ARTICLES

THE TAX BENEFIT RULE

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INTRODUCTION

When a taxpayer recovers or collects an item that was deducted in an earlier year, he is ordinarily taxed on the amount received unless the prior deduction was of no "tax benefit" because it did not reduce his tax liability.1 Because each year's income tax return must be based on the facts as known during that year,2 the deduction in complete good faith of amounts that are recovered in later years is a familiar phenomenon. Creditors, for example, often deduct claims against debtors when they appear to be worthless but subsequently collect part or all of the debt when the debtor's financial circumstances unexpectedly improve. Another example is a claim against the taxpayer, such as a local property tax or an employee's salary, which is deducted when paid but recovered in part when subsequent events establish that the taxpayer paid more than he actually owed.

In the early days of the federal income tax, it was not clear


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that the taxpayer was required to report income on recovering these previously deducted amounts. If the deduction was erroneous when taken, of course, the IRS could assess a deficiency for the year in which the error occurred (assuming action before the year was closed by the statute of limitations); but if the deduction was justified on the facts as then known, it could not be retroactively disallowed, even if the statute of limitations had not run. As for the year of recovery, it was sometimes thought anomalous to require income to be reported when taxpayers merely collected amounts that were owing to them, or received refunds of amounts that had been paid by mistake, especially since *Eisner v. Macomber* defined the term “income” as used in the sixteenth amendment and the tax law as “gain derived from capital, from labor, or from both combined.” Thus, as late as 1929, the Board of Tax Appeals seemed uncertain about the validity of a Treasury regulation providing that the collection of a debt previously charged off as worthless must be included in income. Within a few months, however, the Board of Tax Appeals accepted the principle enunciated by this regulation; by 1931, it was described as a principle that “seems to be taken for granted, as indeed it must be”; and it has been a basic part of the federal income tax structure ever since.

In recent years the tax benefit rule has been applied to numerous areas of taxation. First a product of case law, it was embodied in the Internal Revenue Code thirty-five years ago in section 111, but it has refused to be confined by statute or code section. Its most well-documented recent extension has been in the area of corporate liquidations under sections 336 and 337.

3. Ordinarily a deficiency may not be assessed more than three years after the due date of the return. *See* I.R.C. § 6501(a).


5. Treasury Regulation 62, article 51, T.D. 3295, 24 Treas. Dec. Int. Rev. 230-31 (1922) (issued pursuant to the Revenue Act of 1921), carried forward the principle previously enunciated by Treasury Regulation 33, article 125 (1914) (promulgated under the Act of October 3, 1913). *See* Liberty Ins. Bank v. Commissioner, 14 B.T.A. 1428, 1434 (1929) (validity of regulation not decided, because the earlier deductions were erroneous when taken and hence subject to correction only by deficiency assessment which was barred by statute of limitations), rev’d, 59 F.2d 320 (6th Cir. 1932) (estoppel theory).

6. Excelsior Printing Co. v. Commissioner, 16 B.T.A. 886 (1929). Given the reservation expressed by the Board of Tax Appeals in Liberty Ins. Bank v. Commissioner, 14 B.T.A. 1428 (1929), it is surprising to discover that the taxability of the recovery was accepted without discussion in *Excelsior Printing*.


But the tax benefit rule has also found application in noncorporate taxation areas outside those explicitly mentioned by section 111 and has spawned related concepts along the way both through court decisions and statutes. As a result, the tax advisor needs to be aware of the principles underlying the rule, and alert to its application in new areas.

This Article adduces the considerations that justify the tax benefit rule's existence. Next, the Article distinguishes the exclusionary and inclusionary aspects of the rule. It then identifies the areas where the application of the tax benefit rule is now settled and those where its applicability remains debatable, pointing out the limitations on the rule and the formulations for its application which result from the mixture of case law and single-issue statutes which are the sources from which it has developed.

I. RATIONALES

Although the taxability of recovered amounts that were previously deducted rests primarily on judge-made rather than statutory law, the courts have not devoted much attention to its rationale and, when they have felt impelled to explain the principle, have not expounded wholly consistent theories. Thus, in National Bank of Commerce v. Commissioner,9 involving a bank's collection of loans to customers that had been deducted as bad debts, the court said that the deduction converted the claims from capital investments to potential income to be taxed if collected:

With regard to the recoveries made by petitioner on the debts previously charged off . . . the question as to the taxability thereof is: were they recoveries of capital? The Sixteenth Amendment of the Constitution authorizes Congress to levy taxes on "incomes, from whatever source derived". Such income is said to be "the gain derived from capital, from labor, or from both combined". Eisner v. Macomber, 252 U.S. 189, 207 [(1920)]. Money received from the conversion of capital represented by something other than money is not income within the meaning of the amendment, although a gain on the conversion is.

When [they] made loans of their capital, the repayment of the money lent was not income to the banks, although the interest paid by the borrower for the use of the capital was. Such interest, less whatever deductions may be permitted by statute, is the amount upon which the tax is computed. However, when such a loan becomes worthless, the amount thereof is loss of

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9. 115 F.2d 875 (9th Cir. 1940).
capital, but the income tax laws permit the bank to recoup its capital by deducting from the profits or income the amount of the loss. Thus the bank does not pay a tax on all its income, but on the amount of income less the loss on the worthless debt. The debt itself then loses its nature as capital, but represents that portion of the income which was not taxed, and the capital is the money taken from the profits or income. If the loan, after being deducted from income, is paid, then the lender is receiving profit or income—otherwise the lender would double its capital on one transaction. In other words, the profits or income used to pay back the capital when the debt is charged off is represented by the worthless loan, so that when such loan is paid the profits are replaced.10

