1. INTRODUCTION

Much has been written regarding the tax benefit rule (the Rule).¹ Some of it has been controversial. This Chapter attempts to reconcile that controversy.

The Rule is both attractively simple and intuitively correct - even to a layman. If a taxpayer recovers an item he beneficially deducted, he should pay tax on the recovery. No one truly disagrees with the result; however, explaining why the logical result occurs is sometimes difficult and the explanations are sometimes inconsistent.

Often the Rule has been viewed as naturally evolving from the inequities of an annual, rather than transactional, tax system.² As a result, courts applied the Rule broadly to correct many transactional inequities. An alternate view considers the Rule as the necessary result of a tax system used to accomplish policy goals other than the raising of revenue. Such a policy-oriented system often artificially defines income and expenses in a manner inconsistent with economic reality.³ The tax benefit rule is an additional artificial device necessary to overcome transactional inequities resulting from the use of the tax system to achieve such non-revenue raising policy goals. Arguably, the Rule is unnecessary when used to correct those transactional inequities which are not a result of a policy-oriented goal.

In attacking the judicially created Rule, this chapter will not leave a gaping hole in tax theory. Instead, it will explain how Congress has already fostered a better solution for most of the transactional problems the Rule attempts to solve. The chapter will then show how some courts have not applied the congressional solutions.


² See, e.g., Hillsboro Nat’l Bank v. Commissioner, 460 U.S. 370, 377 (1983) (stating "strict adherence to an annual accounting system would create transactional inequities" and explaining that the tax benefit rule is often a solution for such problems).

³ Steven J. Willis, Masks, Magic and Games: The Use of Tax Law as a Policy Tool, 4 AM. J. TAX POLY 41 (1985). As a result of such artificial definitions, the system breeds many problems, only a few of which are solvable by the artificiality of the tax benefit rule. Other problems include economic distortions and distrust of the system.
B. A STATEMENT OF THE RULE

The tax benefit rule has two arms: the exclusionary arm and the inclusionary arm. The exclusionary arm is statutory. The inclusionary arm is judge-made and arguably unnecessary. Unfortunately, the two are easily confused. The exclusionary arm of the Rule appears in section 111 of the Internal Revenue Code:4

- Gross income does not include income attributable to the recovery during the taxable year of any amount deducted in any prior taxable year to the extent such amount did not reduce the amount of tax imposed by this chapter.

Critically, the exclusionary arm of the Rule only excludes income otherwise included. Section 111 itself does not deal with income inclusion, which is the province of section 61.

The inclusionary arm of the Rule arose from a line of judicial decisions.5 It historically provided6:

Note the requirement of a "recovery" for the section 111(a) exclusionary rule to apply. This requirement was historically consistent with the similar "recovery" requirement of the inclusionary rule. Compare, however, the lack of a "recovery" requirement in the inclusionary rule adopted by the Supreme Court in Hillsboro, 460 U.S. at 377. Naturally the inclusionary arm arose because the government proposed it. Courts quickly embraced the doctrine, which preceded the exclusionary arm.

Although the wisdom of a "recovery" requirement is not the exact focus of this article, it nevertheless is

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The change in the Court-created inclusionary rule, without a corresponding change in the congressionally-created exclusionary rule, raises the same issues of fairness and equity that prompted the adoption of the exclusionary rule in 1942. The inclusionary rule itself is equitable: taxpayers should not benefit from a deduction if they recover the item deducted or, since Hillsboro, act inconsistently with the deduction. Such an equitable inclusionary rule - if it must apply - should not include income corresponding to a non-beneficial deduction. Thus the Hillsboro rejection of the "recovery" requirement necessitates a change in section 111(a) to similarly delete the "recovery" requirement.

5 Hillsboro, 460 U.S. at 377. Naturally the inclusionary arm arose because the government proposed it. Courts quickly embraced the doctrine, which preceded the exclusionary arm.

6 The textual statement is a paraphrase of the combined exclusionary and inclusionary rules, as applied from roughly 1942 until the Court's decision in United States v. Bliss Dairy, Inc. 460 U.S. 370, 395-403 (1983) which discarded the "recovery" requirement. Bliss Dairy was the companion case to Hillsboro, 460 U.S. 370 (1983). The Court previously continued the recovery requirement in Nash v. United States, 398 U.S. 1, 4-5 (1970). Justice Stevens, concurring in Hillsboro and dissenting in Bliss Dairy, accused the majority of treading new ground without any congressional lead: "Since there has been no legislation since Nash suggesting that our approach over the past half-century has been wrong-headed . . . the new doctrine that emerges from today's decision is of the Court's own making." Hillsboro, 460 U.S. at 412 (Stevens, J., dissenting) (citations omitted). In his sharply worded dissent, Justice Stevens further noted that Congress had rejected proposed 1975 legislation which would have accomplished the Bliss Dairy result. Hillsboro, 460 U.S. at 421 n.32.
Gross income includes income attributable to the recovery during the taxable year of any amount deducted or excluded in any prior taxable year to the extent the taxpayer benefited from the prior deduction or exclusion.

Arguably, the inclusionary arm of the Rule is facially superfluous because section 61 of the Internal Revenue Code includes all income from whatever source derived (the maximum reach permitted by the sixteenth amendment). Consequently, the inclusionary Rule does not tax anything not already taxed by section 61. Nevertheless, courts and commentators have universally treated the Rule as an inclusionary device. As will become evident below, the Rule more properly should be viewed as an error-correcting device. Since the joint 1985 Supreme Court decisions in Hillsboro National Bank v. Commissioner and United States v. Bliss Dairy, Inc., the inclusionary arm of the Rule now provides:

Gross income results from events that are fundamentally inconsistent with the deduction or exclusion of an item by the taxpayer in any prior taxable year, to the extent the taxpayer benefited from the prior deduction or exclusion.

C. HISTORY OF THE TAX BENEFIT RULE

Commentators universally accept that the tax benefit rule arose early in our tax history. It is also universally accepted that the Rule clearly arose from a sense of equity: if a taxpayer recovered an item previously deducted, he should include it as income.

relevant to my analysis and proposals. The inclusionary tax benefit rule, if limited per my suggestions, would not contain a recovery requirement. To be fair, the '111(a) recovery requirement should be deleted.

7 I.R.C. ' 61. Section 61 provides: "[G]ross income means all income from whatever source derived . . . . " Id. (emphasis added).

8 U.S. CONST. amend. XVI: "The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration." Id. (emphasis added).

9 See generally supra note 1.


11 Id. at 395 (Bliss Dairy was the companion case to Hillsboro).

12 Bliss Dairy, 460 U.S. at 381-91. The proper citation is to Bliss Dairy rather than to Hillsboro because the Court used the Bliss Dairy facts to replace the "recovery" requirement with the "fundamental inconsistency" requirement.

13 Several good articles cover the history of the Rule. See supra note 1. Likewise, Justice Stevens ably covered the history of the Rule in his well-reasoned dissent to the Bliss Dairy case. Hillsboro, 460 U.S. at 403, 405-12 (Stevens, J., dissenting). Readers unfamiliar with that history should consult such sources.

14 See sources cited supra note 1.
Otherwise, the government would lose revenue. Similarly, no one\footnote{15} disputes that the Rule is the natural evolution of an annual, as opposed to a transactional, accounting system.

1. ANNUAL VERSUS TRANSACTIONAL ACCOUNTING

Because the United States tax system uses an annual theory, it considers each year separately. While such a system allows for regular collection of revenue, it also prompts accusations of harshness: a multi-year transaction can result in taxation of early year revenues despite ultimate and composite transactional losses.

\hspace{1cm} \textbf{Example One}

Taxpayer enters into a business transaction spanning two years. In year one, Taxpayer receives income of $100,000 and neither incurs nor pays any expenses. In year two, Taxpayer incurs expenses of $150,000. Despite the transactional loss of $50,000, Taxpayer must report $100,000 gross income in year one and a $150,000 loss in year two.

\textbf{Example 1} violates the mathematical rule that a total equals the sum of its parts. For tax purposes the $50,000 transactional loss is not the equivalent of $100,000 income in one year less a $150,000 loss in another year. Changing tax rates, brackets, and characterization rules plus the time value of money provide a few examples of the obvious reasons for the lack of equivalence.

Similarly, the taxpayer may deduct losses incurred in prior annual tax periods despite composite transactional profits. Nevertheless, the seminal Supreme Court cases of \textit{Burnet v. Sanford & Brooks Co.}\footnote{16} in 1931, and \textit{North American Oil v. Burnet}\footnote{17} in 1932 held that each year constitutes a distinct period. As discussed in prior chapters, unless one the current myriad exceptions applies, neither the taxpayer nor the government may properly look back at a prior period to determine current income or losses on a transactional basis.

2. STATUTE OF LIMITATIONS

Arguably, another necessary precursor to the creation of the tax benefit rule was the statute of limitations. As in many areas of the law, Congress recognized the need for the conclusion of some matters; consequently, it enacted a statute of limitations for both refunds and deficiencies.\footnote{18}

\footnote{15} The use of the tax system to achieve non-revenue-raising policy goals is also critically important to the evolution of the Rule.

\footnote{16} 282 U.S. 359 (1931).

\footnote{17} 286 U.S. 417 (1932).

\footnote{18} See, e.g., I.R.C. ' 6501 (three-year statute of limitations on assessment of deficiency); I.R.C. ' 6501(e) (six-year statute of limitations on assessment of deficiency involving substantial omission from gross income); I.R.C. ' 6511 (statute of limitations on filing refund generally three years from return or two years from payment, whichever is longer); I.R.C. ' 6531 (statute of limitations on criminal prosecution).
Naturally, a statute of limitations can benefit or harm either the government or the taxpayer. A taxpayer who incorrectly includes income in a closed year cannot recover the overpaid tax, no matter how strident his claim. Also, a taxpayer who incorrectly, but honestly, deducts an item in a closed year need not repay the benefit, no matter how great the loss in revenue. To provide otherwise would cause the ceaseless maintenance of records.

