 634, 33 S.Ct. 725, 57 L.Ed. 998; In re National Public Service Corporation, 2 Cir., 68 F.2d 859; In re American S. S. Nav. Co., D.C., 14 F.Supp. 106.

Moreover, the record does not indicate that any permanent injury to Chase National Bank or to the other general creditors resulted from the operation of the plan. The whole scheme was adopted with the idea that they would be benefited and we cannot say that this purpose has failed

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of achievement. Having proposed and acquiesced in the plan, the Chase National Bank cannot now be heard to complain of any resulting injury, especially an injury that is not apparent in the record.

We conclude from these various considerations that the liens should be held to be valid and in existence despite the failure to follow the provisions of § 57, sub. h, and despite the distribution of dividends contrary to § 65, sub. a. There was never any intention to waive the security and those who might have objected to the distributions are now estopped. But in view of the fact that the bankruptcy proceedings have been unduly prolonged for over 20 years, the bankruptcy court should now take steps to wind up the estate in accordance with the provisions of the Bankruptcy Act. Those provisions are designed to bring about the speedy distribution of the bankrupt's assets, a distribution of the type which definitely has not occurred in this case.

The judgment of the Circuit Court of Appeals is reversed and the case is remanded to the District Court for further proceedings consistent with this opinion.

Reversed.

Mr. Justice FRANKFURTER is of opinion that the order of the District Court should be restored on the ground that the creditors entered into an agreement which was not objectionable under § 57, sub. h, of the Bankruptcy Act, whereby the liens of the petitioners were saved.

Mr. Justice JACKSON concurs in the result.

Mr. Justice DOUGLAS dissents.

331 U.S. 1

CRANE v. COMMISSIONER OF INTERNAL REVENUE.

No. 68.

Argued Dec. 11, 1946.
Decided April 14, 1947.

1. Internal revenue ⟹124
Statutes ⟹188

Words of statutes, including revenue acts, should be interpreted where possible in their ordinary, everyday sense.

2. Internal revenue ⟹153

Where treasury regulation interpreting statutory provision had been in effect since 1918, and such provision had been repeatedly re-enacted by Congress in substantially same form, regulation might be considered to have the force of law.

3. Internal revenue ⟹153

Where the treasury, in construing statute relating to adjusted basis for determining gain or loss on property acquired by bequest, devise, or inheritance, never furnished a guide to problems that arise in connection with depreciating and equity basis but consistently permitted amount of depreciation allowances to be computed on the full value of the property, and subtracted from it as a basis, Congress' long-continued acceptance of such situation gives it full legislative indorsement. Revenue Act 1938, § 113(a) (5), 26 U.S.C.A.Int. Rev.Code, § 113(a) (5).

4. Internal revenue ⚷444, 722

Under statute providing that, when property is acquired by devise, its basis for determining gain or loss shall be its fair market value at time of its acquisition, "property" does not mean the same thing as "equity" but means the land and buildings themselves or owner's legal right in them, undiminished by mortgage, and hence, where devisee took realty incumbered by mortgage lien, proper basis for depreciation as a deduction in computing income tax was the actual value of the realty rather than the value of devisee's equity. Revenue Act 1938, §§ 111(a, b), 113(a) (5), 26 U.S.C.A. Int.Rev.Code, §§ 111(a, b), 113(a) (5).

See Words and Phrases, Permanent Edition, for all other definitions of "Property".

5. Internal revenue ⚷444, 722

Where testator devised to taxpayer mortgaged realty which was appraised at testator's death at exact amount of mortgage, and taxpayer on sale of property, subject to mortgage and past-due taxes, received only $2,500 net, taxpayer was properly assessed for a gain measured by difference between the building's proper proportion of the sum of the principal of the mortgage and $2,500 and value of building at time of the devise, less deductions for depreciation, since the proper basis for depreciation as a deduction in computing income tax was the actual value of the building rather than the value of taxpayer's equity. 26 U.S.C.A. Int.Rev.Code, §§ 23 (*l*), 111(a), 113(a) (5), (b) (1) (B).

6. Internal revenue ⚷431, 438

The word "property", within section 111(a) (b) defining amount realized from sale of property for income tax purposes, means the same as the word "property" in section 113 providing that property to be valued on date of acquisition is the property free of liens. Revenue Act 1938, §§ 111 (a, b), 113(a) (5), 26 U.S.C.A. Int.Rev. Code, §§ 111(a, b), 113(a) (5).

7. Internal revenue ⚷444

Where testator devised to taxpayer mortgaged realty which was appraised at testator's death at exact amount of mortgage, and taxpayer on sale of property, subject to mortgage and past-due taxes, received only $2,500 net, amount of mortgage was properly included in "amount realized" on the sale within statute providing that, in computing net income, amount realized from sale or other disposition of property shall be the sum of any money received plus fair market value of the property received. Revenue Act 1938, §§ 111 (b), 113(a) (5), 26 U.S.C.A. Int.Rev.Code, §§ 111(b), 113(a) (5).

See Words and Phrases, Permanent Edition, for all other definitions of "Amount Realized".

8. Internal revenue ⚷437

A mortgagor, not personally liable on mortgage debt, who sells property subject to the mortgage and for additional consideration, realizes a benefit in amount of the mortgage as well as the boot for income tax purposes, and it is immaterial whether mortgagor is also to receive money from purchaser to discharge mortgage prior to sale, or whether mortgagor is merely to transfer subject to the mortgage. Revenue Act 1938, §§ 111(b), 113(a) (5), 26 U.S.C.A. Int.Rev.Code, §§ 111(b), 113(a) (5).

9. Internal revenue ⚷1638

The Tax Court's determinations that "property" within Section 113(a) meant "equity", and that amount of a mortgage subject to which property is sold is not the measure of a benefit realized within section 111(b) relating to computation of net income, announced rules of general applicability on clear-cut questions of law, and hence Circuit Court of Appeals had jurisdiction to review them. Revenue Act 1938, §§ 111(b), 113(a) (5), 26 U.S.C.A. Int.Rev.Code, §§ 111(b), 113(a) (5); 26 U.S.C.A. Int.Rev.Code, § 1141(a, c).

10. Internal revenue ⚷301

"Income" within Sixteenth Amendment is not limited to direct receipt of cash. U.S.C.A.Const. Amend. 16.

See Words and Phrases, Permanent Edition, for all other definitions of "Income".

Mr. Justice JACKSON, Mr. Justice FRANKFURTER, and Mr. Justice DOUGLAS, dissenting.

On Writ of Certiorari to the United States Circuit Court of Appeals for the Second Circuit.

Petition by the Commissioner of Internal Revenue to review an order of the Tax Court, 3 T.C. 585, expunging a deficiency assessed against Beulah B. Crane in her income tax for the year 1938. To review a judgment of the Circuit Court of Appeals, 153 F.2d 504, which reversed the order of the Tax Court, Beulah B. Crane brings certiorari.

Affirmed.

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Mr. Edward S. Bentley, of New York City, for petitioner.

Mr. J. Louis Monarch, of Washington, D. C., for respondent.

Mr. Chief Justice VINSON delivered the opinion of the Court.

The question here is how a taxpayer who acquires depreciable property subject to an unassumed mortgage, holds it for a period, and finally sells it still so encumbered, must compute her taxable gain.

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Petitioner was the sole beneficiary and the executrix of the will of her husband, who died January 11, 1932. He then owned an apartment building and lot subject to a mortgage,[1] which secured a principal debt of $255,000.00 and interest in default of $7,042.50. As of that date, the property was appraised for federal estate tax purposes at a value exactly equal to the total amount of this encumbrance. Shortly after her husband's death, petitioner entered into an agreement with the mortgagee whereby she was to continue to operate the property—collecting the rents, paying for necessary repairs, labor, and other operating expenses, and reserving $200.00 monthly for taxes—and was to remit the net rentals to the mortgagee. This plan was followed for nearly seven years, during which period petitioner reported the gross rentals as income, and claimed and was allowed deductions for taxes and operating expenses paid on the property, for interest paid on the mortgage, and for the physical exhaustion of the building. Meanwhile, the arrearage of interest increased to $15,857.71. On November 29, 1938, with the mortgagee threatening foreclosure, petitioner sold to a third party for $3,000.00 cash, subject to the mortgage, and paid $500.00 expenses of sale.

Petitioner reported a taxable gain of $1,250.00. Her theory was that the "property" which she had acquired in 1932 and sold in 1938 was only the equity, or the excess in the value of the apartment building and lot over the amount of the mortgage. This equity was of zero value when she acquired it. No depreciation could be taken on a zero value.[2] Neither she nor her vendee ever assumed

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the mortgage, so, when she sold the equity, the amount she realized on the sale was the net cash received, or $2,500.00. This sum less the zero basis constituted her gain, of which she reported half as taxable on the assumption that the entire property was a "capital asset".[3]

The Commissioner, however, determined that petitioner realized a net taxable gain of $23,767.03. His theory was that the

[1] The record does not show whether he was personally liable for the debt.

[2] This position is, of course, inconsistent with her practice in claiming such deductions in each of the years the property was held. The deductions so claimed and allowed by the Commissioner were in the total amount of $25,500.00.

[3] See § 117 (a) (b), Revenue Act of 1938, c. 289, 52 Stat. 447, 26 U.S.C.A. Int.Rev.Code, § 117. Under this provision only 50% of the gain realized on the sale of a "capital asset" need be taken into account, if the property had been held more than two years.

"property" acquired and sold was not the equity, as petitioner claimed, but rather the physical property itself, or the owner's rights to possess, use, and dispose of it, undiminished by the mortgage. The original basis thereof was $262,042.50, its appraised value in 1932. Of this value $55,000.00 was allocable to land and $207,042.50 to building.[4] During the period that petitioner held the property, there was an allowable depreciation of $28,045.10 on the building,[5] so that the adjusted basis of the building at the time of sale was $178,997.40. The amount realized on the sale was said to include not only the $2,500.00 net cash receipts, but also the principal amount[6] of the mortgage subject to which the property was sold, both totaling $257,500.00. The selling price was allocable in the proportion, $54,471.15 to the land and $203,028.85 to the building.[7] The Commissioner agreed that the land was

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a "capital asset", but thought that the building was not.[8] Thus, he determined that petitioner sustained a capital loss of $528.85 on the land, of which 50% or $264.42 was taken into account, and an ordinary gain of $24,031.45 on the building, or a net taxable gain as indicated.

The Tax Court agreed with the Commissioner that the building was not a "capital asset." In all other respects it adopted petitioner's contentions, and expunged the deficiency.[9] Petitioner did not appeal from the part of the ruling adverse to her, and these questions are no longer at issue. On the Commissioner's appeal, the Circuit Court of Appeals reversed, one judge dissenting.[10] We granted certiorari because of the importance of the questions raised as to the proper construction of the gain and loss provisions of the Internal Revenue Code.[11]

The 1938 Act,[12] § 111(a), 26 U.S.C.A. Int.Rev.Code, § 111(a), defines the gain from "the sale or other disposition of property" as "the excess of the amount realized therefrom over the adjusted basis provided in section 113(b) * * *." It proceeds, § 111(b), to define "the amount realized from the sale or other disposition of property" as "the sum of any money received plus

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the fair market value of the property (other than money) received." Further, in § 113(b), 26 U.S.C.A. Int.Rev.Code, § 113(b), the "adjusted basis for determining the gain or loss from the sale or other disposition of property" is declared to be "the basis determined under subsection (a), adjusted * * * [(1) (B)] * * * for exhaustion, wear and tear, obsolescence, amortization * * * to the extent allowed (but not less than the amount allowable) * * *." The basis under subsection (a) "if the property was acquired by * * * devise * * * or by the decedent's estate from the decedent", § 113(a) (5), is "the fair market value of

[4] The parties stipulated as to the relative parts of the 1932 appraised value and of the 1938 sales price which were allocable to land and building.