Less elaborate than this imputed transubstantiation of capital into income is the “balancing entry” theory, whose premise is that the taxpayer's income over the long haul can be correctly computed only by requiring a recovery to be included in gross income, if the debt or other item was deducted in a prior year. Thus, in a case involving taxpayer's recovery of an amount that was embezzled and deducted in a prior year, the Board of Tax Appeals said: “The Commissioner has added no more to income [in the year of recovery] than has been deducted previously, thus bringing the amount of income reported over the period in balance with the actual income of the taxpayer for this period.”11 Acknowledging that the recovery of stolen funds is “compensation for loss” rather than income in the usual sense, the Board pointed out:

[T]he courts and this Board have been fully conscious of the fact that losses will some times be deducted where the future will eventually disclose compensation, and there will be reported as income that which is in fact only compensation for loss. But 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.12

In a later opinion, the Board of Tax Appeals observed even more bluntly that in order to reflect income accurately for the entire period, the taxpayer must make an adjustment “during the taxable year in which actually no income was received” (that is, the year of the recovery) because of the discovery in that year that the earlier deduction, though reasonable when taken, was unnecessary.13

10. Id. at 876-77. The amounts in question were not collected by the lending banks, but by their successor in interest, which was held by the court to occupy their status for this purpose.
12. Id. at 1432.
Still another rationale is based on a theory of waiver or estoppel:

I think that it must be agreed that the repayment of a debt is a return of capital. To my mind, no process of reasoning can make it anything else. Being in fact capital, it does not become income merely because it is not returned as agreed or when expected, or even if the owner concludes in his own mind that he will never get it again. To justify a tax upon the repayment of a debt by referring it to the statutory definition of gross income would undoubtedly extend the constitutional powers of Congress.

But a taxpayer may voluntarily submit to an otherwise illegal or unconstitutional imposition, and, if it is a condition of some benefit which is tendered to him, his acquiescence will be assumed or implied from his acceptance of the benefit. Deductions allowed by law from gross income are not matters of right but of grace. When a taxpayer claims and is allowed a bad debt against his taxable income there is no difficulty in finding an implied consent to be taxed in respect of future recovery of the bad debt, whether or not it is actually income. Whether this be called an implied agreement of waiver for valid consideration or an estoppel, is not of great importance.\(^1\)

While divergent, these theories share the notion that the recoveries do not constitute economic gain in the ordinary sense, and that their inclusion in income is an anomaly requiring an explanation. The premise, evidently, is that a creditor’s collection of an amount owed to him does not increase his net worth, even if he previously concluded that the debtor would never pay, and that a homeowner who receives a partial refund of his local property tax, following recomputation of his liability in the light of newly discovered evidence, would not ordinarily think that this was an income producing event. Thus the taxpayers in these cases are treated as realizing income only because they deducted amounts that, in the light of hindsight, exceeded their actual loss or cost.

In a perceptive recent comment, a Tax Court judge, viewing the tax benefit rule “in its true character—as a necessary counterweight to the consequences of the annual accounting principle,”\(^2\) observed:

The need to assess and collect taxes at fixed and relatively short intervals underpins the principle of taxation that transactions which may possibly be subject to further developments substantially altering their character for tax purposes should nevertheless be treated as final and closed so that their tax consequences can be determined. On the other hand, a taxpayer should not be permitted to take advantage of this governmental

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15. Munter’s Estate v. Commissioner, 63 T.C. 663, 678 (1975) (concurring opinion).
exigency to establish a distorted picture of his income for tax purposes. It is this countervailing consideration which spawned the tax benefit rule. The most common, and most nearly accurate, explanation of the rule is that it recognizes the "recovery" in the current year of taxable income earned in an earlier year but offset by the item deducted.\textsuperscript{16}

As a counterweight to the annual accounting principle, the tax benefit rule expresses a preference, from the perspective of accretions to wealth, for transactional equality of tax treatment over contemporaneous equality, that is, equality of treatment of taxpayers within a single year. Consider, for example, taxpayers \textit{A} and \textit{B} who in year one both take $10,000 deductions for uncompensated casualty losses. Taxpayer \textit{A} effects a tax saving from his deduction but, because of other deductions, taxpayer \textit{B} does not. In year ten, \textit{A} and \textit{B} each recover $10,000 for their losses after a protracted dispute with an insurance company. By linking up events in years one and ten, the tax benefit rule produces \textit{transactional} equality between taxpayers \textit{A} and \textit{B}. On the other hand, it produces contemporaneous inequality between \textit{A} and \textit{B} if year ten is considered alone.

Moreover, as a device to achieve transactional equality, the rule by no means insures that the tax on the recovery will be equal to the tax savings attributable to the prior deduction. Since marginal tax rates vary from year to year, particularly in the case of individuals, the increased tax in the year of recovery will usually either exceed or be less than the tax reduction enjoyed in the earlier year; rarely will the two amounts coincide. With one short-lived exception,\textsuperscript{17} however, the courts have been satisfied with the

\textsuperscript{16} Id. (citations omitted).

\textsuperscript{17} In Perry \textit{v. United States}, 160 F. Supp. 270 (Ct. Cl. 1958), the Court of Claims adopted an "exact tax benefit" rule, under which the recovery was taxed at the rate that was applicable to the deduction; it later overruled this decision and accepted the prevailing judicial view that the recovery is to be taxed at whatever rate is in effect for the year of receipt. Alice Phelan Sullivan Corp. \textit{v. United States}, 381 F.2d 399 (Ct. Cl. 1967).