Still, to leave such matters uncorrected appears harsh, especially if the taxpayer later recovers that which he erroneously deducted, or if he later repays that which he erroneously included. Viewed simply, the recovery should be income and the repayment should be deductible, each to counterbalance the prior erroneous deduction or inclusion. Therein lies the logic of the tax benefit rule, as well as the logic of its opposite cousin, section 1341, a section dealing with the restoration of claims of right.

Courts quickly saw that correction of such errors was stymied by the annual accounting system as well as by the statute of limitations. If each year stands alone, then a transaction cannot remain open, pending a possible recovery or restoration. Instead, taxpayers must deal with the recovery or restoration when it occurs. Also, under the strict annual theory of Sanford & Brooks and North American Oil, the taxpayer need not look back to determine whether either the government or the taxpayer "got away" with something. Instead, the system treats a recovery or restoration on its own merits of includibility or deductibility rather than by reference to a prior treatment of a similar item. Even the discovery of obvious mistakes does not result in the opening of a closed year for correction.

Nevertheless, courts felt the need for a correction device, especially one that would respect both the annual system and the statute of limitations. Not finding one in the Internal Revenue Code [this was an underlying error that has created years of confusion], the courts, at the behest of the government, created the previously discussed inclusionary arm of the tax benefit rule: a recovery of previously deducted items gives rise to income because of the prior deduction. Not long afterward, some courts and then Congress, recognized that the Rule should not tax income if the taxpayer did not receive a benefit. From that logic came the exclusionary arm of the Rule, and later section 111. Similar reasoning led to enactment of section 1341, which controls deductions for the restoration of

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19 I.R.C. ' 1341.

20 Hillsboro, 460 U.S. at 405 (citing tax benefit cases as early as 1929 and 1931); see also supra notes 7-8 and accompanying text.

21 Hillsboro, 460 U.S. at 406. The Board of Tax Appeals adopted the exclusionary rule, but other courts rejected it. (Stevens, J., concurring in part and dissenting in part). Congress resolved the conflict by enacting ' 116(a) of the 1939 Code, the predecessor to ' 111. Id.

22 I.R.C. ' 111 (1990); see also supra note 7 and accompanying text.
items previously included pursuant to a claim of right, and the holding in *North American Oil.*

3. TWO COMMONLY CITED, BUT QUESTIONABLE CASES

The following two court decisions are among the more famous general tax benefit cases. Neither offers novel or difficult facts and each is commonly cited. But, arguably each court reached the correct answer, for wrong reasons. Such flawed reasoning likely prompted the controversial decisions from the Courts of Appeals for the Ninth and Fifth Circuits astray in *Unvert* and *Hughes,* respectively.

**a. Alice Phelan Sullivan Corporation**

In 1939 and 1940, the corporation donated two parcels of real property to a charity. It took contribution deduction at the prevailing tax rates of 18% and 24%, respectively. In 1957, it recovered the two parcels, each of which had been subjected to the condition that the property be used either for a religious or for an educational purpose. The charity returned the parcels after deciding not to use them.

Taking the position that the recoveries were mere returns of capital, the corporation included nothing regarding them in its 1957 tax return. The Commissioner, however, asserted a deficiency of $4,527.60, which amounted to 52% (the 1957 tax rate) of the amount of the prior deductions ($8,706.93). After paying the deficiency, the corporation filed a claim for a refund of $2,650.11, on the theory that a correct assessment could demand no more than the return of the tax benefit originally enjoyed, i.e., $1,877.49. The claim was disallowed.

The court considered, but overruled, its prior decision on the issue. In 1958, the Court of Claims had taxed the income from such a recovery at the prevailing rate in the year of the deduction. The court explained:

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23 See B. Bittker, *FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS* page 6.3.4 (1981). Prior to the enactment of ‘1341, the taxpayer's restoration year deduction was unrelated in value to the earlier inclusion. *United States v. Lewis,* 340 U.S. 590, 592 (1941). For some taxpayers, this was beneficial because the deduction was more valuable than the prior inclusion was detrimental. For other taxpayers, however, the restoration deduction would not fully compensate for the prior detrimental inclusion. Congress enacted section 1341 to ensure that the deduction would fully compensate for the inclusion. Interestingly, it also chose to allow the deduction value sometimes to exceed the prior detriment. Thus, with section 1341 as with section 111, Congress chose to alleviate the harshness of *Sanford & Brooks* by utilizing a partial re-examination of a prior year to determine the current year's tax.


25 *Hughes & Luce v. Commissioner,* 70 F.3d 16 (5th Cir. 1995).

26 381 F. 2d. 399 (Cl. Ct. 1967).

Ever since *Burnet v. Sanford & Brooks* [****] the concept of accounting for items of income and expense on an annual basis has been accepted as the basic principle upon which our tax laws are structured. 'It is the essence of any system of taxation that it should produce revenue ascertained, 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.' 282 U.S. at 365, 51 S.Ct. at 152. To insure the vitality of the single-year concept, it is essential not only that annual income be ascertained without reference to losses experienced in an earlier accounting period, but also that income be taxed without reference to earlier tax rates. And absent specific statutory authority sanctioning a departure from this principle, it may only be said of that it achieved a result which was more equitably just than legally correct.28

Since taxpayer in this case did obtain full tax benefit from its earlier deductions, *those deductions were properly classified as income upon recoupment* and must be taxed as such. This can mean nothing less than the application of that tax rate which is in effect during the year in which the recovered item is recognized as a factor of income. We therefore sustain the Government's position and grant its motion for summary judgment. *Perry v. United States, supra,* is hereby overruled, and plaintiff's petition is dismissed.29

The court's language is correct, but perhaps the explanation is incomplete, particularly the clause *those deductions were properly classified as income upon recoupment.* As the court noted, the corporation retained a right of reversion. Such a right had value - as was ultimately evident - and necessarily had a basis. That basis was also necessarily a function of its cost and the transaction in which it was acquired or created. Presumably the corporation properly deducted the fair market value of the property donated. As a result, it surely retained no basis to allocate to the reversionary interest. The subsequent exercise of that interest was a taxable event, just as the exercise of an option is a taxable event. Such an event would result in income equal to the difference between the basis - zero - and the value recovered. This amount could differ from the amount included by the court, which equaled the amount previously deducted. However, section 111 would exclude the value recovered to the extent it had never been beneficially deducted, thus effectively limiting the recovery income to the amount previously properly deducted. Likewise, consistent with *Arrowsmith*30 and *Skelly Oil,*31 the character of the recovery income would have been ordinary because the related deduction was ordinary.

28 This opinion represents the views of the majority and complies with existing law and decisions. However, in the writer's personal opinion, it produces a harsh and inequitable result. Perhaps, it exemplifies a situation 'where the latter of the law killeth; the spirit giveth life.' The tax-benefit concept is an equitable doctrine that should be carried to an equitable conclusion. Since it is the declared public policy to encourage contributions to charitable and educational organizations, a donor, whose gift to such organizations is returned, should not be required to refund to the Government a greater amount than the tax benefit received when the deduction was made for the gift. Such a rule would avoid a penalty to the taxpayer and an unjust enrichment to the Government. However, the court cannot legislate and any change in the existing law rests within the wisdom and discretion of the Congress.

29 381 F. 2d at 403 (emphasis added).


b. Rosen v. Commissioner\(^{32}\)

In 1972, the Rosens donated real property to the city of Fall River, Massachusetts, claiming a charitable deduction of $51,250. In 1973, the city decided that it could not use the property and returned it to the Rosens. Unlike Alice Phelan Sullivan Corporation, the Rosens had not placed a 'use or return' condition on the gift. Later in 1973, the Rosens gave the property to a hospital, claiming a charitable contribution deduction in the amount of $48,000. In 1974, the hospital also returned the property to the donors, although once again no condition had been placed on the gift.

The Tax Court, affirmed by the First Circuit, applied the tax benefit rule to the taxpayers, finding income on the return of the donations. The taxpayers, however, argued that the rule did not apply to cases not involving a right of reversion. Both courts disagreed. In addition, the taxpayers claimed that in each case the recoveries were actually nontaxable gifts made to them by the city and by the hospital.

The courts, however, denied the Rosens the right to prove that the recoveries were gifts. In so doing, the circuit court found the issue irrelevant. It explained:

>[T]he application of the tax benefit rule does not depend on whether the taxpayers retained a right of reversion. As pointed out in Tennessee-Carolina Transportation v. Commissioner of Internal Revenue, 582 F.2d 378, 382 (6th Cir. 1978):

The tax benefit rule should be applied flexibly in order to counteract the inflexibility of the annual accounting concept that is necessary for administration of the tax laws. The rule should apply *whenever there is an actual recovery of a previously deducted amount or when there is some other event inconsistent with that prior deduction.*

Thus, the rationale of the rule is that if the Rosens received a tax deduction in the year in which the conveyance was made and thereafter the property was returned to them, they were subject to taxation to the extent of the value of the property returned, up to the amount of the charitable deduction previously taken. "(T)he principle is well ingrained in our tax law that the return or recovery of property that was once the subject of an income tax deduction must be treated as income in the year of its recovery." Alice Phelan Sullivan Corp. v. United States, 381 F.2d at 401.

As with *Sullivan* the result of the case is not questioned; however, some commentators dispute its rationale. The court suggests that the income results *because of* the prior deduction, rather than because the recovery itself is income under the annual accounting system. This appears to violate the reiteration of the basic *Sanford & Brooks* principle emphasized by *Sullivan*, upon which the court relied. Consistent with that principle, the taxpayers arguably had the right to introduce proof as to the donative intent of the city and hospital. Whether they could have carried the burden of proving the issue is doubtful; however, they probably should have had the opportunity. Without such proof, the re-conveyances of the property were accessions to the wealth of the Rosens. As such, they constituted income in an amount equal to the value returned.