[5] The parties stipulated that the rate of depreciation applicable to the building was 2% per annum.

[6] The Commissioner explains that only the principal amount, rather than the total present debt secured by the mortgage, was deemed to be a measure of the amount realized, because the difference was attributable to interest due, a deductible item.

[7] See supra, note 4.

[8] See § 117 (a) (1), Revenue Act of 1938, supra.

[9] 3 T.C. 585. The Court held that the building was not a "capital asset" within the meaning of § 117 (a) and that the entire gain on the building had to be taken into account under § 117 (b), because it found that the building was of a character subject to physical exhaustion and that petitioner had used it in her trade or business.

But because the Court accepted petitioner's theory that the entire property had a zero basis, it held that she was not entitled to the 1938 depreciation deduction on the building which she had inconsistently claimed.

For these reasons, it did not expunge the deficiency in its entirety.

[10] 2 Cir., 153 F.2d 504.

[11] 328 U.S. 826, 66 S.Ct. 980.

[12] All subsequent references to a revenue act are to this Act unless otherwise indicated. The relevant parts of the gain and loss provisions of the Act and Code are identical.

such property at the time of such acquisition."

Logically, the first step under this scheme is to determine the unadjusted basis of the property, under § 113 (a) (5), and the dispute in this case is as to the construction to be given the term "property". If "property", as used in that provision, means the same thing as "equity", it would necessarily follow that the basis of petitioner's property was zero, as she contends. If, on the contrary, it means the land and building themselves, or the owner's legal rights in them, undiminished by the mortgage, the basis was $262,042.50.

[1] We think that the reasons for favoring one of the latter constructions are of overwhelming weight. In the first place, the words of statutes—including revenue acts—should be interpreted where possible in their ordinary, everyday senses.[13] The only relevant definitions of "property" to be found in the principal standard dictionaries[14] are the two favored by the Commissioner, i. e., either that "property" is the physical thing which is a subject of ownership, or that it is the aggregate of the owner's rights to control and dispose of that thing.

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"Equity" is not given as a synonym, nor do either of the foregoing definitions suggest that it could be correctly so used. Indeed, "equity" is defined as "the value of a property * * * above the total of the liens. * * *"[15] The contradistinction could hardly be more pointed. Strong countervailing considerations would be required to support a contention that Congress, in using the word "property", meant "equity", or that we should impute to it the intent to convey that meaning.[16]

[2] In the second place, the Commissioner's position has the approval of the administrative construction of § 113(a) (5). With respect to the valuation of property under that section, Reg. 101, Art. 113(a) (5)–1, promulgated under the 1938 Act, provided that "the value of property as of the date of the death of the decedent as appraised for the purpose of the federal estate tax * * * shall be deemed to be its fair market value. * * *" The land and building here involved were so appraised in 1932, and their appraised value —$262,042.50—was reported by petitioner as part of the gross estate. This was in accordance with the estate tax law[17] and regulations,[18] which had always required that the value of decedent's property, undiminished by liens, be so appraised and returned, and that mortgages be separately deducted in computing the net estate.[19] As the quoted provision of the Regulations

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has been in effect since 1918,[20] and as the relevant statutory provision has been repeatedly reenacted since then in substantially the same form,[21] the former may itself now be con-

13 Old Colony R. Co. v. Commissioner, 284 U.S. 552, 560, 52 S.Ct. 211, 213, 76 L.Ed. 484.

14 See Webster's New International Dictionary, Unabridged, 2d Ed.; Funk & Wagnalls' New Standard Dictionary; Oxford English Dictionary.

15 See Webster's New International Dictionary, supra.

16 Crooks v. Harrelson, 282 U.S. 55, 59, 51 S.Ct. 49, 50, 75 L.Ed. 156.

17 See §§ 202 and 203 (a) (1), Revenue Act of 1916; §§ 402 and 403 (a) (1), Revenue Acts of 1918 and 1921; §§ 302, 303 (a) (1), Revenue Acts of 1924 and 1926; § 805, Revenue Act of 1932, 26 U.S.C.A. Int.Rev.Code, §§ 811, 812.

18 See Reg. 37, Arts, 13, 14, and 47; Reg. 63, Arts. 12, 13, and 41; Reg. 68, Arts. 11, 13, and 38; Reg. 70, Arts 11, 13, and 38; Reg. 80, Arts. 11, 13, and 38.

19 See City Bank Farmers' Trust Co. v. Bowers, 2 Cir., 68 F.2d 909, certiorari denied, 292 U.S. 644, 54 S.Ct. 778, 78 L.Ed. 1495; Rodiek v. Helvering, 2 Cir., 87 F.2d 328; Adriance v. Higgins, 2 Cir., 113 F.2d 1013.

20 See also Reg. 45, Art. 1562; Reg. 62, Art. 1563; Reg. 65, Art. 1594; Reg. 69, Art. 1594; Reg. 74, Art. 596; Reg. 77, Art. 596; Reg. 86, Art. 113(a) (5)–1 (c); Reg. 94, Art. 113 (a) (5)–1 (c); Reg. 103, § 19.113 (a) (5)–1 (c); Reg. 111, § 29.113 (a) (5)–1 (c).

21 § 202 (a) (3), Revenue Act of 1921; § 204 (a) (5), Revenue Act of 1924; § 204 (a) (5), Revenue Act of 1926; § 113 (a) (5), Revenue Act of 1928; § 113 (a) (5), Revenue Act of 1932; § 113 (a) (5), Revenue Act of 1934; §

sidered to have the force of law.[22]

Moreover, in the many instances in other parts of the Act in which Congress has used the word "property", or expressed the idea of "property" or "equity", we find no instances of a misuse of either word or of a confusion of the ideas.[23] In some parts of the Act other than the gain and loss sections, we find "property" where it is unmistakably used in its ordinary sense.[24] On the other hand, where either Congress or the Treasury intended to convey the meaning of "equity," it did so by the use of appropriate language.[25]

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A further reason why the word "property" in § 113(a) should not be construed to mean "equity" is the bearing such construction would have on the allowance of deductions for depreciation and on the collateral adjustments of basis.

Section 23(*l*) permits deduction from gross income of "a reasonable allowance for the exhaustion, wear and tear of property * * *." Sections 23(n) and 114 (a), 26 U.S.C.A. Int.Rev.Code, §§ 23(n), 114(a), declare that the "basis upon which depletion exhaustion, wear and tear * * * are to be allowed" is the basis "provided in section 113(b) for the purpose of determining the gain upon the sale" of the property, which is the § 113(a) basis "adjusted * * * for exhaustion, wear and tear * * * to the extent allowed (but not less than the amount allowable) * * *."

Under these provisions, if the mortgagor's equity were the § 113(a) basis, it would also be the original basis from which depreciation allowances are deducted. If it is, and if the amount of the annual allowances were to be computed on that value, as would then seem to be required,[26] they will represent only a fraction of the cost of the corresponding physical exhaustion, and any recoupment by the mortgagor of the remainder of that cost can be effected only by the reduction of his taxable gain in the year of sale.[27] If, however, the amount of the annual allowances

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were to be computed on the value of the property, and then deducted from an equity basis, we would in some instances have to accept deductions from a minus basis or deny deductions altogether.[28] The Commissioner

113 (a) (5), Revenue Act of 1936; § 113 (a) (5), Revenue Act of 1938; § 113 (a) (5), Internal Revenue Code, 26 U.S.C.A. Int.Rev.Code, § 113 (a) (5).

22 Helvering v. R. J. Reynolds Co., 306 U.S. 110, 114, 59 S.Ct. 423, 425, 83 L.Ed. 536.

23 Cf. Helvering v. Stockholms Enskilda Bank, 293 U.S. 84, 87, 55 S.Ct. 50, 51, 79 L.Ed. 211.

24 Sec. 23 (a) (1), 26 U.S.C.A. Int.Rev.Code, § 23 (a) (1), permits the deduction from gross income of "rentals * * * required to be made as a condition to the continued use * * * for purposes of the trade or business, of *property* * * * in which he [the taxpayer] has no *equity*."

Sec. 23 (*l*) permits the deduction from gross income of "a reasonable allowance for the exhaustion, wear and tear of *property* used in the trade or business * * *."

See also § 303 (a) (1), Revenue Act of 1926, c. 27, 44 Stat. 9; § 805, Revenue Act of 1932, c. 209, 47 Stat. 280.

25 See § 23 (a) (1), *supra*, note 24; § 805, Revenue Act of 1932, *supra*, note 24; § 3482, I.R.C., 26 U.S.C.A. Int.Rev.Code, § 3482; Reg. 105, § 81.38. This provision of the Regulations, first appearing in 1937, T.D. 4729, 1937-1 Cum. Bull. 284, 289, permitted estates which were not liable on mortgages applicable to certain of decedent's property to return "only the value of the equity of redemption (or value of the property, less the indebtedness). * * *"

26 Secs. 23 (n) and 114 (a), in defining the "basis upon which" depreciation is "to be allowed", do not distinguish between basis as the minuend from which the allowances are to be deducted, and as the dividend from which the amount of the allowance is to be computed. The Regulations indicate that the basis of property is the same for both purposes. Reg. 101, Art. 23 (1)-4, 5.

27 This is contrary to Treasury practice, and to Reg. 101, Art. 23 (1)-5, which provides in part:

"The capital sum to be recovered shall be charged off over the useful life of the property, either in equal annual installments or in accordance with any other recognized trade practice, such as an apportionment of the capital sum over units of production."

See Detroit Edison Co. v. Commissioner, 319 U.S. 98, 101, 63 S.Ct. 902, 903, 87 L.Ed. 1286.

28 So long as the mortgagor remains in

also argues that taking the mortgagor's equity as the § 113(a) basis would require the basis to be changed with each payment on the mortgage,[29] and that the attendant problem of repeatedly recomputing basis and annual allowances would be a tremendous accounting burden on both the Commissioner and the taxpayer. Moreover, the mortgagor would acquire control over the timing of his depreciation allowances.

[3] Thus it appears that the applicable provisions of the Act expressly preclude an equity basis, and the use of it is contrary to certain implicit principles of income tax depreciation, and entails very great administrative difficulties.[30] It may be added that the Treasury has never furnished a guide through the maze of problems that arise in connection with depreciating an equity basis, but, on the contrary, has consistently permitted the amount of depreciation allowances to be computed on the full value of the property, and subtracted from it as a basis. Surely,

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Congress' long-continued acceptance of this situation gives it full legislative endorsement.[31]

[4] We conclude that the proper basis under § 113(a) (5) is the value of the property, undiminished by mortgages thereon, and that the correct basis here was $262,042.50. The next step is to ascertain what adjustments are required under § 113(b). As the depreciation rate was stipulated, the only question at this point is whether the Commissioner was warranted in making any depreciation adjustments whatsoever.