From 1954 to 1976, I.R.C. § 1342 reached a similar result for certain recoveries of amounts paid as a result of a judicial decision in a patent infringement suit. Section 1346 (in force from 1941 to 1976) was also comparable to the "exact tax benefit" principle of the \textit{Perry} case; it permitted taxpayers receiving a repayment of unconstitutional federal taxes to choose between (a) excluding the receipt currently and amending the earlier year's return to eliminate the deduction (despite the running of the statute of limitations) and (b) reporting the recovery and paying the resulting tax. Sections 1342 and 1346 were repealed by Title XIX (the "deadwood" provisions) of the Tax Reform Act of 1976, Pub. L. No. 94-455, § 1901(a)(147)-(148), 90 Stat. 1788 (1976).

A model income tax statute drafted by an American Law Institute group proposed to require the inclusion of all recoveries of deductible items, whether the deduction was taken or not, and, if a deduction was taken, whether or not it resulted in a reduction of the taxpayer's tax, subject, however, to the taxpayer's option to reopen the earlier year if the statute of limitations had not expired or if the amount exceeded
rough and ready adjustment that results from taxing the recovery at whatever rate prevails in the year of recovery, and have not insisted on exacting a tax equal to the amount saved by the taxpayer in the earlier year.

Once the courts concluded that recovered amounts are taxable not because they increase the taxpayer’s net worth but because they are linked to a prior tax deduction, the door was opened to taxpayer claims that a recovery should be taxed only if the deduction actually reduced the taxpayer’s tax liability for the earlier year, but not if he had enough other deductions to eliminate any tax liability. As a limitation on the basic principle of taxing the recovery of previously deducted items, this aspect of the tax benefit principle had a checkered career in the courts for more than a decade, and the IRS also wavered between accepting and rejecting it.\(^8\) In 1942, however, Congress gave it formal endorsement by enacting the statutory predecessor of Internal Revenue Code section 111, which excludes from gross income the recovery of certain previously deducted items if the deduction “did not result in a reduction of the taxpayer’s tax” in prior years. Although section 111 accords this treatment explicitly only to the recovery of previously deducted bad debts, taxes (whether deducted or taken as a credit), and “delinquency amounts” (primarily interest on past-due taxes), the tax benefit principle is applied by regulations to a much wider assortment of items.\(^9\)

As employed since the enactment of section 111, the tax benefit rule is “both a rule of inclusion and exclusion: recovery of an item previously deducted must be included in income; that portion of the recovery not resulting in a prior tax benefit is excluded.”\(^20\) Section 111 is addressed solely to the exclusionary aspect of the tax benefit rule, as a shield for the taxpayer; but by necessary implication it ratifies the judge-made inclusionary component of the rule, as a sword for the government, without which there would be specified dollar or percentage limits. ALI FED. INCOME TAX STAT. § X332 (Feb. 1954 Draft).

\(^8\) For the twists and turns in the judicial doctrines and administrative rulings, see Tye, supra note 1, at 329.

\(^9\) Treas. Reg. § 1.111-1(a) (1960) (second sentence); see Part III infra.

\(^20\) Putoma Corp. v. Commissioner, 66 T.C. 652, 664 n.10 (1976). Sometimes both features of the rule are merged into a single formulation, as in Nash v. United States, 398 U.S. 1, 3 (1970) (“the so-called tax benefit rule, i.e., that 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”). On other occasions, the exclusionary qualification alone is described as “the tax benefit rule,” as in Alice Phelan Sullivan Corp. v. United States, 381 F. Supp. 399, 401-02 (1967), describing the tax benefit rule as a “limitation” on the principle that the recovery of deducted items generates income. But see Tennessee-Carolina Transp., Inc. v. Commissioner, 582 F.2d 378 (6th Cir. 1978) (referring to inclusionary aspect as “the” tax benefit rule); Rev. Rul. 77-67, 1977-1 C.B. 33 (referring to inclusionary aspect as “the” tax benefit rule).
no raw material on which section 111 could operate. In the discussion that follows, the threshold issue of inclusion will be examined first, and then the exclusionary aspect of the tax benefit rule, which serves to qualify its inclusionary requirement, will be discussed.

II. THE INCLUSION OF RECOVERED ITEMS

As discussed above, the inclusionary component of the tax benefit rule comes into play when the taxpayer recovers an item that would not be includible in income except for the fact that it was previously deducted or credited in computing his federal income tax liability for a prior year. Thus, it embraces a wide range of receipts, of which the most important are the following:

1. **Recoveries on bad debts.** From a historical perspective, the most common example of a recovery evoking application of the tax benefit rule is the collection of a debt that was previously deducted as worthless; this is probably still the most common instance. Such a recovery is subject to the tax benefit rule's inclusionary principle whether the

21. See Part II infra.

22. See Part III infra.

23. For problems in determining whether there has been a "recovery" to which the inclusionary aspect of the tax benefit rule applies, see Textron, Inc. v. United States, 561 F.2d 1023, 1030 (1st Cir. 1977) (Bownes, J., dissenting) (suggestion that a loss carryover is a recovery); Weyher v. Commissioner, 66 T.C. 825 (1976) (on sale of mortgaged property, seller recovered prepaid interest); Tennessee-Carolina Transp., Inc. v. Commissioner, 65 T.C. 440, 446 (1975), aff'd, 582 F.2d 378 (6th Cir. 1978) (expenses were "recovered" by corporation when distributed to shareholders in a corporate liquidation; extended dissent by seven judges); Treas. Reg. § 1.111-1(a)(2) (1960); Statutory Nonrecognition, note 8 supra.

24. Because the recovery of an amount that was taken as a credit is unusual, it is common to describe the tax benefit rule as applicable only to prior deductions, but Treasury Regulation § 1.111-1(b) (1960), recognizes that credits as well as deductions are embraced by the tax benefit rule. The principal example is the recovery of a foreign income tax that was used as a credit pursuant to § 901.