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\(^{32}\) 611 F.2d  942 (1st Cir. 1980).
This analysis would not only be consistent with the annual accounting system, but it would also potentially produce a different result than would the opinion. This is true because the return would be an event separate from and thus not a function of the prior donation. If the property had changed in value since the time of the prior deduction, the income resulting from the recovery would be different than the amount of that deduction. In fact, that was apparently the case in \textit{Rosen}. The 1972 deduction value exceeded the 1973 return value by $3,120. Absent evidence of fraud, there is no theoretical problem with the recovery income being different from the deduction amount when the two events were truly distinct.

An additional issue prompted by the decision involves the basis of the returned property. Neither the \textit{Sullivan} nor the \textit{Rosen} court discussed the issue, which was not before them. Traditional notions of basis suggest that the returned property would have a basis equal to the amount included in income upon the return of the item. However, this could result in an undeserved benefit to the taxpayer. To be transactionally consistent, the basis of the returned property should equal the taxpayer’s basis prior to the donation. Under such an approach, the taxpayer would be placed into the same position he would have occupied had the donation never occurred. But, the courts explained that such is not the goal of the tax benefit rule in reasoning that the tax on the recovery need not equal the tax saved from the prior deduction. As a result, the question of basis remains unresolved.

This basis problem is particularly relevant to cases - such as the above two - involving charitable contributions of real property. \textit{Section 170(e)}\textsuperscript{33} generally permits deductions of such items in an amount equal to their fair market values, rather than their bases. Although neither court spoke of the basis of the donated property, likely the bases differed from - and probably exceeded - the fair market values at the time of the donations. As a result, to avoid a taxpayer windfall in \textit{Sullivan}, the amount of the income from the recovery should have exceeded the basis resulting in the recovered property. No authority exists for such a limitation; however, it appears necessary. Unfortunately courts have been silent on this issue, which does not arise in a tax benefit rule case; instead, it would arise only upon disposition of the property recovered.

In \textit{Rosen} another problem also arises. As explained, the Rosens should be taxed on the value of the recovered property, and then should be permitted a basis equal to that amount. Presumably the items involved were capital assets, precipitating a character issue, not addressed by the court. Absent a sale or exchange, which did not occur, the Rosens would have had ordinary income on the return. This is not troublesome, considering that the prior deduction was ordinary. However, because the prior deduction

\begin{footnotesize}
\footnote{\textit{I.R.C. section 170(e)} reduces the amount of a contribution by the amount of any gain that would be other than long term capital gain if the donor had sold the property rather than donated it. In addition, it generally limits the amount of contributions to non-operating private foundation to the donor’s basis. \textit{I.R.C. ' 170(e)(1)(B)(ii)}. Also limited to basis are contributions of unrelated tangible personal property donated to public charities. \textit{I.R.C. ' 170(e)(1)(B)(i)}.}
\end{footnotesize}
would have exceeded the recovered income, the Rosens effectively would have stepped down the basis in the property in exchange for an ordinary deduction. To them that would be advantageous. *Arrowsmith*\(^{34}\) and *Skelly Oil*\(^{35}\) provide general authority for character transactional consistency; however, they do not seem to apply, leaving the issue unresolved.

If, instead, the facts involved appreciating property, the problem would be more evident. While the taxpayers in such a case would effectively receive a stepped up basis on the return of property, they would do so at the cost of ordinary income, rather than capital gain. This would not seem equitable. A possible solution would be the application of section 111,\(^{36}\) which would exclude from income (and thus presumably tax cost basis) a recovered amount deducted in a prior year without benefit. If the applied, the taxpayers would limit their recovery income to the amount of the prior deduction. The language of section 111 - an exclusion section - would not apply to the *Rosen* facts, however, because to apply it would need to impute, rather than exclude, income.

4. THE ERRONEOUS DEDUCTION EXCEPTION TO THE RULE

In addition to the exclusionary Rule, the Tax Court historically applied an erroneous deduction exception to the inclusionary Rule. The erroneous deduction exception to the inclusionary tax benefit rule provides:37


36 I.R.C. ' 111.

37 The textual statement is a paraphrase of the erroneous deduction exception and the less clear rule defining an "error." Several Tax Court cases have held or stated to the effect "the Tax Benefit Rule does not apply where the original deduction was improper." *Mayfair Minerals, Inc. v. Commissioner*, 56 T.C. 82, 88 (1971), aff'd per curiam, 456 F.2d 622 (5th Cir. 1972) (stating the general erroneous deduction exception, but ultimately estopping the taxpayer from asserting the exception); *Streckfus Steamers, Inc. v. Commissioner*, 19 T.C. 1, 8 (1952) ("An erroneous deduction taken in a prior year may not be treated as income of a later year.").

Other cases have explained the circumstances under which a deduction is "improper" or "erroneous" (In all important aspects, these are synonymous terms.) The similarly synonymous term "unreasonable mistake" represents a deduction that was contrary to information reasonably available to the taxpayer at year end. This is in contrast to deductions that are ultimately shown to be "erroneous" or "mistaken" based on information which becomes reasonably available after the close of the year. These terms flow from the Supreme Court decision in *United States v. Lewis*, 340 U.S. 590, 591 (1951). *Lewis* dealt with an employee who received a bonus in 1944 and included it on his 1944 return. In 1946, the employer determined that the employee was not entitled to the bonus and required that he return it. The Court described the original inclusion as "mistaken" but nevertheless "proper" because the taxpayer based the inclusion on a "good faith" understanding of the facts available to him. Id. at 591-92. The information that showed the inclusion to be "mistaken" arose in a later year and thus was properly the basis of a deduction in the later period. Id. Thus, the Court demonstrated that an item on a return can be reasonably "mistaken" but proper. Hence "unreasonable" mistakes are "improper" or "erroneous." A taxpayer may correct "unreasonable" mistakes only by an amended return, subject to the statute of limitations. *Streckfus Steamers*, 19 T.C. at 8 ("an adjustment [for the erroneous deduction] may be made only for the year [of deduction], which is barred by the statute of [limitations]").
Gross income does not include income attributable to the recovery during the taxable year of any amount deducted or excluded in any prior taxable year, to the extent such deduction or exclusion resulted from an unreasonable mistake of law or fact.

The exception arose from the statute of limitations. The Tax Court historically recognized that improper deductions should be corrected in the year of the deduction. If the statute of limitations barred such a correction, then the Tax Court reasoned that Congress did not support the availability of a correction.38

The exception, however, creates an anomaly because taxpayers can benefit when they act improperly, but not when they act properly. Under the erroneous deduction exception only proper deductions result in a benefit that can create later tax benefit income. Improper deductions, despite providing the same benefit as proper ones, do not subject the taxpayer to later potential tax benefit income.39

The 1981 decision in Unvert v. Commissioner40 rejected the exception as illogical, at least for cases appealable to the Court of Appeals for the Ninth Circuit. Although the Supreme Court in the Hillsboro/Bliss Dairy41 cases did not consider the exception, the Court’s reasoning is consistent with Unvert42 As a result, survival of the exception is doubtful.43 In 1995, the Fifth Circuit also rejected the exception, aligning itself with the Ninth.44

The Supreme Court’s decision in Hillsboro also explained that an apparently proper deduction can be rendered “improper” in a later year. A taxpayer may correct such a deduction, however, only in the later year, if at all. Hillsboro, 460 U.S. at 377. Also, the Tax Court has described deductions which were “proper” at the time taken, but which later prove to be improper. A taxpayer may correct such deductions, again, only, if at all, in the later period. See Canelo v. Commissioner, 53 T.C. 217, 226-27 (1969), aff’d on other grounds, 447 F.2d 484 (9th Cir. 1971).

38 Streckfus Steamers, 19 T.C. at 8; Canelo, 53 T.C. at 226-27; Unvert v. commissioner, 656 F.2d 483, 485 (9th Cir. 1981) (explaining the erroneous deduction exception, although ultimately rejecting it), cert. denied, 456 U.S. 961 (1982).

39 The Second and Ninth Circuits have rejected the erroneous deduction exception as "unjust" because it anomalously rewards taxpayers who act improperly. Unvert, 656 F.2d at 486; Askin & Marine Co. v. Commissioner, 66 F.2d 776, 778 (2d Cir. 1933).

40 656 F.2d 483 (9th Cir. 1981), cert. denied, 456 U.S. 961 (1982).

41 Hillsboro, 460 U.S. at 381(1991). These combined cases expand the tax benefit rule. See infra text accompanying notes 81-93.

42 Unvert, 656 F.2d at 483.

43 Interestingly, however, the Unvert case arose from the Ninth Circuit, as did Bliss Dairy. The Supreme Court reversed the Ninth Circuit in Bliss Dairy and in so doing greatly expanded the Rule. After Bliss Dairy any-taxpayer treatment "fundamentally inconsistent" with a prior deduction gives rise to income. The Court did
Nevertheless, the Tax Court was statutorily correct in creating the exception, despite its arguably incomplete explanation. The anomaly of errant taxpayers benefiting while proper taxpayers suffer is facially apparent but fades under scrutiny. The Tax Court has correctly stated that improper deductions often appear uncorrectable because of the statute of limitations. Nevertheless, Congress provided other correction devices to deal with improper deductions, such as the mitigation provisions in sections 1311-1314. Properly applied, these provisions allow correction of many improper deductions. Without the erroneous deduction exception, however, the mitigation provisions cannot apply as designed. This crucial point is illustrated below. Unfortunately, the Tax Court did not articulate this point and thus left its exception open to attack.