[5] Section 113 (b) (1) (B) provides that "proper adjustment in respect of the property *shall in all cases be made* * * * for exhaustion, wear and tear * * * to the extent allowed (but not less than the amount allowable * * *." The Tax Court found on adequate evidence that the apartment house was property of a kind subject to physical exhaustion, that it was used in taxpayer's trade or business, and consequently that the taxpayer would have been entitled to a depreciation allowance under § 23 (*l*), except that, in the opinion of that Court, the basis of the property was zero, and it was thought that depreciation could not be taken on a zero basis. As we have just decided that the correct basis of the property was not zero, but $262,042.50, we avoid this difficulty, and conclude that an adjustment should be made as the Commissioner determined.

Petitioner urges to the contrary that she was not entitled to depreciation deductions, whatever the basis of the property, because the law allows them only to one who actually bears the capital loss,[32] and here the loss was not hers but the mortgagee's. We do not see, however, that she has established her factual premise. There was no finding of the Tax Court to that effect, nor to the effect

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that the value of the property was ever less than the amount of the lien. Nor was there evidence in the record, or any indication that petitioner could produce evidence, that this was so. The facts that the value of the property was only equal to the lien in 1932 and that during the next six and one-half years the physical condition of the building deteriorated and the amount of the lien increased, are entirely inconclusive, particularly in the light of the buyer's willingness in 1938 to take subject to the increased lien and pay a substantial amount of cash

possession, the mortgagee can not take depreciation deductions, even if he is the one who actually sustains the capital loss, as § 23 (*l*) allows them only on property "used in the trade or business."

29 Sec. 113 (b) (1) (A) requires adjustment of basis "for expenditures * * * properly chargeable to capital account * * *."

30 Obviously we are not considering a situation in which a taxpayer has acquired and sold an equity of redemption only, i. e., a right to redeem the property without a right to present possession. In that situation, the right to redeem would itself be the aggregate of the taxpayer's rights and would undoubtedly constitute 'property' within the meaning of § 113 (a). No depreciation problems would arise. See note 28.

31 See note 22.

32 See Helvering v. F. & R. Lazarus & Co., 308 U.S. 252, 60 S.Ct. 209, 84 L. Ed. 226; Duffy v. Central R. Co., 268

to boot. Whatever may be the rule as to allowing depreciation to a mortgagor on property in his possession which is subject to an unassumed mortgage and clearly worth less than the lien, we are not faced with that problem and see no reason to decide it now.

[6] At last we come to the problem of determining the "amount realized" on the 1938 sale. Section 111(b), it will be recalled, defines the "amount realized" from "the sale * * * of property" as "the sum of any money received plus the fair market value of the property (other than money) received," and § 111(a) defines the gain on "the sale * * * of property" as the excess of the amount realized over the basis. Quite obviously, the word "property", used here with reference to a sale, must mean "property" in the same ordinary sense intended by the use of the word with reference to acquisition and depreciation in § 113, both for certain of the reasons stated heretofore in discussing its meaning in § 113, and also because the functional relation of the two sections requires that the word mean the same in one section that it does in the other. If the "property" to be valued on the date of acquisition is the property free of liens, the "property" to be priced on a subsequent sale must be the same thing.[33]

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[7] Starting from this point, we could not accept petitioner's contention that the $2,500.00 net cash was all she realized on the sale except on the absurdity that she sold a quarter-of-a-million dollar property for roughly one per cent of its value, and took a 99 per cent loss. Actually, petitioner does not urge this. She argues, conversely, that because only $2,500.00 was realized on the sale, the "property" sold must have been the equity only, and that consequently we are forced to accept her contention as to the meaning of "property" in § 113. We adhere, however, to what we have already said on the meaning of "property", and we find that the absurdity is avoided by our conclusion that the amount of the mortgage is properly included in the "amount realized" on the sale.

Petitioner concedes that if she had been personally liable on the mortgage and the purchaser had either paid or assumed it, the amount so paid or assumed would be considered a part of the "amount realized" within the meaning of § 111(b).[34] The cases so deciding have already repudiated the notion that there must be an actual receipt by the seller himself of "money" or "other property", in their narrowest senses. It was thought to be decisive that one section of the Act must be construed so as not to defeat the intention of another or to frustrate the Act as a whole,[35] and that the taxpayer was the "beneficiary" of the payment in "as real and substantial [a sense] as if the money had been paid it and then paid over by it to its creditors."[36]

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[8] Both these points apply to this case. The first has been mentioned already. As for the second, we think that a mortgagor, not personally liable on the debt, who sells the property subject to the mortgage and for additional consideration, realizes a benefit in the amount of the mortgage as well as the boot.[37] If a purchaser pays boot, it is immaterial as to our problem

U.S. 55, 64, 45 S.Ct. 429, 431, 69 L.Ed. 846.

33 See Maguire v. Commissioner, 313 U.S. 1, 8, 61 S.Ct. 789, 794, 85 L.Ed. 1149.

We are not troubled by petitioner's argument that her contract of sale expressly provided for the conveyance of the equity only. She actually conveyed title to the property, and the buyer took the same property that petitioner had acquired in 1932 and used in her trade or business until its sale.

34 United States v. Hendler, 303 U.S. 564, 58 S.Ct. 655, 82 L.Ed. 1018; Brons Hotels, Inc., 34 B.T.A. 376; Walter F. Haass, 37 B.T.A. 948. See Douglas v. Willcutts, 296 U.S. 1, 8, 56 S.Ct. 59, 62, 80 L.Ed. 3, 101 A.L.R. 391.

35 See Brons Hotels, Inc., supra, 34 B.T.A. at page 381.

36 See United States v. Hendler, supra, 303 U.S. at page 566, 58 S.Ct. at page 656, 82 L.Ed. 1018.

37 Obviously, if the value of the property is less than the amount of the mort-

whether the mortgagor is also to receive money from the purchaser to discharge the mortgage prior to sale, or whether he is merely to transfer subject to the mortgage—it may make a difference to the purchaser and to the mortgagee, but not to the mortgagor. Or put in another way, we are no more concerned with whether the mortgagor is, strictly speaking, a debtor on the mortgage, than we are with whether the benefit to him is, strictly speaking, a receipt of money or property. We are rather concerned with the reality that an owner of property, mortgaged at a figure less than that at which the property will sell, must and will treat the conditions of the mortgage exactly as if they were his personal obligations.[38] If he transfers subject to the mortgage, the benefit to him is as real and substantial as if the mortgage were discharged, or as if a personal debt in an equal amount had been assumed by another.

Therefore we conclude that the Commissioner was right in determining that petitioner realized $257,500.00 on the sale of this property.

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[9] The Tax Court's contrary determinations, that "property", as used in § 113 (a) and related sections, means "equity", and that the amount of a mortgage subject to which property is sold is not the measure of a benefit realized, within the meaning of § 111 (b), announced rules of general applicability on clear-cut questions of law.[39] The Circuit Court of Appeals therefore had jurisdiction to review them.[40]

[10] Petitioner contends that the result we have reached taxes her on what is not income within the meaning of the Sixteenth Amendment. If this is because only the direct receipt of cash is thought to be income in the constitutional sense, her contention is wholly without merit.[41] If it is because the entire transaction is thought to have been "by all dictates of common-sense * * * a ruinous disaster", as it was termed in her brief, we disagree with her premise. She was entitled to depreciation deductions for a period of nearly seven years, and she actually took them in almost the allowable amount. The crux of this case, really, is whether the law permits her to exclude allowable deductions from consideration in computing gain.[42] We have
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already showed that, if it does, the taxpayer can enjoy a double deduction, in effect, on the same loss of assets. The Sixteenth Amendment

gage, a mortgagor who is not personally liable cannot realize a benefit equal to the mortgage. Consequently, a different problem might be encountered where a mortgagor abandoned the property or transferred it subject to the mortgage without receiving boot. That is not this case.

38 For instance, this petitioner returned the gross rentals as her own income, and out of them paid interest on the mortgage, on which she claimed and was allowed deductions. See Reg. 77, Art. 141; Reg. 86, Art. 23 (b)–1; Reg. 94, Art. 23 (b)–1; Reg. 101, Art. 23 (b)–1.

39 See Commissioner v. Wilcox, 327 U.S. 404, 410, 66 S.Ct. 546, 550; Bingham's Trust v. Commissioner, 325 U.S. 365, 369–372, 65 S.Ct. 1232, 1234–1236, 89 L.Ed. 1670. Cf. John Kelley Co. v. Commissioner, 326 U.S. 521, 527, 698, 66 S.Ct. 299, 302; Dobson v. Commissioner, 320 U.S. 489, 64 S.Ct. 239, 88 L.Ed. 248.

40 Ibid; see also § 1141 (a) and (c), I.R.C., 26 U.S.C.A. Int.Rev.Code, § 1141 (a, c).

41 Douglas v. Willcutts, supra, 296 U.S. at page 9, 56 S.Ct. at page 62, 80 L.Ed. 3, 101 A.L.R. 391; Burnet v. Wells, 289 U.S. 670, 677, 53 S.Ct. 761, 763, 77 L.Ed. 1439.

42 In the course of the argument some reference was made, as by analogy, to a situation in which a taxpayer acquired by devise property subject to a mortgage in an amount greater than the then value of the property, and later transferred it to a third person, still subject to the mortgage, and for a cash boot. Whether or not the difference between the value of the property on acquisition and the amount of the mortgage would in that situation constitute either statutory or constitutional income is a question which is different from the one before us, and which we need not presently answer.

does not require that result any more than does the Act itself.

Affirmed.

Mr. Justice JACKSON, dissenting.

The Tax Court concluded that this taxpayer acquired only an equity worth nothing. The mortgage was in default, the mortgage debt was equal to the value of the property, any possession by the taxpayer was forfeited and terminable immediately by foreclosure, and perhaps by a receiver pendente lite. Arguments can be advanced to support the theory that the taxpayer received the whole property and thereupon came to owe the whole debt. Likewise it is argued that when she sold she transferred the entire value of the property and received release from the whole debt. But we think these arguments are not so conclusive that it was not within the province of the Tax Court to find that she received an equity which at that time had a zero value. Dobson v. Commissioner, 320 U.S. 489, 64 S.Ct. 239, 88 L.Ed. 248; Commissioner v. Scottish American Investment Co., Ltd., 323 U.S. 119, 65 S.Ct. 169, 89 L.Ed. 113. The taxpayer never became personally liable for the debt, and hence when she sold she was released from no debt. The mortgage debt was simply a subtraction from the value of what she did receive, and from what she sold. The subtraction left her nothing when she acquired it and a small margin when she sold it. She acquired a property right equivalent to an equity of redemption and sold the same thing. It was the "property" bought and sold as the Tax Court considered it to be under the Revenue Laws. We are not required in this case to decide whether depreciation was properly taken, for there is no issue about it here.

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We would reverse the Court of Appeals and sustain the decision of the Tax Court.

Mr. Justice FRANKFURTER and Mr. Justice DOUGLAS join in this opinion.

331 U.S. 17

WALLING, Adm'r, Wage & Hour Div., U. S. Department of Labor, v. HALLIBURTON OIL WELL CEMENTING CO.

No. 74.

Argued Feb. 7, 10, 1947.

Decided April 14, 1947.