Other tax allowances may also serve as a foundation for the inclusionary aspect of the tax benefit rule. Thus, in Keystone Nat'l Bank v. United States, 52 Am. FED. TAX. REP. (P-H) 1511 (W.D. Pa. 1957), the taxpayer recovered embezzled funds that had been omitted from income when received because they were secretly misappropriated by an employee; the court held that the tax benefit resulting from this inadvertent omission from gross income warranted inclusion of the recovery in gross income when received. See also Alsop v. Commissioner, 290 F.2d 726 (2d Cir. 1961) (receipts includible not because they represent a "recovery" of embezzled funds, but because they became income to a cash basis taxpayer for the first time when received). An alternate approach to these cases would treat the omission as the equivalent of including the embezzled funds and deducting the same amount as a loss from theft.

For a case involving receipts in a year following an inventory write-down that did not produce a full tax benefit, see Union Trust Co. v. United States, 173 F.2d 54 (7th Cir.), cert. denied, 337 U.S. 940 (1949).

25. For the recovery of items that could have been, but were not, deducted in earlier years, see Boehm v. Commissioner, 146 F.2d 553 (2d Cir.), aff'd, 326 U.S. 287 (1945).
prior deduction was based on complete or partial worthlessness. The rule does not apply to debts that were charged off against a bad debt reserve, however, since in this situation the debt itself was not deducted, and recoveries are credited to the reserve rather than taken into income.26

2. **Tax refunds.** Refunds of taxes (including interest or other payments for delays or failures in filing returns or paying taxes) that were previously deducted or credited are listed by section 111 as items to which the exclusionary component of the tax benefit rule applies;27 and this carries the clear implication that the inclusionary part of the rule also applies to these items. Thus, they must be included in income, except to the extent that the prior deduction or credit produced no tax benefit.

3. **Casualty losses.** Casualty and other losses are deductible only if and to the extent that they are not compensated by insurance or otherwise.28 If the right to compensation is unknown, contested, or otherwise doubtful during the taxable year of the damage, however, the taxpayer is entitled to deduct the loss when it occurs but must include in income any subsequent recoveries.29

4. **Other losses.** If a taxpayer deducts a loss on selling property and subsequently recoups the loss in whole or in part from the person from whom he bought the property (for example, for misrepresenting its value or breaching a warranty), or from another third party for misconduct injuring the property, the recovery must be included in income.30

5. **Accrued liabilities abandoned by the creditor.** After issuing and deducting checks for such business expenses as wages, supplies, and customer overcharges, taxpayers often find that some checks are returned because the addressee cannot be found or are not cashed by the payee. Unless subject to a local escheat law, these unclaimed or abandoned items cannot remain outstanding for tax purposes forever. The inclusionary aspect of the tax benefit rule requires them to be taken into income, but the date when this is mandatory is unclear.31

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27. I.R.C. § 111(b)(2)-(3).
30. This is the only example given by the regulations of the "other items subject to the rule of exclusion" that are governed by I.R.C. § 111 although not expressly described therein. Treas. Reg. § 1.111-1(a)(1) (1960).
31. See Roxy Custom Clothes Corp. v. United States, 171 F. Supp. 851 (Ct. Cl. 1959) (income when accounts payable was credited to eliminate liability); Lime Cola Co. v. Commissioner, 22 T.C. 593, 601 (1954) (income when amount was credited to
6. *Unnecessary bad debt reserves.* Taxpayers using the reserve method of providing for bad debts make periodic additions to the reserve, which are deducted from income under Internal Revenue Code section 166(c). As specific debts become worthless, they are charged to the reserve, and any subsequent recoveries are credited to the reserve; and these adjustments affect the amounts to be added to the reserve thereafter. If the reserve becomes unnecessary (because, for example, the taxpayer sells its receivables, or changes from the reserve method to a direct charge-off method), the balance in the reserve must be taken into income, since the reserve was built up by prior deductions.

7. *Cancellation of taxpayer's indebtedness.* When a debt is discharged for less than its face amount, the debtor ordinarily realizes income under *United States v. Kirby Lumber Co.* and later cases. If the discharged debt gave rise to a tax deduction when it was incurred (for example, an accrual basis taxpayer's liability for wages or business supplies), then the *Kirby Lumber* principle overlaps the tax benefit doctrine in certain respects.

The inclusionary component of the tax benefit rule applies to the foregoing items because they involve the partial or complete recovery of amounts that were previously deducted or credited. In the absence of a prior tax allowance, however, the tax benefit rule does not require the inclusion in income of recoveries that do not increase the taxpayer's net worth. Thus, it does not embrace the recovery of items that did not give rise to tax allowances when paid or incurred, such as the refund of an amount paid for personal goods or services or a nondeductible tax (for example, the federal income tax or a local real property tax paid by a taxpayer who did not itemize his personal deductions) or the recovery of long-lost property (for example, forgotten bank accounts or misplaced jewelry). These events do not generate income even if the taxpayer views the recovery as a windfall because he never expected to see the items again. The same principle has been applied in surplus); G.M. Standifer Constr. Corp. v. Commissioner, 30 B.T.A. 184 (1934), *appeal dismissed*, 78 F.2d 285 (9th Cir. 1935) (income in year of settlement).