Five cases in particular - three from the Tax Court, one from the Fifth Circuit, and one from the Ninth Circuit - are interesting and will aid in an understanding of the remainder of this chapter. The five are *Streckfus Steamers, Inc. v. Commissioner* in 1952, *Canelo v. Commissioner* in 1969, *Mayfair Minerals, Inc. v. Commissioner* in 1971, *Unvert v. Commissioner* in 1981, and *Hughes & Luce v. Commissioner* in 1995. Interestingly, *Mayfair Minerals* applied an estoppel exception to the erroneous deduction exception. However, in *Unvert* the Ninth Circuit, and in *Hughes* the Fifth Circuit, rejected both the estoppel exception and the erroneous deduction exception itself. Instead, both courts

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44 Hughes & Luce v. Commissioner, 70 F.3d 16 (5th Cir. 1995).

45 Canelo v. Commissioner, 53 T.C. 217, 226-27 (1969), on other grounds, 447 F.2d 484 (9th Cir. 1971). The Supreme Court later noted this obvious point, but unfortunately concluded that the tax benefit Rule is an appropriate way to overcome the statutory bar, and ignored the importance of other correction devices. *Hillsboro*, 460 U.S. at 378 n.10.

46 I.R.C. 1311-1314; see also Canelo, 53 T.C. at 227.


48 53 T.C. 217 (1969), aff’d on other grounds, 447 F.2d 484 (9th Cir. 1971).

49 56 T.C. 82 (1971), aff’d per curiam, 456 F.2d 622 (5th Cir. 1972).

50 *Unvert*, 656 F.2d at 483.

51 Hughes & Luce v. Commissioner, 70 F.3d 16 (5th Cir. 1995).

52 *Mayfair Minerals*, 56 T.C. at 88.

53 *Unvert*, 656 F.2d at 485; 70 F.3d at 20.
held that the recovery of erroneous deductions results in income under the inclusionary arm of the Rule. In the courts= eagerness to resolve the anomaly, they effectively precluded application of the mitigation provisions as Congress intended. This point is also illustrated below.

a. Streckfus Steamers

On its 1940 federal tax return, Streckfus deducted $2,867.98 in Illinois sales taxes. The company had not paid the sales tax, but rather had accrued it. Such an accrual was not proper because Streckfus contested the liability. In 1943, an Illinois court determined that Streckfus did not owe the sales tax.

The Commissioner alleged that Streckfus realized income in 1943 when the Illinois court relieved the company of the sales tax liability. The Commissioner did not rely on the discharge of indebtedness theory, because no real debt ever existed. Instead, the Commissioner used a tax benefit theory: Streckfus benefited from the prior deduction, and thus, must pay tax on the "liability" relief. The Tax Court, however, did not agree.

Although the court acknowledged the beneficial 1940 deduction, it found no taxable event in 1943: the taxpayer had merely been relieved of a liability it never owed. The court explained, "an adjustment may be made only for the year 1940, which is barred by the statute . . . . An erroneous deduction taken in a prior year may not be treated as income of a later year." The court further explained that no basis existed to estop Streckfus from asserting the statute of limitation or from admitting the prior deduction was improper.

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54 Id. at 484-86.
55 See infra text accompanying notes 177-202.
56 Streckfus Steamers, 19 T.C. at 6.
57 Id. at 8.
58 Id. at 6.
59 Id. at 8.
60 Id.
61 Id. at 8-9.
b. Canelo v. Commissioner

Canelo was an attorney. He paid various costs owed by his clients in the form of advancements. The clients agreed to reimburse Canelo and later did so. Canelo deducted the amounts he paid during certain tax years prior to 1960. He included the reimbursements received in subsequent years.62

The earlier deductions were improper because at the time Canelo made them, he had a right to reimbursement. Therefore, the amounts paid should have resulted in a loan representing that right.63 Consequently, the subsequent reimbursement, on its own, did not result in income because it merely constituted a repayment of a loan: Canelo received that which he already owned.64

As in Streckfus Steamers, the Commissioner argued the tax benefit rule: Canelo had income because he recovered an amount previously deducted.65 Critically, the argument did not maintain that the recovered amount was income on its own merits; rather, the argument required an examination of a prior-year treatment. The court, however, citing Streckfus Steamers66 applied the erroneous deduction exception to the tax benefit rule. Because Canelo's prior deduction was improper, no tax benefit issue arose. Instead, the court judged the recovery on its own merits. With that preface, the court then determined the recovered amount constituted a non-taxable repayment of a loan.67

The Commissioner might have argued that Canelo had no basis in the right to reimbursement. Such an argument would assert that the capital account basis disappeared when Canelo deducted the expenses. Critically, the Commissioner did not so argue the case and therefore, the court did not directly address Canelo's basis. However, by describing the transaction as a repayment of a loan,68 the court essentially determined that Canelo had maintained his basis in the right to reimbursement.

c. Mayfair Minerals v. Commissioner


63 Id. at 224.

64 Id. at 226.

65 Id.

66 Id. (Citing Streckfus Steamers, 19 T.C. at 1).

67 Id. at 227.

68 Id. at 226-27. The court never used the phrase "return of capital." However, it described the recover as a return of a loan and as a recovery of that which Canelo "started with." Id.
Mayfair Minerals was a producer of natural gas. In 1954 Mayfair negotiated a contract for the sale of gas at 12 cents per thousand cubic feet. Such contracts were regulated by the Federal Power Commission (FPC), which refused to approve Mayfair's contract. Nevertheless, from 1955 through 1960 Mayfair obtained permission from the FPC to collect the contract price, with the stipulation that it would refund any amount in excess of 7.5 cents, if the FPC later required Mayfair to do so.69

During 1955 through 1960 Mayfair collected the contract price of 12 cents, included the full amount in gross income, and also deducted an accrued liability for the potential refunds. The accrued liabilities exceeded $4 million. During 1960, after litigation, the FPC rescinded its stipulation with Mayfair and approved the contract price. As a result, the FPC never required Mayfair to refund any amount.70 The deductions for accrued but contingent liabilities were clearly erroneous.71 Also, the relief of the liability did not truly give rise to discharge of indebtedness income because Mayfair did not ever incur a true debt to pay the refunds. Nevertheless, the Commissioner asserted a deficiency based on the tax benefit rule: Mayfair received a benefit from the deductions, and therefore, should have income when the "liability" was discharged.72

The Tax Court analyzed the case in light of Streckfus Steamers.73 The cases were factually almost identical: they each involved improperly accrued, contingent, unpaid liabilities of which a government agency subsequently absolved the taxpayer. The court, however, did not apply the erroneous deduction exception of Streckfus. Instead, the court fashioned an exception to the exception based on estoppel. Because of the manner in which it had disclosed the deductions, and because the government was misled by that inaccurate disclosure, Mayfair was estopped from arguing the invalidity of its deductions.74

d. Unvert v. Commissioner

During 1969, Alan Unvert paid over $54,000 to a finance company. He allegedly thought the amount was applied to deductible pre-paid interest connected to his planned

69 Mayfair Minerals, 56 T.C. at 83.
70 Id.
71 See Security Flour Mills Co. v. Commissioner, 321 U.S. 281, 284 (1944); Dixie Pine Products Co. v. Commissioner, 320 U.S. 516, 519 (1944), both cited by Mayfair Minerals "for the proposition that contingent liabilities are not properly deductible." Id. Mayfair Minerals, 56 T.C. at 88.
72 56 T.C. at 85-86.
73 Id. at 87-88.
74 Id. at 88-94. Although the Tax Court invoked the equitable doctrine of estoppel in Mayfair Minerals, it is also interesting to note that the Tax Court has maintained that it lacks equitable jurisdiction and thus it cannot apply, for example, the doctrine of equitable recoupment. See infra, note 153.
purchase of a condominium. He deducted the payment on his 1969 tax return. Unvert never purchased the condominium; consequently, he received a refund of the $54,000 in 1972. He did not report the refund on his 1972 return, apparently taking the position that the amount represented a non-taxable return of capital. In 1976, long after the statute of limitations had expired for 1969, the Commissioner issued a notice of deficiency for 1972 asserting that the 1972 refund was taxable pursuant to the tax benefit rule.75

The 1969 deduction was erroneous. The "payment" merely represented a deposit and thus was non-deductible because Unvert could not "pay" interest he did not owe. Unvert himself maintained that the deduction was erroneous; neither the Tax Court nor the Ninth Circuit disagreed. However, rather than apply the erroneous deduction exception to the tax benefit rule, the Tax Court chose to apply the estoppel rule.76

As a result, Unvert was estopped from arguing the true nature of the 1969 deduction. Left with no argument tending to prove the 1969 error, the court effectively found that the "erroneous" payment actually constituted a proper deduction. Consequently, the erroneous deduction exception did not apply and the court applied the traditional tax benefit rule.77 The Court of Appeals for the Ninth Circuit agreed with the result, but altered the reasoning.78 In applying the tax benefit rule, the court did not first determine whether the initial deduction was erroneous and then whether estoppel should apply. Instead, the court rejected the erroneous deduction exception, claiming that it represented poor public policy.79 The court questioned the Tax Court's fairness in subjecting taxpayers who take proper deductions to the Rule but exempting taxpayers who take improper deductions from its application. The court, thus, greatly expanded the Rule by applying it to recoveries of erroneous deductions.

75 Unvert, 656 F.2d at 484.
77 Id. at 818.
78 Unvert, 656 F.2d at 485, n.1.
79 Id. at 486.
The logic of the erroneous deduction exception is that an improper deduction should be corrected by assessing a deficiency before the statute of limitations has run, not by treating recovery of the expenditure as income. This rationale was explained most comprehensively in Canelo: We realize that petitioners herein have received a windfall through the improper deductions. But the statute of limitations requires eventual repose. The "tax benefit" rule disturbs that repose only if respondent (the Commissioner) 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 respondent should have challenged it before the years prior to 1960 were closed by the statute of limitations. 53 T.C. at 226-27.