Master and servant ⚷69

Where volume of work and hours of employment of oil well cementing company's employees fluctuated widely from week to week, an agreement between company and employees by which each employee was paid a regular basic hourly rate at or above statutory minimum for the first 40 hours of any work week and not less than 1½ times such basic hourly rate for all time over 40 hours in any work week with a guarantee the employee should receive not less than specified amount for each work week was valid, even though the hourly rate was so related to guaranteed flat sum that employee became entitled to more than the guarantee only in weeks in which he worked more than 84 hours. Fair Labor Standards Act of 1938, §§ 1 et seq., 7(a) (3), 29 U.S.C.A. §§ 201 et seq., 207(a) (3).

Mr. Justice MURPHY and Mr. Justice BLACK dissenting.

On Writ of Certiorari to the United States Circuit Court of Appeals for the Ninth Circuit.

Action by L. Metcalfe Walling, Administrator of the Wage and Hour Division, United States Department of Labor, against Halliburton Oil Well Cementing Company for an injunction against violations of the Fair Labor Standards Act. A judgment denying injunctive relief and dismissing the complaint, 57 F.Supp. 408, was affirmed, 152 F.2d 622, and the plaintiff brings certiorari.

Affirmed.

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Mr. Morton Lixtin, of Washington, D. C., for petitioner.

procedural provisions drafted with the private citizen in mind need not be applied with slavish literalness to States.[4]

Finally, we cannot ignore the special nature of the lands at issue in this case. The beds of navigable waters pass to the States when they achieve statehood under the constitutional equal footing doctrine, as an incident of sovereignty. *Montana v. United States*, 450 U.S. 544, 551, 101 S.Ct. 1245, 1251, 67 L.Ed.2d 493 (1981); *Pollard's Lessee v. Hagan*, 3 How. 212, 11 L.Ed. 565 (1845). And the lands are of critical importance to North Dakota, which holds them in its sovereign capacity in trust for its citizens.[5] Congress has recognized the special importance of these lands in the Submerged Lands Act, 67 Stat. 30, 43 U.S.C. § 1301 *et seq.*[6] Until today, the Court too has shown special sensitivity to the importance of these lands, recognizing the strongest presumption that Congress will not act to convey the lands rather than to preserve them for the State. *Montana v. United States, supra*, 450 U.S., at 552, 101 S.Ct., at 1251. Given that solicitude for the State's ownership of these lands, it becomes extremely difficult to believe that Congress intended to deny States dominion over these lands by silently extinguishing their right to quiet title. I would affirm the judgment below.

4. Cf. *Wilson v. Omaha Indian Tribe,* 442 U.S. 653, 667, 99 S.Ct. 2529, 2537, 61 L.Ed.2d 153 (1979) (rule that statute must expressly include sovereign is particularly applicable "where the statute imposes a burden or limitation, as distinguished from conferring a benefit or advantage").

5. Cf. *United States v. Oregon,* 295 U.S. 1, 14, 55 S.Ct. 610, 615, 79 L.Ed. 1267 (1935) ("Dominion over navigable waters and property in the soil under them are so identified with the sovereign power of government that a presumption against their separation from sovereignty must be indulged, in construing either grants by the sovereign of the lands to be held in private ownership or transfer of sovereignty itself.... For that reason, upon the admission of a State to the Union, the title of the United States to lands underlying navigable waters within the States passes to it, as incident to the transfer to the State of local sovereignty, and is subject only to the paramount power of the United States to control such waters for purposes of navigation in interstate and foreign commerce").

6. In § 3(a) of the Act, 67 Stat. 30, 43 U.S.C. § 1311(a), Congress provided:

"It is hereby determined and declared to be in the public interest that (1) title to and ownership of the lands beneath navigable waters within the boundaries of the respective States, and the natural resources within such lands and waters, and (2) the right and power to manage, administer, lease, develop, and use the said lands and natural resources all in accordance with applicable State law be, and they are, subject to the provisions hereof, recognized, confirmed, established, and vested in and assigned to the respective States...."

461 U.S. 300, 75 L.Ed.2d 863

COMMISSIONER OF INTERNAL REVENUE, Petitioner

v.

John F. TUFTS et al.

No. 81-1536.

Argued Nov. 29, 1982.
Decided May 2, 1983.
Rehearing Denied June 27, 1983.
See 463 U.S. 1215, 103 S.t. 3555.

Petition for writ of certiorari was filed seeking review of decision of the United States Court of Appeals for the Fifth Circuit, 651 F.2d 1058, which reversed a decision of the United States Tax Court, 70 T.C. 756, which upheld certain deficiencies assessed with respect to sale of partnership property. The Supreme Court, Justice Blackmun, held that where taxpayers sold or disposed of partnership property encumbered by a nonrecourse obligation, Commissioner of Internal Revenue properly required them to include among the assets realized the outstanding amount of the obligation; fair market value of the property was irrelevant to that calculation.

Judgment of Court of Appeals reversed.

Justice O'Connor filed concurring opinion.

1. Internal Revenue ⇐3194

A nonrecourse loan should be treated as a true loan and therefore a taxpayer must account for the proceeds of obligations he has received tax-free and included in basis for purpose of determination of gains and losses on the disposition of property. 26 U.S.C.A. § 1001(b).

2. Internal Revenue ⇐3934

Fair market value limitation of section of Internal Revenue Code providing that a liability to which property is subject shall, to extent of fair market value of such property, be considered as a liability of the owner of the property for purposes of section prescribing tax treatment of certain partnership transactions applied only to transactions between a partner and his partnership under statutory subsections prescribing rules for treatment of liabilities in transactions between a partner and his partnership but was not intended to limit amount realized in a sale or exchange of a partnership interest under statutory subsection specifically mandating that partnership liabilities be treated in the same manner as liabilities in connection with sale or exchange of property not associated with partnerships. 26 U.S.C.A. § 752(a-d).

3. Internal Revenue ⇐3194, 3934

Where taxpayers sold or disposed of partnership property encumbered by a nonrecourse obligation, Commissioner of Internal Revenue properly required them to include among the assets realized the outstanding amount of the obligation; fair market value of the property was irrelevant to that calculation. 26 U.S.C.A. §§ 752, 1001.

Syllabus *

Section 752(d) of the Internal Revenue Code of 1954 (IRC) provides that liabilities involved in the sale or exchange of a partnership interest are to be treated "in the same manner as liabilities in connection with the sale or exchange of property not associated with partnerships." Under § 1001(a) of the IRC, the gain or loss from a sale or other disposition of property is defined as the difference between "the amount realized" on the disposition and the property's adjusted basis. Section 1001(b) defines the "amount realized" as "the sum of any money received plus the fair market value of the property (other than money) received." A general partnership formed by respondents in 1970 to construct an apartment complex entered into a \$1,851,500 nonrecourse mortgage loan with a savings association. The complex was completed in 1971. Due to the partners' capital contributions to the partnership and income tax deductions for their allocable shares of ordinary losses and depreciation, the partnership's claimed adjusted basis in the property in 1972 was \$1,455,740. Because of an unanticipated reduction in rental income, the partnership was unable to make the payments due on the mortgage. Each partner thereupon sold his interest to a third party, who assumed the mortgage. The fair market value on the date of transfer did not exceed \$1,400,000. Each partner reported the sale on his income tax return and indicated a partnership loss of \$55,740. The Commissioner of Internal Revenue, however, determined that the sale resulted in a partnership gain of approximately \$400,000 on the theory that the partnership had realized the full amount of the nonrecourse obligation. The United States Tax Court upheld the deficiencies, but the Court of Appeals reversed.

Held: When a taxpayer sells or disposes of property encumbered by a nonrecourse obligation exceeding the fair market value of the property sold, as in this case, the Commissioner may require him to include in the "amount realized" the outstanding amount of the obligation; the fair

* The syllabus constitutes no part of the opinion of the Court but has been prepared by the Reporter of Decisions for the convenience of the reader. See *United States v. Detroit Lumber Co.*, 200 U.S. 321, 337, 26 S.Ct. 282, 287, 50 L.Ed. 499.

market value of the property is irrelevant to this calculation. Cf. *Crane v. Commissioner,* 331 U.S. 1, 67 S.Ct. 1047, 91 L.Ed. 1301. Pp. 1829–1836.

301 (a) When the mortgagor's obligation to repay the mortgage loan is canceled, he is relieved of his responsibility to repay the sum he originally received and thus realizes value to that extent within the meaning of § 1001(b). To permit the taxpayer to limit his realization to the fair market value of the property would be to recognize a tax loss for which he has suffered no corresponding economic loss. A taxpayer must account for the proceeds of obligations he has received tax-free and has included in basis. Nothing in either § 1001(b) or in this Court's prior decisions requires the Commissioner to permit a taxpayer to treat a sale of encumbered property asymmetrically, by including the proceeds of the nonrecourse obligation in basis but not accounting for the proceeds upon transfer of the property. Pp. 1829–1834.

(b) Section 752(c) of the IRC—which provides that for purposes of § 752 "a liability to which property is subject shall, to the extent of the fair market value of such property, be considered as a liability of the owner of the property"—does not authorize this type of asymmetrical treatment in the sale or disposition of partnership property. Rather, the legislative history indicates that the fair market value limitation of § 752(c) was intended to apply only to transactions between a partner and his partnership under §§ 752(a) and (b), and was not intended to limit the amount realized in a sale or exchange of a partnership interest under § 752(d). Pp. 1834–1836.

651 F.2d 1058 (5th Cir. 1981), reversed.

Stuart A. Smith, Washington, D.C., for petitioner.

Ronald M. Mankoff, Dallas, Tex., for respondents.

Justice BLACKMUN delivered the opinion of the Court.

Over 35 years ago, in *Crane v. Commissioner,* 331 U.S. 1, 67 S.Ct. 1047, 91 L.Ed. 1301 (1947), this Court ruled that a taxpayer, who sold property encumbered by a nonrecourse mortgage (the amount of the mortgage being less than the property's 302 value), must include the unpaid balance of the mortgage in the computation of the amount the taxpayer realized on the sale. The case now before us presents the question whether the same rule applies when the unpaid amount of the nonrecourse mortgage exceeds the fair market value of the property sold.

I

On August 1, 1970, respondent Clark Pelt, a builder, and his wholly owned corporation, respondent Clark, Inc., formed a general partnership. The purpose of the partnership was to construct a 120-unit apartment complex in Duncanville, Tex., a Dallas suburb. Neither Pelt nor Clark, Inc., made any capital contribution to the partnership. Six days later, the partnership entered into a mortgage loan agreement with the Farm & Home Savings Association (F & H). Under the agreement, F & H was committed for a $1,851,500 loan for the complex. In return, the partnership executed a note and a deed of trust in favor of F & H. The partnership obtained the loan on a nonrecourse basis: neither the partnership nor its partners assumed any personal liability for repayment of the loan. Pelt later admitted four friends and relatives, respondents Tufts, Steger, Stephens, and Austin, as general partners. None of them contributed capital upon entering the partnership.

The construction of the complex was completed in August 1971. During 1971, each partner made small capital contributions to the partnership; in 1972, however, only Pelt made a contribution. The total of the partners' capital contributions was $44,212. In each tax year, all partners claimed as income tax deductions their allocable shares of ordinary losses and depreciation. The deductions taken by the partners in 1971 and 1972 totalled $439,972. Due to these contributions and deductions, the partnership's adjusted basis in the property in August 1972 was $1,455,740.