33. *See* Arcadia Sav. & Loan Ass'n v. Commissioner, 300 F.2d 247 (9th Cir. 1962) (sale of business); S. Rossin & Sons, Inc. v. Commissioner, 113 F.2d 652 (2d Cir. 1940) (shift to direct charge-off method); Geyer, Cornell & Newell, Inc. v. Commissioner, 6 T.C. 96 (1946) (need for reserve terminated in prior year, not before the court, when taxpayer abandoned line of business). Although § 111 does not apply to the recovery of specific debts charged to a bad debt reserve, *see* Treas. Reg. § 1.111-1(a)(1) (1960), it is applicable when the reserve itself is includible in income because the need therefore has ceased. *See* M & E Corp. v. Commissioner, 7 T.C. 1276 (1946); Rev. Rul. 65-258, 1965-2 C.B. 94. *See also* Haynsworth v. Commissioner, 68 T.C. 703 (1977) (closing of subdivider's reserve for development expenses generates income).
34. 284 U.S. 1 (1931).
It is not clear whether the inclusionary or exclusionary aspects of the tax benefit rule apply if the taxpayer claims a tax allowance based on a status for which he would not have qualified if his right to the recovery had been known when the status was determined. For example, a taxpayer may claim a dependency exemption of $1,000 on paying a grandchild's college tuition bill of $5,000. If the taxpayer later receives a refund of $1,500 because the bill was erroneously calculated, and would not have been entitled to the exemption if only $3,500 had been paid at the outset, it is not clear whether the refund must be included in income up to the amount of $1,000 under the inclusionary principle, and, if so, whether the exclusionary principle applies to exemptions that were of tax benefit.

The status of a recovered amount that was improperly deducted is also problematical. If the error was apparent on the face of the return, it has been held that the government's sole remedy is to assess a deficiency for the deduction year, and, if the statute of limitations has run, the IRS cannot seize upon a subsequent recovery and compel it to be included in income. A contrary rule would sanction an indirect recoupment by the IRS of its loss after the statute of limitations ran on the earlier year, but this hardly seems more objectionable than to allow the error to stand and also exclude the recovery from income when received. The earlier return must be examined in order to determine whether the recovered amount was properly deducted, since if it was properly deducted, the recovery is taxable. Thus, an exclusion for amounts that were improperly deducted is not a device to let sleeping dogs lie. The courts have held that the taxpayer cannot rely on the impropriety of the deduction if the earlier return was either deliberately or inadvertently "misleading," and that the recovery can be excluded only if the IRS should have known that the deduction was erroneous.

35. California & Hawaiian Sugar Ref. Corp. v. United States, 311 F.2d 235 (Ct. Cl. 1962); cf. I.R.C. § 1016(a)(3) (requiring the basis of property to be reduced by depreciation for periods when the taxpayer was not subject to federal income taxation).

36. Similar questions can arise with respect to the right to file a head of household or surviving spouse return or deduct medical expenses, privileges that are restricted to taxpayers who have a "dependent" within the meaning of I.R.C. § 152.


In *Boehm v. Commissioner*, the Second Circuit held that an amount received in settlement of a derivative stockholder's action by a taxpayer whose stock could have been, but was not, deducted as worthless in an earlier year was not includible in gross income when received. The taxpayer had actually claimed a loss in the earlier year but had abandoned the claim when it was disallowed by the IRS. Not being based on an estoppel rationale, the opinion is broad enough to exclude the recovery from income if the taxpayer, though entitled to a deduction in the earlier year, failed to claim it. A contrary rule would open the door, whenever a debt or other item is collected after a long delay, to an assertion by the IRS that it could have been deducted in an earlier year, and that the current receipt is a taxable recovery unless the hypothetical deduction would have produced no tax benefit. To be sure, *Boehm* enables the unusually prescient taxpayer to refrain from taking a deduction in a low-tax year in order to prepare the way for a subsequent tax-free recovery, but the likelihood of this abuse is slim, and it could be minimized by an exception for taxpayers who deliberately forego a clearly proper deduction.

When the inclusionary branch of the tax benefit rule is applicable, it is necessary to determine whether the taxable recovery constitutes ordinary income or capital gain. In making this determination the courts often impress the character of the original transaction on the recovery, rather than viewing it as an isolated transaction. When employed, this relation-back doctrine taxes the recovery as ordinary income if the earlier loss or expense was deducted from ordinary income; conversely, the recovery can, and usually does, constitute a capital gain if the earlier deduction was a capital loss.

### III. Exclusion of Items That Were Deducted Without Tax Benefit

The exclusionary aspect of the tax benefit rule, now embodied in Internal Revenue Code section 111, qualifies the rule's inclusionary principle by excluding the recovery from income if, and to the extent that, the earlier deductions or credits were of no tax benefit. This result is achieved by a "recovery exclusion," defined by section 111(b)(4) as the amount by which the deductions or credits failed to reduce the taxpayer's taxes, less any exclusion already allowed. Although section 111(a) explicitly sanctions a recovery exclusion for only three categories of recoveries—bad debts, prior taxes, and "delinquency amounts" (interest or other amounts paid or accrued for delays or failures in filing tax returns...
or paying taxes, etc.)—the regulations extend the same treatment to “all other losses, expenditures, and accruals made the basis of deductions,” with the exception of deductions for depreciation, depletion, amortization, or bond premiums.40

In determining whether a recovered item produced a tax benefit when it was deducted, the regulations assume that the deduction was used only if, and to the extent that, the taxpayer’s income exceeded his other deductions.41 This computational assumption, along with other aspects of the exclusion sanctioned by section 111, can be illustrated by the following examples,42 which compare the return as filed for the year when the recovered item was deducted with a hypothetical return for the same year without any section 111 items:

**Example A**

**Determination of Tax Benefit Attributable to Section 111 Items**

<table>
<thead>
<tr>
<th></th>
<th>A. 1977 Return as filed</th>
<th>B. Recomputation of 1977 return (without deduction of §111 items)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Gross income</td>
<td>$25,000</td>
<td>$25,000</td>
</tr>
<tr>
<td>2. Less deductions:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>a. Depreciation</td>
<td>$20,000</td>
<td>$20,000</td>
</tr>
<tr>
<td>b. Section 111 items (business bad debts and taxes)</td>
<td>6,300</td>
<td></td>
</tr>
<tr>
<td>c. Personal exemption</td>
<td>750</td>
<td>750</td>
</tr>
<tr>
<td>d. Total deductions</td>
<td>27,050</td>
<td>20,750</td>
</tr>
<tr>
<td>3. Taxable income (loss)</td>
<td>(2,050)</td>
<td>$4,250</td>
</tr>
<tr>
<td>4. Adjustment under section 172(d)(3)</td>
<td></td>
<td>750</td>
</tr>
<tr>
<td>5. Net operating loss (used in 1975)</td>
<td>($1,300)</td>
<td></td>
</tr>
</tbody>
</table>

The purpose of the comparison in Example A is to determine the amount (if any) of the tax benefit resulting from deducting the recovered items. From the comparison, it can be seen that the section 111 items, amounting in the aggregate to $6,300 (line 2b), served to offset $4,250 of 1977 income (line 3, as recomputed) and

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40. Treas. Reg. § 1.111-1(a) (1960); see note 46 infra.


42. This example is based on Treas. Reg. § 1.111-1(b)(3) (1960) which, like the revised example in the text, assumes that the reduction in taxable income attributable to the §111 items served to reduce actual tax liability. If the taxpayer in the example was entitled to a credit for 1976 (e.g., for foreign income taxes subject to I.R.C. § 901) so that no tax would have been payable for 1976 even if none of the §111 deductions had been available, the recovery exclusion would be $5,000 (i.e., line 2b less line 5), rather than $750.
$1,300 of 1975 income (line 5); hence the "recovery exclusion" as defined by section 111(b)(4) (in other words, the section 111 items that produced no tax benefit) was the balance ($750), computed as follows:

**Example B**

**Computation of Recovery Exclusion**

1. Section 111 items (from line 2b of Example A) $6,300
2. Portion of section 111 items used to reduce 1977 taxable income (line 3, as recomputed) $4,250
3. Portion of section 111 items carried back to reduce 1975 taxable income (line 5) 1,300
4. Total of section 111 items deducted with tax benefit (lines 7 plus 8) 5,550
5. Recovery exclusion $ 750

On the foregoing assumptions, if the taxpayer recovers $400 in 1979 in respect of the bad debts or taxes (line 2b of Example A), this amount is excluded; and if $500 more is recovered in 1980, $350 is excludible, and the balance ($150) is includible in income.

This method of computing the tax benefit attributable to the recovery items is favorable to the taxpayer, since it assumes that the recovered items were the last to be deducted. Moreover, this presumption is buttressed, if the statute of limitations has run, by the subsidiary presumption that all other deductions taken in the earlier years were valid.43 Thus, the IRS cannot reduce or eliminate the recovery exclusion by showing that the 1977 deduction for depreciation (line 2a) was excessive to the extent of $750, even though this possibility may have been disregarded when the 1977 return was audited because the deduction for the section 111 items (line 2b of Example A) was clearly valid. On the other hand, the taxpayer cannot introduce deductions, however valid, that were not claimed on the earlier return to establish that deducting the recovered item served no tax benefit.44

The regulations provide that recoveries of deductions for depreciation, depletion, amortization, and amortizable bond premi-

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43. Query, however, whether a deduction that was improper on its face (e.g., a personal exemption of a dollar amount larger than authorized by statute) must be left intact.

44. First Nat'l Bank v. Commissioner, 22 T.C. 209 (1954), aff'd per curiam, 221 F.2d 959 (2d Cir.), cert. denied, 350 U.S. 887 (1955) (exclusion allowable only if deduction of recovered item "did not result" in a tax reduction; exclusion not allowed merely because deduction "would not have resulted" in a tax reduction had other deductions been claimed). Cf. United States v. Rexach, 482 F.2d 10, 21-27 (1st Cir.), cert. denied, 414 U.S. 1039 (1973) (tax benefit rule inapplicable unless claimed losses were actually deducted in prior year; contrary rule would require auditing old returns on stale and inadequate evidence).
ums are not subject to the "rule of exclusion." The Code explicitly requires the basis of property generating these deductions to be reduced by the "allowable" deductions (whether deducted or not) and requires gain or loss on a disposition of the property to be determined by reference to the basis so computed. This leaves little room for an exclusionary principle that would reduce the taxpayer's gain to take account of deductions that were of no tax benefit. Thus, the sole statutory remedy for a taxpayer incurring deductions for depreciation, amortization, and depletion in a loss year is the net operating loss carryover authorized by Internal Revenue Code section 172, which permits excess business deductions to be used in any profitable year within the specified carryover period.

The taxpayer cannot rely on section 111, but must look to the net operating loss carryover for a remedy, in another important category of cases which can be illustrated by a business venture requiring expenditures for wages, supplies, and other deductible items that exceed income in one year, followed by substantial receipts in a later year. Although the receipts flow from and in a sense serve to recoup the expenditures, it has been held that they cannot be excluded under section 111 even if the prior deductions were of no tax benefit.

In reaching this conclusion, the First Circuit relied on the annual accounting rationale of Burnet v. Sanford & Brooks Co., holding that taxable income is realized when payment is received under a long-term contract, even if the taxpayer incurred a loss over the life of the project.

Since Sanford & Brooks was decided long before the enactment of section 111, the case by itself sheds no light on the intended scope of that provision; but if section 111 had been enacted

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46. I.R.C. § 1011(a) (basis for gain or loss); I.R.C. § 1016(a)(2) (depreciation, amortization, and depletion); I.R.C. § 1016(a)(5) (amortization of bond premium).