We find this unpersuasive. Prior decisions under the tax benefit rule state clearly that inclusion of the recovery as income does not reopen the tax liability for the prior year and does not implicate the statute of limitations. 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. 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. [*]

Unvert attempts to provide a more fully reasoned justification for this exception. He argues that whether the recovery of a previous expenditure is taxable depends on its character as income or a return of capital. This character, he contends, is determined from the inherent characteristics of the transaction, not whether the taxpayer originally deducted the expenditure. See Bishop, The Tax Benefit Rule After Unvert: Does it Compromise the Statute of Limitations, 51 J. Tax 272, 273 (1979). The Commissioner does not contest that the 1969 deduction was improper because the expenditure was capital. Unvert argues that the Commissioner has attempted to recoup the 1969 deduction by improperly re-characterizing the recovery as income rather than correctly treating it as a nontaxable return of capital.

This argument is unpersuasive. The decisions creating and applying the tax benefit rule make clear that the recovery must be taxed because it previously created a tax benefit, not because of the inherent characteristic of the recovery. To the extent of deductions taken, a debt loses its nature as capital and takes on the character of the untaxed income which the deduction represents. West Seattle National Bank v. Commissioner, 288 F.2d 47, 49 (9th Cir. 1961); accord, National Bank of Commerce v. Commissioner, 115 F.2d 875, 876-77 (9th Cir. 1940).

The erroneous deduction exception is also poor public policy. A taxpayer who properly claims a deduction for an expenditure that is recovered in a later year must treat the recovery as income, while one who claims an improper deduction may not be required to include the recovery as income only because of the impropriety of the deduction. We agree with the Second Circuit that improperly taken tax deductions should not be rewarded. We need in this case to concern ourselves with the theory advanced that when ... a deduction has improperly been claimed and allowed, no part of such deduction when collected can be included in income. 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. Askin & Marine Co. v. Commissioner, 66 F.2d 776, 778 (2d Cir. 1933) (court avoided erroneous deduction exception through estoppel theory).

At least three circuits have implicitly rejected or criticized the erroneous deduction exception. See 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); Askin & Marine Co. v. Commissioner, 66 F.2d 776, 778 (2d Cir. 1933); Commissioner v. Liberty Bank & Trust Co., 59 F.2d 320, 325 (6th Cir. 1932).

AFFIRMED.2

In 1995, in a very similar opinion, the Fifth Circuit followed Unvert. The case was Hughes & Luce v. Commissioner.80

An analysis of Unvert and Hughes appears later, in Section D. For now, some reflection is necessary regarding the Ninth Circuit’s statement, repeated by the Fifth Circuit in its 1995 decision,81 that the Second, Sixth, and Seventh Circuits acted similarly to reject the erroneous deduction exception. The three cited cases are not only quite old - each dating to the 1930’s - but they are also not clearly on point. This issue is significant because, to the extent that the Fifth and Ninth Circuits were persuaded by prior authority, their conclusions are suspect if the authorities relied upon are themselves suspect.

Arguably, the Second, Sixth, and Seventh Circuits have not rejected the erroneous deduction exception. Under such a theory, the Tax Court would not be bound to reject the exception for cases appealable to those circuits. The Court of Appeals for the Fifth Circuit appears to have borrowed its reference to those cases from the Ninth Circuit Unvert decision82 without much analysis of the cited cases. Unfortunately, while the Ninth Circuit

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2 As noted previously, the Tax Court held that the erroneous deduction exception did not apply on the basis that the taxpayer was estopped from claiming that the prior deduction was improper. Unvert, 72 T.C. at 813-16. We do not decide whether that approach was a sufficient basis to find for the Commissioner. We believe the Tax Court’s approach is inferior to rejecting the erroneous deduction exception outright because it would involve courts in more complex case-by-case adjudication. The Tax Court held that a taxpayer is estopped by deliberate or unintentional misrepresentations of fact. The taxpayer is invited to argue that the mistake upon which the deduction was based was one of law. Id. at 816. The principal case relied upon by the Tax Court suggests also that the taxpayer could argue that the IRS should have known the deduction was improper. See Mayfair Minerals, Inc. v. Commissioner, 56 T.C. 82, 89-91 (1971), aff’d per curiam, 456 F.2d 622 (5th Cir. 1972). It may be open to debate whether it is the taxpayer or the Commissioner who has changed position. See Bishop, 51 J.Tax at 274. Finally, if the erroneous deduction exception is retained in any form, there always will be inquiry as to whether the original deduction was erroneous. In this sense, the erroneous deduction exception actually undermines the policies of the statute of limitations.

80 Hughes & Luce v. Commissioner, 70 F.3d 16 (5th Cir. 1995). For a critical discussion of the Tax Court opinion in Hughes & Luce, affirmed on other grounds by the Fifth Circuit, see Steven J. Willis Erroneous Deductions and the Tax Benefit Rule, 68 TAX NOTES 1479 (1995).

81 Hughes & Luce, 70 F.3d 16 (5th Cir. 1995).

82 In 1981, the Ninth Circuit stated:
correctly stated that the prior circuits had *implicitly* rejected or *criticized* the exception, the Fifth Circuit described those cases as having *rejected* it, stronger language. A consideration of the three cases is thus in order.

e. **Commissioner v. Liberty Bank & Trust**^83^

This 1932 Sixth Circuit opinion considered taxable years pre-dating both the erroneous deduction exception and the mitigation provisions. As a result, it is facially suspect as support for *Unvert* and *Hughes* because both judicial and statutory approaches changed subsequent to 1932.

The taxpayer reported bad debt deductions during the years 1916 through 1919. It later collected the written-off receivables in 1920 and 1921. The commissioner treated the recoveries as income. While the taxpayer apparently asserted that the prior deductions were erroneous, the court ultimately estopped him from denying their validity. This result is more consistent with the Tax Court’s later estoppel exception to the erroneous deduction exception than it is with the later *Unvert* and *Hughes* cases which specifically discarded both exceptions. Thus it hardly supports those courts.

In addition the Sixth Circuit relied on the then recent *Sanford & Brooks*^84^ decision from the Supreme Court, which death with *proper*, rather than *improper*, deductions. The Circuit Court stated: Even if the taxpayer is not estopped from asserting that there was no ascertainment of worthlessness for the former years, we are of the opinion that the amounts received in payment of the debts were chargeable to gross income for the years in

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At least three circuits have implicitly rejected or criticized the erroneous deduction exception. See 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); Askin & Marine co. v. Commissioner, 66 F.2d 776, 778 (2d Cir. 1933); Commissioner v. Liberty Bank & Trust co., 59 F.2d 320, 325 (6th Cir. 1932).

656 F.2d at 485-86.

In 1995, the Fifth Circuit stated:

In its opinion, the Tax court noted candidly that the erroneous deduction exception has been criticized or rejected by many Courts of Appeals. 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.

70 F.3d at 19. The court then cited the cases previously cited by the Ninth Circuit.

^83^ 59 F.2d 320 (6th Cir. 1932).

which they were received.\textsuperscript{85} While that is the language relied on by the Ninth Circuit, it is far short of controlling support for several reasons. First, the Sixth Circuit wrote it as mere \textit{dicta} and not part of its holding. Second, the circuit court wrote in the context of a then brand new Supreme Court decision dealing with timing of proper deductions followed by recoveries. The circuit’s use of the \textit{Sanford & Brooks} case as authority for its statement suggests that the circuit read the Supreme Court’s decision very broadly, probably more so than was justified in hindsight. To rely on that broad reading today - six decades later - seems unwise. Third, the decision is actually the first of the estoppel exception cases and thus supports the Tax Court’s approach, rather than that of the Ninth and Fifth Circuits. Fourth, the decision pre-dates the enactment of section 1312(7), which appears to control the situation, by twenty years.

In light of those four reasons, the Tax Court would likely not feel bound by the decision in cases appealable to the Sixth Circuit. Further, the Sixth Circuit should probably consider the situation as one of first impression when faced with it again.

f. \textit{Kahn v. Commissioner}\textsuperscript{86}

This 1940 opinion of the Second Circuit is particularly weak authority for the Ninth and Fifth Circuits to have relied on. The case involved bad debt deductions in 1932 as well as the possibility of income from recoveries of the debts in 1933. The court, dealing with two open years (a critical fact because both \textit{Unvert} and \textit{Hughes} dealt with one open and one closed year), denied the deductions for 1932 and excluded the recoveries for 1933. The case thus had nothing to do with the tax benefit rule and error correction.

In addition to the litigated facts, however, the taxpayer asserted that similar recoveries it had reported as income in 1932 should not be included. The court refused to so hold, stating \textit{Finally, it is urged that if the claimed deductions be disallowed, then the recoveries of $4,374.06 on debts charged off in prior years pursuant to the firm’s practice should not be included in its income for 1933. Assuming that this contention, which apparently was not presented to the Board, may be considered by us, it cannot withstand scrutiny.}\textsuperscript{87}

That is the language relied upon by the Ninth and Fifth Circuits as having criticized or rejected the erroneous deduction exception. Such reliance is flawed for six reasons.

First, the statement is not part of the holding and is at most unclear. The court never explained why it thought such an argument would not withstand scrutiny.\textsuperscript{85} Second, the facts necessary for a decision on the issue were not litigated before the lower court. Third, the issue was not presented to the circuit court and thus was mere speculation. Fourth, the

\begin{itemize}
  \item \textit{Liberty Bank}, 59 F.2d at 325.
  \item 108 F.2d 748 (2d Cir. 1940).
  \item Id. at 749.
\end{itemize}
court did not say whether the 1932 recoveries correlated with prior deductions, when those deductions occurred, whether they were erroneous, and whether the statute of limitations involving them was open. Without those facts, one cannot now evaluate the court’s dicta. Fifth, the case arose prior to the later opinions of the Tax Court creating the erroneous deduction exception. Thus, how could the court, with no facts and no issue before it, reject Tax Court analysis which did not then exist? Logically it could not. Sixth, the case arose fourteen years before the enactment of section 1312(7), which would now be relevant to the issue.