⌊303 ⌊In 1971 and 1972, major employers in the Duncanville area laid off significant numbers of workers. As a result, the partnership's rental income was less than expected, and it was unable to make the payments due on the mortgage. Each partner, on August 28, 1972, sold his partnership interest to an unrelated third party, Fred Bayles. As consideration, Bayles agreed to reimburse each partner's sale expenses up to $250; he also assumed the nonrecourse mortgage.

On the date of transfer, the fair market value of the property did not exceed $1,400,000. Each partner reported the sale on his federal income tax return and indicated that a partnership loss of $55,740 had been sustained.[1] The Commissioner of Internal Revenue, on audit, determined that the sale resulted in a partnership capital gain of approximately $400,000. His theory was that the partnership had realized the full amount of the nonrecourse obligation.[2]

Relying on *Millar v. Commissioner,* 577 F.2d 212, 215 (CA3), cert. denied, 439 U.S. 1046, 99 S.Ct. 721, 58 L.Ed.2d 704 (1978), the United States Tax Court, in an unreviewed decision, upheld the asserted deficiencies. 70 T.C. 756 (1978). The United States Court of Appeals for the Fifth Circuit reversed. 651 F.2d 1058 (1981). That court expressly disagreed with the *Millar* analysis, and, in limiting *Crane v. Commissioner, supra,* to its facts, questioned the
⌊304 theoretical underpinnings of the *Crane* ⌊decision. We granted certiorari to resolve the conflict. 456 U.S. 960, 102 S.Ct. 2034, 72 L.Ed.2d 483 (1982).

II

[1] Section 752(d) of the Internal Revenue Code of 1954, 26 U.S.C. § 752(d), specifically provides that liabilities involved in the sale or exchange of a partnership interest are to "be treated in the same manner as liabilities in connection with the sale or exchange of property not associated with partnerships." Section 1001 governs the determination of gains and losses on the disposition of property. Under § 1001(a), the gain or loss from a sale or other disposition of property is defined as the difference between "the amount realized" on the disposition and the property's adjusted basis. Subsection (b) of § 1001 defines "amount realized": "The amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received." At issue is the application of the latter provision to the disposition of property encumbered by a nonrecourse mortgage of an amount in excess of the property's fair market value.

A

In *Crane v. Commissioner, supra,* this Court took the first and controlling step toward the resolution of this issue. Beulah B. Crane was the sole beneficiary under the will of her deceased husband. At his death in January 1932, he owned an apartment building that was then mortgaged for an amount which proved to be equal to its fair market value, as determined for federal estate tax purposes. The widow, of course, was not personally liable on the mortgage. She operated the building for nearly seven years, hoping to turn it into a profitable venture; during that period, she

1. The loss was the difference between the adjusted basis, $1,455,740, and the fair market value of the property, $1,400,000. On their individual tax returns, the partners did not claim deductions for their respective shares of this loss. In their petitions to the Tax Court, however, the partners did claim the loss.

2. The Commissioner determined the partnership's gain on the sale by subtracting the adjusted basis, $1,455,740, from the liability assumed by Bayles, $1,851,500. Of the resulting figure, $395,760, the Commissioner treated $348,661 as capital gain, pursuant to § 741 of the Internal Revenue Code of 1954, 26 U.S.C. § 741, and $47,099 as ordinary gain under the recapture provisions of § 1250 of the Code. The application of § 1250 in determining the character of the gain is not at issue here.

claimed income tax deductions for depreciation, property taxes, interest, and operating expenses, but did not make payments upon the mortgage principal. In computing her basis for the depreciation deductions, she
305 included the full amount of the mortgage debt. In November 1938, with her hopes unfulfilled and the mortgagee threatening foreclosure, Mrs. Crane sold the building. The purchaser took the property subject to the mortgage and paid Crane $3,000; of that amount, $500 went for the expenses of the sale.

Crane reported a gain of $2,500 on the transaction. She reasoned that her basis in the property was zero (despite her earlier depreciation deductions based on including the amount of the mortgage) and that the amount she realized from the sale was simply the cash she received. The Commissioner disputed this claim. He asserted that Crane's basis in the property, under § 113(a)(5) of the Revenue Act of 1938, 52 Stat. 490 (the current version is § 1014 of the 1954 Code, as amended, 26 U.S.C. § 1014 (1976 ed. and Supp. V)), was the property's fair market value at the time of her husband's death, adjusted for depreciation in the interim, and that the amount realized was the net cash received plus the amount of the outstanding mortgage assumed by the purchaser.

In upholding the Commissioner's interpretation of § 113(a)(5) of the 1938 Act,[3] the Court observed that to regard merely the taxpayer's equity in the property as her basis would lead to depreciation deductions less than the actual physical deterioration of the property, and would require the basis to be recomputed with each payment on the mortgage. 331 U.S., at 9–10, 67 S.Ct., at 1052. The Court rejected Crane's claim that any loss due to depreciation belonged to the mortgagee. The effect of the Court's ruling was that the taxpayer's basis was the value of the property undiminished by the mortgage. *Id.*, at 11, 67 S.Ct., at 1053.

The Court next proceeded to determine 306
the amount realized under § 111(b) of the 1938 Act, 52 Stat. 484 (the current version is § 1001(b) of the 1954 Code, 26 U.S.C. § 1001(b)). In order to avoid the "absurdity," see 331 U.S., at 13, 67 S.Ct., at 1054, of Crane's realizing only $2,500 on the sale of property worth over a quarter of a million dollars, the Court treated the amount realized as it had treated basis, that is, by including the outstanding value of the mortgage. To do otherwise would have permitted Crane to recognize a tax loss unconnected with any actual economic loss. The Court refused to construe one section of the Revenue Act so as "to frustrate the Act as a whole." *Ibid.*

Crane, however, insisted that the nonrecourse nature of the mortgage required different treatment. The Court, for two reasons, disagreed. First, excluding the nonrecourse debt from the amount realized would result in the same absurdity and frustration of the Code. *Id.*, at 13–14, 67 S.Ct., at 1054. Second, the Court concluded that Crane obtained an economic benefit from the purchaser's assumption of the mortgage identical to the benefit conferred by the cancellation of personal debt. Because the value of the property in that case exceeded the amount of the mortgage, it was in Crane's economic interest to treat the mortgage as a personal obligation; only by so doing could she realize upon sale the appreciation in her equity represented by the $2,500 boot. The purchaser's assumption of the liability thus resulted in a taxable economic benefit to her, just as if she had been given, in addition to the boot, a sum of cash sufficient to satisfy the mortgage.[4]

3. Section 113(a)(5) defined the basis of "property ... acquired by ... devise ... or by the decedent's estate from the decedent" as "the fair market value of such property at the time of such acquisition." The Court interpreted the term "property" to refer to the physical land and buildings owned by Crane or the aggregate of her rights to control and dispose of them. 331 U.S., at 6, 67 S.Ct., at 1050.

4. Crane also argued that even if the statute required the inclusion of the amount of the nonrecourse debt, that amount was not Six-

307 In a footnote, pertinent to the present case, the Court observed:

> "Obviously, if the value of the property is less than the amount of the mortgage, a mortgagor who is not personally liable cannot realize a benefit equal to the mortgage. Consequently, a different problem might be encountered where a mortgagor abandoned the property or transferred it subject to the mortgage without receiving boot. That is not this case." *Id.*, at 14, n. 37, 67 S.Ct., at 1054–55, n. 37.

B

This case presents that unresolved issue. We are disinclined to overrule *Crane*, and we conclude that the same rule applies when the unpaid amount of the nonrecourse mortgage exceeds the value of the property transferred. *Crane* ultimately does not rest on its limited theory of economic benefit; instead, we read *Crane* to have approved the Commissioner's decision to treat a nonrecourse mortgage in this context as a true loan. This approval underlies *Crane's* holdings that the amount of the nonrecourse liability is to be included in calculating both the basis and the amount realized on disposition. That the amount of the loan exceeds the fair market value of the property thus becomes irrelevant.

When a taxpayer receives a loan, he incurs an obligation to repay that loan at some future date. Because of this obligation, the loan proceeds do not qualify as income to the taxpayer. When he fulfills the obligation, the repayment of the loan likewise has no effect on his tax liability.

Another consequence to the taxpayer from this obligation occurs when the taxpayer applies the loan proceeds to the purchase price of property used to secure the loan. Because of the obligation to repay, the taxpayer is entitled to include the amount of the loan in computing his basis in the property; the loan, under § 1012, is part of the taxpayer's cost of the property. 308
Although a different approach might have been taken with respect to a nonrecourse mortgage loan,[5] the Commissioner has cho-

teenth Amendment income because the overall transaction had been "by all dictates of common sense ... a ruinous disaster." Brief for Petitioner in *Crane v. Commissioner*, O.T.1946, No. 68, p. 51. The Court noted, however, that Crane had been entitled to and actually took depreciation deductions for nearly seven years. To allow her to exclude sums on which those deductions were based from the calculation of her taxable gain would permit her "a double deduction ... on the same loss of assets." The Sixteenth Amendment, it was said, did not require that result. 331 U.S., at 15–16, 67 S.Ct., at 1055.

5. The Commissioner might have adopted the theory, implicit in Crane's contentions, that a nonrecourse mortgage is not true debt, but, instead, is a form of joint investment by the mortgagor and the mortgagee. On this approach, nonrecourse debt would be considered a contingent liability, under which the mortgagor's payments on the debt gradually increase his interest in the property while decreasing that of the mortgagee. Note, Federal Income Tax Treatment of Nonrecourse Debt, 82 Colum.L.Rev. 1498, 1514 (1982); Lurie, Mortgagor's Gain on Mortgaging Property for More than Cost Without Personal Liability, 6 Tax L.Rev. 319, 323 (1951); cf. Brief for Respondents 16 (nonrecourse debt resembles preferred stock). Because the taxpayer's investment in the property would not include the nonrecourse debt, the taxpayer would not be permitted to include that debt in basis. Note, 82 Colum.L.Rev., at 1515; cf. *Gibson Products Co. v. United States*, 637 F.2d 1041, 1047–1048 (CA5 1981) (contingent nature of obligation prevents inclusion in basis of oil and gas leases of nonrecourse debt secured by leases, drilling equipment, and percentage of future production).

We express no view as to whether such an approach would be consistent with the statutory structure and, if so, and *Crane* were not on the books, whether that approach would be preferred over *Crane's* analysis. We note only that the *Crane* Court's resolution of the basis issue presumed that when property is purchased with proceeds from a nonrecourse mortgage, the purchaser becomes the sole owner of the property. 331 U.S., at 6, 67 S.Ct., at 1050. Under the *Crane* approach, the mortgagee is entitled to no portion of the basis. *Id.*, at 10, n. 28, 67 S.Ct., at 1052, n. 28. The nonrecourse mortgage is part of the mortgagor's investment in the property, and does not constitute a coinvestment by the mortgagee. But see Note, 82 Colum.L.Rev., at 1513 (treating nonrecourse mortgage as coinvestment by mortgagee and critically concluding that *Crane* departed from traditional analysis that basis is taxpayer's investment in property).

sen to accord it the same treatment he gives to a recourse mortgage loan. The Court approved that choice in *Crane*, and the respondents do not challenge it here. The choice and its resultant benefits to the taxpayer are predicated on the assumption that the mortgage will be repaid in full.