Deductions for other items (e.g., losses) reduce the taxpayer's basis only to the extent of a "proper adjustment" under I.R.C. § 1016(a). To the effect that a basis adjustment is not required if the deduction is of no tax benefit to the taxpayer, see Ridge Realization Corp. v. Commissioner, 45 T.C. 508, 519-22 (1966). See also Merchants Nat'l Bank v. United States, 52 AM. FED. TAX REP. (P-H) 1600 (D. Kan. 1956) (earlier improper write-down of certain bonds without tax benefit not properly chargeable to capital account, hence unimpaired basis can be offset against sales proceeds in later year; but proper charge-off of a different debt reduced basis despite lack of tax benefit, hence recovery is excludible under I.R.C. § 111 but no loss allowable for remaining unrecovered amount).

to reverse the result reached in *Sanford & Brooks*, there would be virtually no need for the elaborate provisions of section 172 (relating to the net operating loss carryover). For this reason, ordinary business receipts for goods and services seem clearly outside the scope of section 111, even if the expenses making these receipts possible were deducted without tax benefit. On the other hand, refunds and abatements of amounts paid or accrued for wages or supplies qualify for exclusion if they were deducted without tax benefit, since these receipts are "recoveries" within the meaning of section 111(a).

Because section 111 is concerned with the "recovery" of items that were previously deducted or credited, a receipt must be closely associated with the prior allowance to qualify for exclusion. Thus, if in 1977 a taxpayer accepts property worth $3,000 in settlement of a $5,000 claim and deducts the remaining $2,000 as a bad debt, the transaction is closed. If the property is sold in 1978 for $5,000, the taxpayer's gain of $2,000 is not a "recovery" of the bad debt and hence cannot be excluded under section 111 even if the 1977 deduction produced no tax benefit. On the other hand, if the taxpayer collects an additional $1,000 from the debtor in 1979 (for example, because the 1977 settlement was induced by fraud), this receipt would qualify as a partial recovery of the 1977 deduction.

In addition to requiring the recovery of a previously deducted item, section 111 presupposes that the recovery is received by the taxpayer who took the deduction. This principle ordinarily bars relief under section 111 when otherwise qualified items are recovered by the original taxpayer's successor in interest (by liquidation, merger, etc.), but this barrier is lifted by Internal Revenue Code section 381(c)(12) for certain corporate liquidations and other reorganizations. Moreover, since a partnership is treated for most income tax purposes as a conduit, each partner takes into

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49. Rev. Rul. 66-320, 1966-2 C.B. 37 (relying on Allen v. Trust Co., 180 F.2d 527 (5th Cir.), cert. denied, 340 U.S. 814 (1950)). See also Waynesboro Knitting Co. v. Commissioner, 225 F.2d 477 (3d Cir. 1955) (taxpayer received insurance policy on life of embezzler in settlement of claim and deducted loss without tax benefit; held that subsequent collection of insurance proceeds is taxable under I.R.C. § 101(a)(2) despite tax benefit rule, because receipt of policy terminated the original transaction and initiated a new and separate one); Sloane v. Commissioner, 188 F.2d 254 (6th Cir. 1951) (insufficient relationship between bad debt deductions and later receipts from debtor for personal services to qualify latter for exclusion under I.R.C. § 111); Brutsche v. Commissioner, 65 T.C. 1034, 1066 (1976) (I.R.C. § 111 inapplicable; "no showing that there has been a recovery of the same item that was deducted in the prior years").

50. But see Ridge Realization Corp. v. Commissioner, 45 T.C. 508, 523-26 (1966) (successor entitled to use I.R.C. § 111). See also Brutsche v. Commissioner, 65 T.C. 1034 (1976) (expressing doubt that recoveries by a Subchapter S corporation qualify under I.R.C. § 111 if the deductions were passed through to the shareholders).
account his distributive share of the firm's recoveries.\textsuperscript{51}

\textbf{IV. TAX DETRIMENT, REVERSE TAX BENEFIT, AND RELATED PRINCIPLES}

The tax benefit doctrine is not the only judicial and legislative departure from the annual accounting principle enacted in order to harmonize a transaction's tax consequences when it is finally closed with its tax treatment in an earlier year.

Internal Revenue Code Section 1341, among other analogies to the tax benefit rule, is applicable when a taxpayer must refund $3,000 or more that was included in income in an earlier year when he apparently had an unrestricted right to receive and retain it. In the year of repayment, the taxpayer is permitted by section 1341 to pay the lesser of (a) a tax computed in the usual fashion after deducting the refunded amount, or (b) a tax computed in the usual fashion on his other income (before deducting the refunded amount) minus the tax detriment suffered in the year when the refunded amount was received and included in income. This "tax detriment" approach guarantees that the tax saved by deducting the refunded amount will be at least as great as the tax paid when the item was received.\textsuperscript{52}

If the taxpayer prefers to take the deduction in the usual way in the year of repayment (the first branch of the option just described), however, the deduction allowable under section 1341 is limited by what might be termed a "reverse tax benefit" rule, which serves to protect the government against a deduction that is excessive when compared with the amount included in income in the earlier year. This limitation was applied by the Supreme Court in \textit{United States v. Skelly Oil Co.},\textsuperscript{53} involving deductions claimed when the taxpayer refunded overcharges collected from customers in earlier years on sales of natural gas. Because the sales gave rise to deductions for percentage depletion equal to 27.5\% of the amount received, so that taxable income was increased by only 72.5\% of the receipts, the Court held that only 72.5\% of the amount refunded could be deducted.