In light of those six reasons, the Tax Court would likely not feel bound by the decision in cases appealable to the Second Circuit. Further, the Second Circuit should consider the situation as one of first impression when faced with it.

g. Union Trust Company v. Commissioner\(^\text{88}\)

This 1940 Seventh Circuit opinion is not only weak authority for Unvert and Hughes, it is also clearly wrong.

In 1929, an estate for which the taxpayer was executor paid estate taxes and took a corresponding income tax deduction. In 1932, the executor received a refund of the taxes. The commissioner claimed the refund as income and the court agreed. In so doing, the court alternatively described the 1929 payment of the taxes as erroneous and the 1929 deduction of the taxes as erroneous. It also emphasized that - at the time of the decision - the error year, 1929, was closed and thus could not be corrected. As a result, it applied the tax benefit rule.

This decision is subject to criticism for three reasons. First, whether 1929 was open or closed in 1940 was irrelevant. Surely the year was open in 1932, the year of the recovery. If indeed the prior deductions were erroneous, then they should have been corrected by way of an amended return or deficiency notice for 1929. The tax benefit rule would be relevant only if the prior deductions were proper. Even today, no court - including the Ninth and Fifth Circuits - would use the tax benefit rule to correct for erroneous deductions when the error year was open at the time of recovery. Second, the case pre-dated the Tax Court’s erroneous deduction analysis and thus can hardly reject a non-existent doctrine. Third, the case pre-dated section 1312(7), which is now relevant to the issue.

5. FURTHER EXPANSION OF THE RULE

The Supreme Court, in the 1983 Bliss Dairy decision,\(^\text{89}\) further expanded the Rule by applying it to taxpayer actions "fundamentally inconsistent"\(^\text{90}\) with prior tax benefits. The

\(^{88}\) 111 F.2d 60 (7th Cir. 1940).

\(^{89}\) United States v. Bliss Dairy, Inc. was the companion case to Hillsboro, 460 U.S. at 370.
expanded Rule no longer requires a "recovery" of anything.\textsuperscript{91} As explained later, it may not even require a traditionally taxable transaction.

Bliss Dairy, Inc. deducted the full cost of cattle feed purchased during its fiscal year 1973.\textsuperscript{92} Such a deduction by a cash method taxpayer was clearly proper in advance of the time the cattle consumed the feed, even though much of the feed was unconsumed at the end of the year.\textsuperscript{93} During the following fiscal year Bliss Dairy, Inc. adopted a plan of liquidation and distributed its assets, including the remaining cattle feed, to its shareholders.\textsuperscript{94} Pursuant to then section 336,\textsuperscript{95} the corporation properly reported no gain or loss as a result of the liquidation.\textsuperscript{96}

The shareholders, electing under section 333,\textsuperscript{97} limited its respective gains from the liquidation to their respective shares of accumulated earnings and profits plus boot received in excess of such respective shares. Pursuant to section 334(c),\textsuperscript{98} the shareholders' bases in the assets received were set as a share of their respective bases in the canceled stock plus the limited gain recognized.

Although the record did not reflect the amount, the Court presumed that the shareholders "took] a basis greater than zero in the feed . . . [and] in turn deducted their basis in the feed as an expense of doing business under section 162."\textsuperscript{99}

The government understandably was scandalized at the apparent double deduction of the cattle feed - once by the corporation and then again by the shareholders. It therefore argued that the tax benefit rule should apply to tax the corporation on the distribution of the feed.\textsuperscript{100} The Court agreed.\textsuperscript{101} Application of the Rule, however, required a new expansive

\begin{footnotesize}
\begin{enumerate}
\item [90] Hillsboro, 460 U.S. at 385.
\item [91] Id. at 381-83.
\item [92] Id. at 374.
\item [93] See id. at 384, n. 17; Zaninovich v. Commissioner, 616 F.2d 429 (9th Cir. 1980).
\item [94] Hillsboro, 460 U.S. at 374.
\item [95] I.R.C. ' 336 (1973).
\item [96] Hillsboro, 460 U.S. at 375.
\item [97] I.R.C. ' 333 (1973); see Hillsboro, 460 U.S. at 375 n.5.
\item [98] I.R.C. ' 334(c) (1973); see Hillsboro, 460 U.S. at 376 n.6.
\item [99] Hillsboro, 460 U.S. at 376.
\item [100] Id. at 376-77.
\end{enumerate}
\end{footnotesize}
interpretation. Traditionally, the Rule applied to a recovery of a previously deducted item. However, the Court explained that prior cases also contained language that would apply the Rule to events merely "inconsistent" with the prior treatment. Thus, the majority clearly rejected the "recovery" requirement: a requirement that had earlier formed the rationale for applying the Rule.

HILLSBORO NATIONAL BANK v. COMMISSIONER
UNITED STATES v. BLISS DAIRY, INC.
460 U.S. 370
March 7, 1983

Justice O'CONNOR delivered the opinion of the Court.

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, ' 558, customarily paid the taxes for the shareholders. Under ' 164(e) the bank was allowed a deduction for the amount of the tax, but the shareholders were not.

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 repeal of the tax in 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. 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. 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.

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. 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, Bliss reported no income on the transaction. The shareholders continued to operate the dairy business in non-corporate form. They filed an election under ' 333 to limit the gain recognized by them. 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,

101 Id. at 395-403.
102 Id. at 383-87.
103 Id. at 381.

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).
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's 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. 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.

The tax benefit rule - a judicially developed principle 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 uncollectible 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 from recouping any of the tax saved because of the improper deduction. Recognizing and seeking to avoid the possible

6 Although the rule originated in the courts, it has the implicit approval of Congress, which enacted '111 as a limitation on the rule. See note 12, infra.

7 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 '1341, 26 U.S.C. '1341; 1 B. Bittker Federal Taxation of Income, Estates and Gifts '6.3 (1981).

8 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 s 7.34 (J. Doheny rev. ed. 1981); Bittker & Kanner, The Tax Benefit Rule, 26 U.C.L.A. L. Rev. 265, 266 (1978). 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, 1166. See note 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 recognized 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 permit 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 note 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. 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.

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 (E.D. Pa.1942), while another explained that the deduction offset income in the earlier year, which
The Court's footnote 10 suggestion that financial accounting is consistent with the Court's theory is inaccurate. While financial accounting would achieve the same result as the Court's approach, it would do so by using the basis mechanism, as described above. The original deduction would prompt a bookkeeping entry, including a debit to "loss" and a credit to the note's basis, which would become zero. The recovery would cause a debit to cash and a credit to income.

The result is the same; however, the approach is profoundly different. This difference becomes important in other factual situations.]

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.

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. Lower courts have been able to stretch the definition of "recovery" to include a great variety of events. 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.

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 and T. Keller, Intermediate Accounting 109 (3d ed. 1974). This concern with more accurate measurement of income underlies the tax benefit rule and always has.

10 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 benefit 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 (Cl. Ct.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.
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.14 That is, if that event had occurred within the same taxable year, it would have foreclosed the deduction.15 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), e.g., Zaninovich v. Commissioner, 616 F.2d 429 (CA9 1980),16 the tax benefit 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 business17 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

14 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.

15 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.

16 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 benefitting the taxpayer substantially beyond the taxable year. See generally 1 B. Bittker, supra n. 1, at P 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, 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. 1429, 1432 (1932).

17 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. 11, at P 20.3.2.
fundamentally inconsistent with the business use on which the deduction was based.\(^\text{18}\) 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 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.\(^\text{19}\)

\[\text{[The prior paragraph - and footnote 19 - are very important. The court limits the new Tax Benefit Rule to Situations not resolved by Congress. Transactional inconsistencies for which Congress has provided a solution - such as through section 1245 - are thus not within the clear ambit of this case.]}\]

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\(^\text{[****]}\). Nor does the concern with transactional equity entail a change in our approach to the annual accounting system. Although the tax system relies basically on annual accounting, see Burnet v. Sanford & Brooks Co., 282 U.S. 359, 365, 51 S.Ct. 150, 152, 75 L.Ed. 383 (1931), the tax benefit rule eliminates some of the distortions that would otherwise arise from such a system. See, e.g., Bittker and Kanner, The Tax Benefit Rule, 26 U.C.L.A. L. REV. 265, 268-270 (1978); Tye 350; Plumbe 178 and n. 172. The limited nature of the

\[^{18}\] See 1 B. Bittker, supra, n. 11, P 20.2.2 ("Food and shelter are quintessential nondeductible personal expenses"). See also pp. 1149-1150, infra.

\[^{19}\] 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 the United States in No. 81-830 and the Commissioner in No. 81-485 at 20; Reply Brief for the Petitioner in No. 81-485 at 12; Tr. of Oral Arg. at 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, that event occurs in the context of a nonrecognition rule, see, e.g., Campbell v. Prothro, supra, at 336; 1 B. Bittker, Federal Taxation of Income, Estates, and Gifts P 5.21 (1981), and resolution of these cases would require a determination whether the nonrecognition rule or the tax benefit rule prevails.
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.23

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 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 ld. at 381., 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.

In evaluating this argument, it is 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. [****] 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. [****] The shareholder, however, would be entitled to a deduction since the constructive dividend is used to satisfy his tax liability. Section 164(a)(2). Thus, for the shareholder, the transaction would be a wash: he would recognize the amount of the tax as income, [****] 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. Section 311(a).

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 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

23 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 note 9, supra, the problem is that the taxpayer has mis-characterized 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.
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. [****]

The payment by the corporations of a liability that Congress knew was not a tax imposed on them [****] 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 the state does not require the corporation to recognize income, and we reverse the judgment below. [****]

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. [****] In general, if the taxpayer converts the expensed asset to some other, non-business 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 non-business 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. [****] Thus, if a corporation turns expensed assets to the analog of personal consumption, as Bliss did here it would seem that it should take into income the amount of the earlier deduction.29

29 Justice STEVENS' dissent takes issue with this conclusion, characterizing the situation as identical to that in Nash, 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 and 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
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.30

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. [****] 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. Sections 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. [****] In spite of the language of nonrecognition, the courts have applied the assignment of income doctrine and required the corporation to recognize the income.31 Section 336, then, clearly does not shield the taxpayer from recognition of all income on the distribution.