When encumbered property is sold or otherwise disposed of and the purchaser assumes the mortgage, the associated ⊥309 extinguishment of the mortgagor's obligation to repay is accounted for in the computation of the amount realized.[6] See *United States v. Hendler*, 303 U.S. 564, 566–567, 58 S.Ct. 655, 656, 82 L.Ed. 1018 (1938). Because no difference between recourse and nonrecourse obligations is recognized in calculating basis,[7] *Crane* teaches that the Commissioner may ignore the nonrecourse nature of the obligation in determining the amount realized upon disposition of the encumbered property. He thus may include in the amount realized the amount of the nonrecourse mortgage assumed by the purchaser. The rationale for this treatment is that the original inclusion of the amount of the mortgage in basis rested on the assumption that the mortgagor incurred an obligation to repay. Moreover, this treatment balances the fact that the mortgagor originally received the proceeds of the nonrecourse loan tax-free on the same assumption. ⊥310 Unless the outstanding amount of the mortgage is deemed to be realized, the mortgagor effectively will have received untaxed income at the time the loan was extended and will have received an unwarranted increase in the basis of his property.[8] The Commissioner's interpretation of § 1001(b) in this fashion cannot be said to be unreasonable.

C

The Commissioner in fact has applied this rule even when the fair market value of the property falls below the amount of the nonrecourse obligation. Treas.Reg. § 1.1001–2(b), 26 CFR § 1.1001–2(b) (1982);[9] Rev.Rul. 76–111, 1976–1 Cum.Bull. 214. Because the theory on which the rule is based applies equally in this situation, see *Millar v. Commissioner*, 67 T.C. 656, 660 (1977), aff'd on this issue, 577 F.2d 212, 215–216 (CA3), cert. denied, 439 U.S. 1046,

6. In this case, respondents received the face value of their note as loan proceeds. If respondents initially had given their note at a discount, the amount realized on the sale of the securing property might be limited to the funds actually received. See *Commissioner v. Rail Joint Co.*, 61 F.2d 751, 752 (CA2 1932) (cancellation of indebtedness); *Fashion Park, Inc. v. Commissioner*, 21 T.C. 600, 606 (1954) (same). See generally J. Sneed, The Configurations of Gross Income 319 (1967) ("[I]t appears settled that the reacquisition of bonds at a discount by the obligor results in gain only to the extent the issue price, where this is less than par, exceeds the cost of reacquisition").

7. The Commissioner's choice in *Crane* "laid the foundation stone of most tax shelters," Bittker, Tax Shelters, Nonrecourse Debt, and the *Crane* Case, 33 Tax L.Rev. 277, 283 (1978), by permitting taxpayers who bear no risk to take deductions on depreciable property. Congress recently has acted to curb this avoidance device by forbidding a taxpayer to take depreciation deductions in excess of amounts he has at risk in the investment. Pub.L. 94–455, § 204(a), 90 Stat. 1531 (1976), 26 U.S.C. § 465; Pub.L. 95–600, §§ 201–204, 92 Stat. 2814–2817 (1978), 26 U.S.C. § 465(a) (1976 ed., Supp. V). Real estate investments, however, are exempt from this prohibition. § 465(c)(3)(D) (1976 ed., Supp. V). Although this congressional action may foreshadow a day when nonrecourse and recourse debts will be treated differently, neither Congress nor the Commissioner has sought to alter *Crane's* rule of including nonrecourse liability in both basis and the amount realized.

8. Although the *Crane* rule has some affinity with the tax benefit rule, see Bittker, *supra*, at 282; Del Cotto, Sales and Other Dispositions of Property Under Section 1001: The Taxable Event, Amount Realized and Related Problems of Basis, 26 Buffalo L.Rev. 219, 323–324 (1977), the analysis we adopt is different. Our analysis applies even in the situation in which no deductions are taken. It focuses on the obligation to repay and its subsequent extinguishment, not on the taking and recovery of deductions. See generally Note, 82 Colum.L.Rev., at 1526–1529.

9. The regulation was promulgated while this case was pending before the Court of Appeals for the Fifth Circuit. T.D. 7741, 45 Fed.Reg. 81743, 1981–1 Cum.Bull. 430 (1980). It merely formalized the Commissioner's prior interpretation, however.

99 S.Ct. 721, 58 L.Ed.2d 704 (1978);[10] *Mendham Corp. v. Commissioner,* 9 T.C. 320, 323–324 (1947); *Lutz & Schramm Co. v. Commissioner,* 1 T.C. 682, 688–689 (1943), we have no reason, after *Crane,* to question this treatment.[11]

⊥311 ⊥Respondents received a mortgage loan with the concomitant obligation to repay by the year 2012. The only difference between that mortgage and one on which the borrower ⊥312 ⊥is personally liable is that the mortgagee's remedy is limited to foreclosing on the securing property. This difference does not alter the nature of the obligation; its only effect is to shift from the borrower to the lender any potential loss caused by devaluation of the property.[12] If the fair market value of the property falls below the amount of the outstanding obligation, the mortgagee's ability to protect its interests is impaired, for the mortgagor is free to abandon the property to the mortgagee and be relieved of his obligation.

This, however, does not erase the fact that the mortgagor received the loan proceeds tax-free and included them in his basis on the understanding that he had an

10. The Court of Appeals for the Third Circuit in *Millar* affirmed the Tax Court on the theory that inclusion of nonrecourse liability in the amount realized was necessary to prevent the taxpayer from enjoying a double deduction. 577 F.2d, at 215; cf. n. 4, *supra.* Because we resolve the question on another ground, we do not address the validity of the double deduction rationale.

11. Professor Wayne G. Barnett, as *amicus* in the present case, argues that the liability and property portions of the transaction should be accounted for separately. Under his view, there was a transfer of the property for $1.4 million, and there was a cancellation of the $1.85 million obligation for a payment of $1.4 million. The former resulted in a capital loss of $50,000, and the latter in the realization of $450,000 of ordinary income. Taxation of the ordinary income might be deferred under § 108 by a reduction of respondents' bases in their partnership interests.

Although this indeed could be a justifiable mode of analysis, it has not been adopted by the Commissioner. Nor is there anything to indicate that the Code requires the Commissioner to adopt it. We note that Professor Barnett's approach does assume that recourse and nonrecourse debt may be treated identically.

The Commissioner also has chosen not to characterize the transaction as cancellation of indebtedness. We are not presented with and do not decide the contours of the cancellation-of-indebtedness doctrine. We note only that our approach does not fall within certain prior interpretations of that doctrine. In one view, the doctrine rests on the same initial premise as our analysis here—an obligation to repay—but the doctrine relies on a freeing-of-assets theory to attribute ordinary income to the debtor upon cancellation. See *Commissioner v. Jacobson,* 336 U.S. 28, 38–40, 69 S.Ct. 358, 363–64, 93 L.Ed. 477 (1949); *United States v. Kirby Lumber Co.,* 284 U.S. 1, 3, 52 S.Ct. 4, 76 L.Ed. 131 (1931). According to that view, when nonrecourse debt is forgiven, the debtor's basis in the securing property is reduced by the amount of debt canceled, and realization of income is deferred until the sale of the property. See *Fulton Gold Corp. v. Commissioner,* 31 B.T.A. 519, 520 (1934). Because that interpretation attributes income only when assets are freed, however, an insolvent debtor realizes income just to the extent his assets exceed his liabilities after the cancellation. *Lakeland Grocery Co. v. Commissioner,* 36 B.T.A. 289, 292 (1937). Similarly, if the nonrecourse indebtedness exceeds the value of the securing property, the taxpayer never realizes the full amount of the obligation canceled because the tax law has not recognized negative basis.

Although the economic benefit prong of *Crane* also relies on a freeing-of-assets theory, that theory is irrelevant to our broader approach. In the context of a sale or disposition of property under § 1001, the extinguishment of the obligation to repay is not ordinary income; instead, the amount of the canceled debt is included in the amount realized, and enters into the computation of gain or loss on the disposition of property. According to *Crane,* this treatment is no different when the obligation is nonrecourse: the basis is not reduced as in the cancellation-of-indebtedness context, and the full value of the outstanding liability is included in the amount realized. Thus, the problem of negative basis is avoided.

12. In his opinion for the Court of Appeals in *Crane,* Judge Learned Hand observed:
"[The mortgagor] has all the income from the property; he manages it; he may sell it; any increase in its value goes to him; any decrease falls on him, until the value goes below the amount of the lien.... When therefore upon a sale the mortgagor makes an allowance to the vendee of the amount of the lien, he secures a release from a charge upon his property quite as though the vendee had paid him the full price on condition that before he took title the lien should be cleared...." 153 F.2d 504, 506 (CA2 1945).

obligation to repay the full amount. See *Woodsam Associates, Inc. v. Commissioner*, 198 F.2d 357, 359 (CA2 1952); Bittker, *supra* n. 7, at 284. When the obligation is canceled, the mortgagor is relieved of his responsibility to repay the sum he originally received and thus realizes value to that extent within the meaning of § 1001(b). From the mortgagor's point of view, when his obligation is assumed by a third party who purchases the encumbered property, it is as if the mortgagor first had been paid with cash borrowed by the third party from the mortgagee on a nonrecourse basis, and then had used the cash to satisfy his obligation to the mortgagee.

Moreover, this approach avoids the absurdity the Court recognized in *Crane*. Because of the remedy accompanying the mortgage in the nonrecourse situation, the
313 depreciation in the fair market value of the property is relevant economically only to the mortgagee, who by lending on a nonrecourse basis remains at risk. To permit the taxpayer to limit his realization to the fair market value of the property would be to recognize a tax loss for which he has suffered no corresponding economic loss.[13] Such a result would be to construe "one section of the Act ... so as ... to defeat the intention of another or to frustrate the Act as a whole." 331 U.S., at 13, 67 S.Ct., at 1054.

In the specific circumstances of *Crane*, the economic benefit theory did support the Commissioner's treatment of the nonrecourse mortgage as a personal obligation. The footnote in *Crane* acknowledged the limitations of that theory when applied to a different set of facts. *Crane* also stands for the broader proposition, however, that a nonrecourse loan should be treated as a true loan. We therefore hold that a taxpayer must account for the proceeds of obligations he has received tax-free and included in basis. Nothing in either § 1001(b) or in the Court's prior decisions requires the Commissioner to permit a taxpayer to treat a sale of encumbered property asymmetrically, by including the proceeds of the nonrecourse obligation in basis but not accounting for the proceeds upon transfer of the encumbered property. See
Estate of Levine v. Commissioner, 634 314
F.2d 12, 15 (CA2 1980).

III

[2] Relying on the Code's § 752(c), 26 U.S.C. § 752(c), however, respondents argue that Congress has provided for precisely this type of asymmetrical treatment in the sale or disposition of partnership property. Section 752 prescribes the tax treatment of certain partnership transactions,[14]

13. In the present case, the Government bore the ultimate loss. The nonrecourse mortgage was extended to respondents only after the planned complex was endorsed for mortgage insurance under §§ 221(b) and (d)(4) of the National Housing Act, 12 U.S.C. §§ 1715*l* (b) and (d)(4) (1976 ed. and Supp. V). After acquiring the complex from respondents, Bayles operated it for a few years, but was unable to make it profitable. In 1974, F & H foreclosed, and the Department of Housing and Urban Development paid off the lender to obtain title. In 1976, the Department sold the complex to another developer for $1,502,000. The sale was financed by the Department's taking back a note for $1,314,800 and a nonrecourse mortgage. To fail to recognize the value of the nonrecourse loan in the amount realized, therefore, would permit respondents to compound the Government's loss by claiming the tax benefits of that loss for themselves.