In so holding, the Court suggested that the decision would "affect only a few cases" because percentage depletion is "quite unusual [in that] it allows a fixed portion of gross income to go


\textsuperscript{52} As pointed out in note 17, \textit{supra}, at one time the Court of Claims interpreted the inclusionary aspect of the tax benefit rule to require a comparable result, in that the tax attributable to a recovery was not to exceed the tax saved in the earlier year when the recovered item was deducted.

\textsuperscript{53} 394 U.S. 678 (1969) (divided court).
untaxed"\textsuperscript{54} and it cited, with seeming approval, a Tax Court case involving a similar refund, in which, after adjusting for percentage depletion, the court allowed the taxpayer to deduct the balance even though the earlier receipts were included in income in a loss year for which no tax was payable.\textsuperscript{55} On the other hand, the Court said in \textit{Skelly Oil} that it could not "believe that Congress intended to give taxpayers a deduction for refunding money that was not taxed when received,"\textsuperscript{56} which implies a broader scope for this "reverse tax benefit" principle than the Court was prepared to acknowledge.

V. RECOVERIES OF FOREIGN EXPROPRIATION LOSSES

Under Internal Revenue Code section 1351, enacted in 1966, a domestic corporation receiving money or property in respect of a foreign expropriation loss may elect to exclude the recovery from gross income, up to the amount of the allowable deductions for the loss in prior taxable years.\textsuperscript{57} In return for excluding the recovery, an electing corporation must pay an additional tax equal to the increased taxes for the loss years attributable to decreasing the deductions for the loss by the amount of the recovery. Section 1351 thus results in a tax liability comparable to the amount that would have been due if the recovery had been predicted when the expropriation occurred and had been applied to reduce or eliminate the deductible loss,\textsuperscript{58} except that the tax rate prevailing in the recovery year is used rather than the rates in force in the loss years. If the recovery exceeds the prior deductions, the excess is treated as gain from an involuntary conversion of property which

\textsuperscript{54} Id. at 686.

\textsuperscript{55} O'Meara v. Commissioner, 8 T.C. 622, 632-35 (1947). The IRS asserted that inclusion of the income in the year of receipt "brought the Government no tax benefit," but this may have meant only that no tax was paid in that year. Id. at 632. Since inclusion of the receipts in that year's gross income reduced the taxpayer's net operating loss, thereby reducing the amount carried over to other years, the government may in fact have realized a "tax benefit" in those years.


\textsuperscript{56} 394 U.S. at 685.


\textsuperscript{58} Compare the "exact tax benefit" rule, created, but soon abandoned, by the Court of Claims. See note 17 supra.
TAX BENEFIT RULE

qualifies for nonrecognition if the conditions of Internal Revenue Code section 1033, relating to the replacement of converted property, are satisfied.

Since it is elective, section 1351 offers the taxpayer a choice between the normal tax benefit rules, under which prior deductions remain in force but recoveries are taxable if the deductions produced tax benefits, and a special rule, under which the recovery is excluded but the prior deductions must be disgorged.

Domestic corporations that do not avail themselves of section 1351 are subject to Internal Revenue Code section 80, under which securities deducted as worthless because of a foreign expropriation (as defined) must be included in gross income if their value is restored in whole or in part, up to the prior deductions resulting in a tax benefit. Amounts includible under section 80 are taxed as ordinary income unless the correlative loss was taken into account as a loss from the sale or exchange of a capital asset.59

VI. DAMAGES FOR ANTITRUST VIOLATIONS, PATENT INFRINGEMENTS, AND BREACH OF CONTRACT OR FIDUCIARY OBLIGATIONS

Inspired by tax benefit principles, Internal Revenue Code section 186 promulgates a special rule applicable to damages recovered for injuries attributable to antitrust violations, patent infringements, and breaches of contract or fiduciary obligations.60 To the extent of the taxpayer's "unrecovered losses" (defined by section 186(d) as those net operating losses attributable to the injury that could not be deducted in any carryover year), the damages, if included in gross income, are allowed as a deduction.

The regulations prescribe in some detail the method of determining whether a particular year's net operating loss is attributable to an injury subject to section 186.61 Since the exclusionary aspect of the normal tax benefit doctrine would permit damages to be excluded from gross income on proof that they constituted a recovery of prior deductions that produced no tax benefit, the principal contribution of section 186 lies in its simplified method of determining whether the taxpayer received a tax benefit in prior

59. For a more detailed explanation of § 80, see S. Rep. No. 1091, note 58 supra; Rev. Rul. 76-41, 1976-1 C.B. 52 (no worthless security loss for securities pledged to and seized by a foreign government, if domestic parent can regain expropriated securities through judicial proceedings in United States); Rev. Rul. 75-501, 1975-2 C.B. 69 (expropriation of operating assets of domestic corporation's wholly owned domestic subsidiary, which owns a bank account in the United States and whose certificates are located here, does not render the securities worthless).
years for the subsequently compensated injury. By concentrating on the taxpayer's net operating loss, section 186 makes it unnecessary to associate the damages with any specific deductions.

**Conclusion**

Through the evolutionary development of a common law of taxation as well as by small statutory steps, the tax benefit rule has grown from an obscure relief provision for bad debt recoveries into a rule with many applications. Despite its inexactitude and various forms, the rule reflects a concern with equality of tax treatment for transactions which transcend the boundaries of a single taxable year. In a recent decision applying tax benefit principles to an event that did not entail a conventional "recovery" of items previously deducted, the Sixth Circuit expressed the view that the "rule should be applied flexibly in order to counteract the inflexibility of the annual accounting concept [and] whenever there is an actual recovery of a previously deducted amount or when there is some other event inconsistent with that prior deduction."62 This generalization may imply a more imperial corrective role than the doctrine is destined to play, but it surely points in the right direction.

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