Next, we look to a companion provision - ' 337, which governs sales of assets followed by distribution of the proceeds in liquidation. [****] It uses essentially the same broad language to shield the corporation from the recognition of gain on the sale of the assets. The similarity in

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.

30 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 s 1245 overrides s 336. Section 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, 94th Cong., 2d Sess. (1976); H.R. No. 94-1350, 94th Cong., 2d Sess. (1976), the House passed it, and Congress adjourned without any action by the Senate. See Government Printing Office, 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. No. 94-1350, supra, at 2. Given this background, we cannot draw any inference from the failure to enact the amendment.

31 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 non-liquidating 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, supra, at 247.
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. [****]

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. [****] Congress has recently undertaken major revisions of the Code. [****] but it did not act to change this long-standing, universally accepted rule. If the construction of the language in section 337 as permitting recognition in these circumstances has the acquiescence of Congress, [****] we must conclude that Congress intended the same construction of the same language in the parallel provision in ' 336.

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.32

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. [****]

Justice STEVENS, with whom Justice MARSHALL joins, concurring in the judgment in No. 81-485 and dissenting in No. 81-930. [****]

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

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

32 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 1161 and n. 26, 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 1149, 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.
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. 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. Unfortunately, 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. 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.

Any inconsistent event theory of the tax benefit rule would make the tax system more complicated than it has been under the recovery theory. Inconsistent event analysis forces a

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3 The flaws in the Court’s approach are exemplified by its discussion, ante, at 1143-1144, of a hypothetical situation involving a tenant who has paid the entire cost of a 30-day lease that 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 (S.D.N.Y.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 pro-rated, 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.

4 The Court suggests, ante, at 1142, 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
deviation from the traditional 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 already mandated deviations from that traditional pattern, 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 events theory.

Nonetheless, a general inconsistent events 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 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 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 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, and at least once suggests that when an expensed asset is sold, (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. s 61(a)(12). Cf. s 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 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.

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

7 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
only the "amount of the proceeds on sale," ante, at 1150, is income. 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. [****]

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 1142. It could modify the manner in which deductions are authorized under 162. 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, 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 the United States, at 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 (Ct. Cl.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 (S.D.N.Y.1979) (Weinfeld, J.) (supporting the Commissioner) with Fryinger v. Commissioner, 645 F.2d 523 (CA5 1981); Commissioner v. Van Raden, 650 F.2d 1046 (CA9 1981) (supporting the taxpayer).

In 1975, Congress had before it, but was unable to pass, such legislation. H.R. 10936, 94th Cong., 1st Sess. (1975).
the manner in which basis is allocated under s 334. 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.

Justice BLACKMUN, dissenting.

[I]t seems to me that the better resolution [****] 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 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. [****]

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 farther than it should.

D. THE TAX BENEFIT RULE: AN ANALYSIS

Viewed in context - as one of many correction devices - the modern tax benefit rule is subject to two main criticisms: it is both over broad and poorly designed. Other correction devices are better suited for errors now covered by the Rule. Also, other correction devices offer more effective correction of the errors.

Current applications of the Rule fall into three classes:

- A. Reasonable Mistakes of Fact.

11 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 1142. 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).

12 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 1151-1154, 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, 41 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 (Ct. Cl.), cert. denied, 409 U.S. 1064, 93 S.Ct. 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, 65 T.C. 440, 453 (1975) (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").
B. Unreasonable Mistakes of Fact and Law.

C. Proper treatment.

As explained earlier, the Tax Court traditionally applied the Rule only to Class A. The erroneous deduction exception prevented application to Class B. The Court of Appeals for the Ninth Circuit, in the 1981 Unvert decision, expanded the Rule to apply to Class B as well. The Fifth Circuit followed suit in the Hughes decision. The Supreme Court in the 1983 Bliss Dairy decision also expanded the Rule to apply to Class C. The Court was not clear whether it agreed with the Ninth Circuit regarding application to Class B.

A summary of the argument is:

- The Rule is unnecessary as to Class A because section 1016 and the basis mechanism of the Code achieve the same result.

- The Rule is inapplicable to Class B because the Mitigation provisions - particularly section 1312(7) - apply. If the Rule were to apply to situations involving unreasonable mistakes of fact or mistakes of law then section 1312(7) would have little meaning. Consequently, for the section to have meaning, the Rule must not apply to Class B. In addition, section 1312(7) is a better correction device than is the Rule.

- The Rule should apply only to Class C - the very class to which it traditionally did not apply. Refinement of the Rule as to Class C is warranted. Also appropriate would be a re-designing of the Rule so that it provides approximate correction such as provided by section 1341 or the doctrine of equitable recoupment.

1. CLASS A: REASONABLE MISTAKES OF FACT

a. Background

Traditionally Class A is the area to which the tax benefit rule applied. "Reasonable Mistakes of Fact" involve mistakes that the annual accounting system deems appropriate; hence, they are "reasonable".

Under annual accounting, a taxpayer must use information reasonably available at year-end to determine the tax consequences of a transaction. The annual system considers such a determination appropriate even if information available in a subsequent year shows

104 See supra text accompanying notes 39-74.

105 656 F.2d at 483.

106 Hughes & Luce v. Commissioner, 70 F.3d 16 (5th Cir. 1995).

107 Bliss Dairy was the companion case to Hillsboro, 460 U.S. at 370.
it to be mistaken. Thus, the prior deduction, omission, inclusion, or capitalization, although truly mistaken in hindsight, is reasonable and thus legally correct. Thus, it is not subject to amendment. That was the message of Sanford & Brooks$^{108}$ and North American Oil.$^{109}$

b. Application of the Tax Benefit Rule

Intuitively the recovery of a deducted item produces income. No one quarrels with that general conclusion. More specifically, under the Tax Benefit Rule, the recovery produces income because of the prior beneficial deduction. Without the prior benefit, the recovery produces no income - at least not since the enactment of section 111.$^{110}$ Again, no one quarrels with these results. However, one might reasonably disagree with the cause of the income. Such a disagreement supports the Tax Court's traditional erroneous deduction analysis.

Strictly, the recovery of a deducted item does produce income because of the prior beneficial deduction; however, the complete and correct analysis is more complex than the traditional tax benefit rule explanation suggests. Section 1016$^{111}$ and the basis mechanism offer the alternative analysis. The results are the same. However, the income exists because the taxpayer realizes an amount in excess of his basis rather than simply "because of the prior beneficial deduction." If this analysis is correct, the tax benefit rule is unnecessary for reasonable mistakes of fact. Consider the following steps in the argument:

1. In the traditional tax benefit scenario - involving reasonable mistakes of fact - a taxpayer deducts an item he believes he owes based on information reasonably available at year-end. He later discovers his right to recover the item. Nevertheless, the original deduction is proper under the annual accounting system. It is not subject to correction; however, the subsequent recovery is a separate taxable event that the taxpayer must also analyze based on information reasonably available at the time.

2. The right to a recovery is an asset. The asset exists as a result of the transaction that caused the deduction. It exists even if the taxpayer is unaware of its existence.

3. The asset necessarily has a basis. A basic tenet of tax law is that all assets have a basis.

4. The basis in the asset is a function of the taxpayer's basis in the item exchanged or otherwise expended in the transaction giving rise to the apparent deduction.

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$^{108}$ Sanford & Brooks, 282 U.S. at 359.

$^{109}$ North Am. Oil, 286 U.S. at 417.


$^{111}$ I.R.C. * 1016.
5. Because the taxpayer properly deducted his basis or a portion of his basis in the prior transaction, his basis in the asset is correspondingly less than a simple transfer basis. If the item were fully deducted, then his asset basis is zero.

6. When the taxpayer recovers the asset he experiences a taxable event: the recovery constitutes an "accession to wealth, clearly realized" under Commissioner v. Glenshaw Glass. Under similar analysis, the taxpayer's collection of the right to recover can be deemed a sale or exchange of the right and thus a taxable event. The taxpayer has a zero, or at least a reduced basis, in the right to recover the asset. Thus, the taxpayer's amount realized equals the value of the asset recovered. His gain equals the amount realized less the zero or otherwise reduced basis.

7. Section 111 then operates on the recovery to exclude that portion of the value for which no beneficial deduction occurred. Thus, if the asset has appreciated following the original transaction, the appreciation value should be excluded under section 111. Similarly, if the asset had a value greater than basis at the time of the transaction, and if the deduction was limited to the basis, then the extra value would be excluded from income under section 111. The resulting income thus would equal the prior deduction.

8. The new basis of the recovered asset would equal the amount of the recognized income, which, as demonstrated above, would equal the old basis which had been deducted. Thus, the taxpayer would be in the same position as if he had never taken the deduction.

Section 1016 requires an adjustment to basis "for expenditures, receipts, losses, or other items, properly chargeable to [a] capital account." In the typical scenario, the taxpayer's prior deduction would be based on all information then reasonably available; thus, it would be a proper deduction and properly chargeable to a capital account. Such a "charge" can involve an increase (capitalization) or a decrease in the capital account (expense). When the deduction is "charged" (expensed) to the capital account the basis is reduced. Thus, the newly acquired asset, albeit unknown, obtains a reduced transfer basis.

This point is also consistent with financial accounting. When an asset is expensed, the resulting bookkeeping entry contains a debit to an expense temporary account and a credit to an asset permanent account. The credit amounts to a basis reduction.

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The *Glenshaw Glass*\(^\text{113}\) case supports the Step Six notion that all accessions to wealth "clearly realized" are taxable. *Section 1271*\(^\text{114}\) supports the notion that collection of a note is a taxable event. However, it justifies the Rule as something other than a judicial creation. It does not correct fully the error because it does not account for changing tax rates, collateral matters, and the time value of money. The situation, however, does not involve a true error. Under an annual accounting system, reasonable mistakes based on reasonably available information are not errors. Thus, the failure of the basis mechanism to fully correct is not a failure of the mechanism, but rather a failure of the annual accounting system. Also, the basis mechanism is consistent with the annual accounting theory of the United States’ tax system: each year stands alone. The current income exists not because of the prior deduction, but rather because the recovery results in an accession to wealth clearly realized.