14. Section 752 provides:

"(a) Increase in partner's liabilities

"Any increase in a partner's share of the liabilities of a partnership, or any increase in a partner's individual liabilities by reason of the assumption by such partner of partnership liabilities, shall be considered as a contribution of money by such partner to the partnership.

"(b) Decrease in partner's liabilities

"Any decrease in a partner's share of the liabilities of a partnership, or any decrease in a partner's individual liabilities by reason of the assumption by the partnership of such individual liabilities, shall be considered as a distribution of money to the partner by the partnership.

"(c) Liability to which property is subject

"For purposes of this section, a liability to which property is subject shall, to the extent of the fair market value of such property, be considered as a liability of the owner of the property.

"(d) Sale or exchange of an interest

"In the case of a sale or exchange of an interest in a partnership, liabilities shall be treated in the same manner as liabilities in and § 752(c) provides that "[f]or purposes of this section, a liability to which property is subject shall, to the extent of the fair market value of such property, be considered as a liability of the owner of the property." Section 752(c) could be read to apply to a sale or disposition of partnership property, and thus to limit the amount realized to the fair market value of the property transferred. Inconsistent with this interpretation, however, is the language of § 752(d), which specifically mandates that partnership liabilities be treated "in the same manner as liabilities in connection with the sale or exchange ⊥315 of property not associated with partnerships." The apparent conflict of these subsections renders the facial meaning of the statute ambiguous, and therefore we must look to the statute's structure and legislative history.

Subsections (a) and (b) of § 752 prescribe rules for the treatment of liabilities in transactions between a partner and his partnership, and thus for determining the partner's adjusted basis in his partnership interest. Under § 704(d), a partner's distributive share of partnership losses is limited to the adjusted basis of his partnership interest. 26 U.S.C. § 704(d) (1976 ed., Supp. V); see Perry, Limited Partnerships and Tax Shelters: The *Crane* Rule Goes Public, 27 Tax L.Rev. 525, 543 (1972). When partnership liabilities are increased or when a partner takes on the liabilities of the partnership, § 752(a) treats the amount of the increase or the amount assumed as a contribution by the partner to the partnership. This treatment results in an increase in the adjusted basis of the partner's interest and a concomitant increase in the § 704(d) limit on his distributive share of any partnership loss. Conversely, under § 752(b), a decrease in partnership liabilities or the assumption of a partner's liabilities by the partnership has the effect of a distribution, thereby reducing the limit on the partner's distributive share of the partnership's losses. When property encumbered by liabilities is contributed to or distributed from the partnership, § 752(c) prescribes that the liability shall be considered to be assumed by the transferee only to the extent of the property's fair market value. Treas.Reg. § 1.752–1(c), 26 CFR § 1.752–1(c) (1982).

The legislative history indicates that Congress contemplated this application of § 752(c). Mention of the fair market value limitation occurs only in the context of transactions under subsections (a) and (b).[15] The sole reference to subsec⊥316tion (d) does not discuss the limitation.[16] While the legislative history is certainly not conclusive, it indicates that the fair market value limitation of § 752(c) was directed to transactions between a partner and his partnership.[17] 1 A. Willis, J. Pennell, & P. Postle-

connection with the sale or exchange of property not associated with partnerships."

15. "The transfer of property subject to a liability by a partner to a partnership, or by the partnership to a partner, shall, to the extent of the fair market value of such property, be considered a transfer of the amount of the liability along with the property." H.R.Rep.No. 1337, 83d Cong., 2d Sess., A236 (1954); S.Rep.No. 1622, 83d Cong., 2d Sess., 405 (1954).

16. "When a partnership interest is sold or exchanged, the general rule for the treatment of the sale or exchange of property subject to liabilities will be applied." H.R.Rep. No. 1337, at A236–A237; S.Rep. No. 1622, at 405. These Reports then set out an example of subsection (d)'s application, which does not indicate whether the debt is recourse or nonrecourse.

17. The Treasury Regulations support this view. The Regulations interpreting § 752(c) state:

"Where property subject to a liability is contributed by a partner to a partnership, or distributed by a partnership to a partner, the amount of the liability, to an extent not exceeding the fair market value of the property at the time of the contribution or distribution, shall be considered as a liability assumed by the transferee." § 1.752–1(c), 26 CFR § 1.752–1(c) (1982). The Regulations also contain an example applying the fair market limitation to a contribution of encumbered property by a partner to a partnership. *Ibid.* The Regulations interpreting § 752(d) make no mention of the fair market limitation. § 752–1(d). Both Regulations were issued contemporaneously with the passage of the statute, T.D. 6175, 1956–1 Cum.Bull. 211, and are entitled to deference as an administrative interpretation of the statute. See *Commissioner v. South Texas Lumber Co.,* 333 U.S. 496, 501, 68 S.Ct. 695, 698, 92 L.Ed. 831 (1948).

waite, Partnership Taxation § 44.03, p. 44–3 (3d ed. 1981); Simmons, *Tufts v. Commissioner:* Amount Realized Limited to Fair Market Value, 15 U.C.D.L.Rev. 577, 611–613 (1982).

By placing a fair market value limitation on liabilities connected with property contributions to and distributions from partnerships under subsections (a) and (b), Congress apparently intended § 752(c) to prevent a partner from inflating the basis of his partnership interest. Otherwise, a partner with no additional capital at risk in the partnership could raise the § 704(d) limit on his distributive share of partnership losses or could reduce his taxable gain upon disposition of his partner⊥317ship interest. See Newman, The Resurgence of Footnote 37: *Tufts v. Commissioner,* 18 Wake Forest L.Rev. 1, 16, n. 116 (1982). There is no potential for similar abuse in the context of § 752(d) sales of partnership interests to unrelated third parties. In light of the above, we interpret subsection (c) to apply only to § 752(a) and (b) transactions, and not to limit the amount realized in a sale or exchange of a partnership interest under § 752(d).

IV

[3] When a taxpayer sells or disposes of property encumbered by a nonrecourse obligation, the Commissioner properly requires him to include among the assets realized the outstanding amount of the obligation. The fair market value of the property is irrelevant to this calculation. We find this interpretation to be consistent with *Crane v. Commissioner,* 331 U.S. 1, 67 S.Ct. 1047, 91 L.Ed. 1301 (1947), and to implement the statutory mandate in a reasonable manner. *National Muffler Dealers Assn. v. United States,* 440 U.S. 472, 476, 99 S.Ct. 1304, 1306, 59 L.Ed.2d 519 (1979).

The judgment of the Court of Appeals is therefore reversed.

It is so ordered.

Justice O'CONNOR, concurring.

I concur in the opinion of the Court, accepting the view of the Commissioner. I do not, however, endorse the Commissioner's view. Indeed, were we writing on a slate clean except for the decision in *Crane Commissioner,* 331 U.S. 1, 67 S.Ct. 1047, 91 L.Ed. 1301 (1947), I would take quite a different approach—that urged upon us by Professor Barnett as *amicus.*

Crane established that a taxpayer could treat property as entirely his own, in spite of the "coinvestment" provided by his mortgagee in the form of a nonrecourse loan. That is, the full basis of the property, with all its tax consequences, belongs to the mortgagor. That rule alone, though, does not in any way tie nonrecourse debt to the cost of property or to the proceeds upon disposition. I see no reason to treat the ⊥318 purchase, ownership, and eventual disposition of property differently because the taxpayer also takes out a mortgage, an independent transaction. In this case, the taxpayer purchased property, using nonrecourse financing, and sold it after it declined in value to a buyer who assumed the mortgage. There is no economic difference between the events in this case and a case in which the taxpayer buys property with cash; later obtains a nonrecourse loan by pledging the property as security; still later, using cash on hand, buys off the mortgage for the market value of the devalued property; and finally sells the property to a third party for its market value.

The logical way to treat both this case and the hypothesized case is to separate the two aspects of these events and to consider, first, the ownership and sale of the property, and, second, the arrangement and retirement of the loan. Under *Crane,* the fair market value of the property on the date of acquisition—the purchase price—represents the taxpayer's basis in the property, and the fair market value on the date of disposition represents the proceeds on sale. The benefit received by the taxpayer in return for the property is the cancellation of a mortgage that is worth no more than the fair market value of the property, for that is all the mortgagee can expect to collect on the mortgage. His gain or loss on the disposition of the property equals the difference between the proceeds and the cost of acquisition. Thus, the taxation of the transaction *in property* reflects the economic fate of the *property*. If the property has declined in value, as was the case here, the taxpayer recognizes a loss on the disposition of the property. The new purchaser then takes as his basis the fair market value as of the date of the sale. See, *e.g., United States v. Davis,* 370 U.S. 65, 72, 82 S.Ct. 1190, 1194, 8 L.Ed.2d 335 (1962); *Gibson Products Co. v. United States,* 637 F.2d 1041, 1045, n. 8 (CA5 1981) (dictum); see generally Treas.Reg. § 1.1001–2(a)(3), 26 CFR § 1.1001–2(a)(3) (1982); 2 B. Bittker, Federal Taxation of Income, Estates and Gifts ¶ 41.2.2., pp. 41–10—41–11 (1981).

319 In the separate borrowing transaction, the taxpayer acquires cash from the mortgagee. He need not recognize income at that time, of course, because he also incurs an obligation to repay the money. Later, though, when he is able to satisfy the debt by surrendering property that is worth less than the face amount of the debt, we have a classic situation of cancellation of indebtedness, requiring the taxpayer to recognize income in the amount of the difference between the proceeds of the loan and the amount for which he is able to satisfy his creditor. 26 U.S.C. § 61(a)(12). The taxation of the financing transaction then reflects the economic fate of the loan.

The reason that separation of the two aspects of the events in this case is important is, of course, that the Code treats different sorts of income differently. A gain on the sale of the property may qualify for capital gains treatment, §§ 1202, 1221 (1976 ed., and Supp. V), while the cancellation of indebtedness is ordinary income, but income that the taxpayer may be able to defer. §§ 108, 1017 (1976 ed. Supp. V). Not only does Professor Barnett's theory permit us to accord appropriate treatment to each of the two types of income or loss present in these sorts of transactions, it also restores continuity to the system by making the taxpayer-seller's proceeds on the disposition of property equal to the purchaser's basis in the property. Further, and most important, it allows us to tax the events in this case in the same way that we tax the economically identical hypothesized transaction.

Persuaded though I am by the logical coherence and internal consistency of this approach, I agree with the Court's decision not to adopt it judicially. We do not write on a slate marked only by *Crane.* The Commissioner's longstanding position, Rev. Rul. 76–111, 1976–1 Cum.Bull. 214, is now reflected in the regulations. Treas.Reg. § 1.1001–2, 26 CFR § 1.1001–2 (1982). In the light of the numerous cases in the lower courts including the amount of the unrepaid proceeds of the mortgage in the proceeds on sale or disposition, see, *e.g.,* 320
Estate of Levine v. Commissioner, 634 F.2d 12, 15 (CA2 1980); *Millar v. Commissioner,* 577 F.2d 212 (CA3), cert. denied, 439 U.S. 1046, 99 S.Ct. 721, 58 L.Ed.2d 704 (1978); *Estate of Delman v. Commissioner,* 73 T.C. 15, 28–30 (1979); *Peninsula Properties Co., Ltd. v. Commissioner,* 47 B.T.A. 84, 92 (1942), it is difficult to conclude that the Commissioner's interpretation of the statute exceeds the bounds of his discretion. As the Court's opinion demonstrates, his interpretation is defensible. One can reasonably read § 1001(b)'s reference to "the amount realized *from* the sale or other disposition of property" (emphasis added) to permit the Commissioner to collapse the two aspects of the transaction. As long as his view is a reasonable reading of § 1001(b), we should defer to the regulations promulgated by the agency charged with interpretation of the statute. *National Muffler Dealers Assn. v. United States,* 440 U.S. 472, 488–489, 99 S.Ct. 1304, 1312–13, 59 L.Ed.2d 519 (1979); *United States v. Correll,* 389 U.S. 299, 307, 88 S.Ct. 445, 449, 19 L.Ed.2d 537 (1967); see also *Fulman v. United States,* 434 U.S. 528, 534,

98 S.Ct. 841, 845, 55 L.Ed.2d 1 (1978). Accordingly, I concur.

461 U.S. 321, 75 L.Ed.2d 879

Oralia MARTINEZ, as Next Friend of Roberto Morales, Petitioner

v.

Raymon L. BYNUM, etc., et al.

No. 81–857.

Argued Jan. 10, 1983.

Decided May 2, 1983.

Suit was brought challenging constitutionality of Texas statute permitting school district to deny tuition-free admission to its public schools for a minor who lived apart from a "parent, guardian, or other person having lawful control of him" if his presence in the district was "for the primary purpose of attending the public free schools." The United States District Court for the Southern District of Texas, 482 F.Supp. 212, George P. Kazen, J., found for defendants, and plaintiffs appealed. The Court of Appeals for the Fifth Circuit, 648 F.2d 425, Politz, Circuit Judge, affirmed, and certiorari was granted. The Supreme Court, Justice Powell, held that the statute was a bona fide residence requirement that satisfied constitutional standards.

Affirmed.

Justice Brennan concurred and filed an opinion.

Justice Marshall dissented and filed an opinion.

1. Constitutional Law ⇨83(1), 242.2(5) Schools ⇨10

Bona fide residence requirement, of Texas statute, which was appropriately defined and uniformly applied with respect to attendance in free public schools, did not violate equal protection clause of Fourteenth Amendment, and does not burden or penalize constitutional right of interstate travel. U.S.C.A. Const.Amend. 14; V.T.C.A., Education Code § 21.031(d).

2. Constitutional Law ⇨42.1(4)

Even if Texas statute governing residency requirement for minors who wished to attend public schools while living apart from their parents or guardians could be read to exclude child who moved to school district with intent of making his home there when desire to make new home was motivated solely by desire to attend school, sister of such a child did not have standing to raise constitutionality claim on behalf of child, where record showed that child did not intend to make his home in city where his sister lived. V.T.C.A., Education Code § 21.031(d).

3. Schools ⇨10

Texas statute permitting school district to deny free admission to minor who lived apart from his parent or guardian if his presence in district was for primary purpose of attending free public schools was a bona fide residence requirement that satisfied constitutional standards. V.T.C.A., Education Code § 21.031(d); U.S.C.A. Const.Amend. 14.

Syllabus *

Texas Education Code § 21.031(d) permits a school district to deny tuition-free admission to its public schools for a minor who lives apart from a "parent, guardian, or other person having lawful control of him" if his presence in the district is "for the primary purpose of attending the public free schools." Petitioner's brother left his parents' home in Mexico to live with petitioner in McAllen, Tex., for the primary purpose of attending school there. When the School District denied her brother's ap-

* The syllabus constitutes no part of the opinion of the Court but has been prepared by the Reporter of Decisions for the convenience of the reader. See *United States v. Detroit Lumber Co.*, 200 U.S. 321, 337, 26 S.Ct. 282, 287, 50 L.Ed. 499.

Law 5267: Tax Accounting
Reading #8

Code: §§ 1001(a), (b); 453(a), (b), (c), (d), (f), (j); 453B(a), (b).
Regulations: § 1.453-9(a), (b).
Temp. Regulations: § 15a.453-1(a), (b), (d).

Crane v. Commissioner, 331 U.S. 1 (1947); and
Commissioner v. Tufts, 461 U.S. 300 (1983).

Problem:

(a) Stan owns Greenacre, 20 acres of raw land held for investment purposes, with a basis of $30,000 and a fair market value of $100,000. The land is subject to a $30,000 nonrecourse mortgage. Stan sells the land for $20,000 in cash and a $50,000 note, payable at the rate of $10,000 per year, plus 10% annual interest on the unpaid balance of the note. The first annual payment on the note is due one year from the date of sale. In addition, Ollie, the purchaser, agrees to take the land subject to the mortgage.

How much gain or loss does Stan realize and when does he report it? Consider Reg. § 15A.453-1(b).

(b) Assume the same facts as in (a), except that the mortgage is with recourse. Does this affect when Stan will report the gain?

(c) Assume the same facts as in (a), except that the outstanding mortgage on the land is in the amount of $40,000 and Stan receives only $10,000 in cash in the year of sale. How much gain or loss does Stan realize and when does he report it? How does Reg. § 15A.453-1(b)(3)(i) accommodate the Crane and Tufts cases?

Law 5267: Tax Accounting

Reading #9

Code § 1272.

Problems:

1. On January 1, 2016, Wile E. Coyote, a cash basis taxpayer, pays $7,462 to purchase a bond issued on that date by Acme Corporation. The bond has a face value of $10,000 and a redemption date of December 31, 2018. There is no stated interest. What does Wile include in income and when? What does Acme deduct and when?

(Hint: "Growing" at an annual rate of 10%, compounded semi-annually, a sum of $7,462 on January 1, 2016, will amount to $10,000 by December 31, 2018.)

2. Same as above, except that the bond has a face value of $8,300 and makes six semi-annual interest payments of $250, with the first payment due on June 30, 2016, and the last payment due on December 31, 2018. What does Wile include in income and when? What does Acme deduct and when?

Law 5267: Tax Accounting

Reading #10

Code §§ 1274, 1274A, 7872.

Problems:

1. On January 1, 2016, Wile E. Coyote, a cash basis taxpayer, pays $7,462 to purchase a bond issued on that date by Acme Corporation. The bond has a face value of $10,000 and a redemption date of December 31, 2018. There is no stated interest.

a. Suppose Wile sold the note on January 1, 2017, for $8,227. What would he report?

b. What if Wile sold the note for $8,500?

2. Dilbert's employer loans him $100,000, which he is required to pay back at the end of three years. There is no interest stated. Assume the applicable federal rate is 10 percent compounded semiannually.

a. What does the employer include in income (or deduct) and when?

b. What does Dilbert include (or deduct) and when?

c. What if the $100,000 is payable on demand?

d. How would your answers above change if instead of his employer, Dilbert's father had loaned him the money?

3. Lucy holds Blackacre, 20 acres of raw land, with an adjusted basis of $400,000.

a. If Lucy sells Blackacre to Ricky for $800,000 cash, what would she report and when? What is Ricky's basis in Blackacre?

b. How would your answers in part (a) change if Lucy sells Blackacre to Ricky for $200,000 in cash and three $200,000 notes due on January 1st of each of the next three years? The notes have adequate stated interest.

c. How would your answers in part (a) change if there is a $300,000 mortgage on the property that was included in Lucy's $400,000 basis? Ricky assumes the mortgage and gives Lucy five $100,000 notes due on January 1st of each of the next five years. The notes have adequate stated interest.

d. How would your answers in part (c) change if the mortgage was an after-acquired mortgage so that Lucy's original cost basis was only $100,000?

e. How would your answers in part (a) change if Ricky agrees to pay $1,011,000 for Blackacre? He gives Lucy a $100,000 down payment and a note with a redemption price of $911,000 due at the end of Year 3. There is no stated interest on the note. Assume the applicable federal rate is 10 percent compounded semiannually. Assume $911,000 discounted at 9 percent compounded semiannually for three years is $700,000.

Law 5267: Tax Accounting
Reading #11

Code §§ 446(a)-(c); 451(a); 461(a),(h), (i)(1).

Problems:

1. You are the lawyer for Christina Wilson, winner of Season 10 of the reality TV show "Hell's Kitchen," starring Gordon Ramsay, and broadcast on Fox. Christina is a cash-basis taxpayer. Describe the likely treatment of each of the following and provide relevant advice:

a. You meet with Christina for the first time on December 15, 2019. She informs you that Fox would like to add her to the cast of the show for next season. Fox has offered her a signing bonus of $1 million, which she is inclined to accept. If she does accept, Fox will mail her a check for that amount immediately. Christina tells you that she will just spend the money if she gets it and would prefer to be paid out in the future, say in two years, when she may not be so much in demand. What other information would you need to provide adequate advice?

b. To offset her income, Christina's accountant suggests prepaying the entire cost of her 2019 contract with her investment advisor with a check for $240,000 (12 x $20,000) to be mailed on December 31, 2019.

c. Christina is also entitled to receive a salary of $2 million for a run of 13 episodes during the show's 2020 season. During the year, however, network executives make a number of highly insulting comments about the quality of the show and advertisers pull out. Viewership plummets, and Fox faces significant financial problems. Fox pays Christina none of her first-year salary and instead gives her an unsecured note for $2 million on December 10, 2020.

2. Now suppose that you are the tax lawyer for Backstage Inc., an accrual-basis taxpayer, that trains potential reality TV show actors. Describe the likely treatment of each of the following and provide relevant advice:

a. Backstage offers one-day training sessions for $200. On December 31, 2019, it conducts these sessions for 10 people who are presented a bill at the end of the day. None of them pays until January 2020. When does Backstage include that amount in income?

b. Suppose in the alternative that Backstage's premier package sells for $2,000 and entitles the purchaser to attend three years' worth of weekly classes. In November 2019, Backstage sells 10 of these packages. When does Backstage include that amount in income?

c. Backstage hires an instructor to teach some of the classes. Backstage and the instructor enter into a contract in November 2019 that requires Backstage to pay her $20,000 in exchange for her willingness to teach ten classes. Her contract, however, is guaranteed. Specifically, Backstage must pay her even if no one signs up for the classes. When can Backstage deduct her salary?

d. Backstage has an incredible stroke of good fortune when it is able to enter into a contract with Christina Wilson in December 2019 to be its spokesman. The contract guarantees Christina a payment of $2 million a year for the next ten years, payable at the end of each year. The accountant for Backstage suggested that because Christina's contract was guaranteed for ten years, that in 2019 Backstage should accrue a deduction for $20 million. She also recommended that the company purchase an annuity that will pay Backstage $2 million a year for ten years, beginning December 31, 2020. The accountant has received a price quotation of $14,720,000 for that annuity, reflecting an annual interest rate of 6 percent. When can Backstage deduct Christina's salary?