### 2. CLASS B: UNREASONABLE MISTAKES OF FACT AND MISTAKES OF LAW

#### a. Background

"Unreasonable mistakes of fact" are those mistakes that a taxpayer should have discovered from information reasonably available in the year of the original deduction, omission, inclusion, or capitalization. Such mistakes are subject to correction by way of an amended return or a notice of deficiency, subject only to the statute of limitations and in some instances, *section 481*.\(^\text{115}\) Mistakes of law are appropriately grouped with such unreasonable mistakes of fact because legal mistakes are similarly not binding under the annual accounting system.\(^\text{116}\) They too are subject to correction by way of an amended return or a notice of deficiency, subject to the statute of limitations.

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\(^{113}\) 348 U.S. 426, 431 (1955).

\(^{114}\) I.R.C. ' 1271. Internal Revenue Code section 1271 provides that collection of a note is a sale or exchange. Id. Prior to the enactment of the predecessor to section 1271, I.R.C. ' 1232 (1954), *Fairbanks v. United States*, 306 U.S. 436 (1939), provided that collection of a note was not a sale or exchange. Id. at 438. In any event, no one legitimately doubts that collection is a taxable event. With this in mind, the phrase "recovery of capital" to denote a non-taxable transaction is a misnomer. For example, a taxpayer who withdraws funds from a bank account "recovers capital" and incurs no income. The reason, however, is not that the transaction is non-taxable because it is a "recovery of capital;" rather, the taxpayer inevitably has a basis in the right to recover equal to the amount withdrawn. Thus the taxable event of withdrawing the funds produces no gain or loss.

\(^{115}\) The government has argued that some erroneous treatment by a taxpayer amounted to a method of accounting. In such cases, section 481 - dealing with changes of accounting methods - arguably requires current or prospective rather than retroactive correction.

\(^{116}\) *Unvert v. Commissioner*, 72 T.C. 807, 816 (1979) ("It is well-settled that estoppel does not apply to mistakes of law, but before a mistake of law can occur both parties must know the facts." (citation omitted)), *aff'd*, 656 F.2d 483 (9th Cir. 1981), *cert. denied*, 456 U.S. 961 (1982).
Traditionally, the Rule has not applied in this area; instead, the Tax Court has applied the erroneous deduction exception to the Rule.\textsuperscript{117} The Ninth Circuit decision in \textit{Unvert}\textsuperscript{118} casts doubt on that tradition. The tradition, however, is correct - and \textit{Unvert} incorrect - for reasons not articulated by the Tax Court’s erroneous deduction exception.

The mitigation provisions, particularly section 1312(7),\textsuperscript{119} provide the congressional solution for correction of errors caused by unreasonable mistakes of fact and mistakes of law. This solution is superior to the \textit{Unvert} use of the Rule because the mitigation provisions are a superior - though more cumbersome - error correction device: they provide for more complete correction.

Understanding this analysis requires what some authorities might consider a departure from traditional tax thought. It requires agreement with the following:

An erroneous deduction or expense of an item does not result in a basis reduction.

Not only does section 1016 support this statement, but also section 1312(7) has no application if the statement is incorrect. Nevertheless, many tax authorities may experience initial difficulty with the concept.

\section*{b. A Defense of the Erroneous Deduction/Basis Theory}

Consider section 1016(a):

- \textbf{GENERAL RULE --} Proper adjustment in respect of the property shall in all cases be made -- (1) for expenditures, receipts, losses, or other items, properly chargeable to capital account.\textsuperscript{120}

A "charge" to an account can either involve an increase or a decrease. Normally a decreasing charge is thought of as a "charge off"; however, such a viewpoint is not inconsistent with viewing section 1016(a)(1) as applying to expenses which both increase as well as decrease the basis of assets.

This provision is consistent with a double-entry system of financial accounting. On the acquisition of an asset, the bookkeeper will debit an asset account (also known as a capital account) and will credit some other account - a liability, income, equity, or another asset. Similarly, on the consumption or expense or loss of an asset, the bookkeeper will credit an asset account and debit some other account. Ultimately, these entries must occur

\textsuperscript{117} See supra text accompanying notes 39-74.

\textsuperscript{118} 656 F.2d at 483.

\textsuperscript{119} I.R.C. \textsection 1312(7).

\textsuperscript{120} I.R.C. \textsection 1016(a).
- either in the proper period, or as an extraordinary item adjustment in some later period if the original entry is incorrect.

Section 1016(a)(2) provides for basis reductions due to "exhaustion, wear and tear, obsolescence, amortization, and depletion, to the extent of the amount -- (A) allowed as deductions . . . but not less than the amount allowable . . . . "\(^{121}\) This provision suggests that an excessive and thus erroneous allowed deduction would indeed reduce basis. Nevertheless, section 1016(a)(1), which would apply in nearly all events other than those involving depreciation and depletion, has no comparable provision. The section merely requires a basis effect for "proper" charges. Excessive or improper charges do not affect basis.

- Example Two: Taxpayer spent $1000 moving a particular piece of machinery to a special location. In most cases such an expenditure would be "properly chargeable" to a capital account - namely the machinery. Thus, taxpayer increases his basis in the machinery.

In Example 2, if the taxpayer discovers in a later year either that he never paid the $1000 or that the $1000 expenditure was not attributable to that particular machinery and that he should have known this information in the prior period, then the increase in basis was erroneous. Section 1016(a)(1) then provides that no adjustment to basis would have occurred because the payment was not "properly chargeable to a capital account."\(^{122}\) Likewise, for financial accounting, a bookkeeper who discovered an incorrect entry debiting such an asset for $1000 would correct it in a later period by crediting the asset account $1000 and debiting some other account to reflect the prior period adjustment. While the books and statements for the prior period would not reflect the change, it would occur in the year of discovery as an extraordinary item if it affected the income statement.

This analysis does only a little violence to the annual accounting theory. Although the determination of basis requires an examination of a transaction in a prior period, such a look-back is essential to any determination of basis. Also, the determination would not itself require a prior period correction of any errors that resulted from a prior erroneous determination of basis. As explained below, section 1312(7) supports this analysis.\(^{123}\)

- Example Three: Taxpayer consumes supplies not previously expensed in his business. Such consumption properly reduces or "is charged to" the capital account containing the supplies. It also results in a deduction.

In Example 3, if the taxpayer discovers in a later year that he never consumed the supplies and that he could and should have known the truth during the taxable year of the expenses, then the deduction was erroneous. Again, section 1016(a)(1) provides that no

\(^{121}\) I.R.C. \( \cdot \) 1016(a)(2).

\(^{122}\) I.R.C. \( \cdot \) 1016(a)(1).

\(^{123}\) See infra text accompanying notes 177-97.
downward adjustment to basis ever occurred because the original deduction was not "properly chargeable to [a] capital account." Also, once again the determination is prospective: it does not affect prior periods. Section 1312(7), instead, concerns prior errors. Similarly, for financial accounting, the bookkeeper for Example 3 would - in the later period - debit the asset account to reflect the unconsumed supplies and would credit an extraordinary (non-current) income account reflecting the prior erroneous expense.

- **Example Four:** Taxpayer pays what he believes to be an interest payment for his business. He creates no capital account because the payment creates no asset. He later receives a refund of the payment.

   Legally, the Example 4 taxpayer's "payment" amounted to a mere deposit that he has a right to recover. Thus, he unknowingly created an asset. Under section 1012, the asset has a cost basis equal to the amount deposited. The erroneous deduction of the deposit does not affect this capital account because section 1016(a) - the basis adjustment section - applies only to proper deductions rather than to erroneous ones. Once again, the financial accounting treatment would be similar. Upon discovery of the refund right, the bookkeeper should debit an asset account and credit a non-current extraordinary income account.

**c. Application to Unvert Facts**

Example 4 uses the Unvert facts. Mr. Unvert paid an amount erroneously believing it to be interest. In fact, Mr. Unvert had a right to recover the amount and later

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124 I.R.C. § 1012.

125 For an analogous application of a cost basis, see William A. Raby, *IRS Change of Position May up the Cost of Tax Malpractice*, 56 Tax Notes 195, 197(1992), in which the author discussed the tax implications of tax indemnity payments. Such payments arise, *inter alia*, when a practitioner must reimburse a client for excessive taxes paid resulting from bad tax advice. An early Board of Tax Appeals case held such payments to be excludable from income because they were neither previously deductible, nor deducted. Clark v. United States, 40 B.T.A. 333 (1933). As explained by the author, recent letter rulings have treated inconsistently. Explaining why the court's return of capital holding was correct, Raby correctly explained:

The taxpayer can be viewed as having a 'cost basis' in the amount received as damages based upon the nondeductible outlay for the income tax or the penalty. That was the viewpoint of Judge Leech in Clark. If that viewpoint is accepted, then it matters not whether the claim for reimbursement rose out of a mechanical error in preparing the return, a bungled election, poor tax advice, or a mislabeled investment. The recovery of that amount should be merely a recovery of that basis and produce no income.

While Mr. Raby did not discuss the basis consequences of an erroneous deduction, I note that he phrased his statement on the item having been a nondeductible rather than a non-deducted. For additional discussion of indemnity payments, see William A. Raby, *Tax Controversy Legal Malpractice Award Excluded From Income*, 65 Tax Notes 591 (1994).

126 656 F.2d at 483.
recovered it. The Tax Court held that Unvert had income under an estoppel theory. It explained that the tax benefit rule does not apply to the recovery of erroneous deductions. The Court of Appeals for the Ninth Circuit affirmed, but rejected the estoppel theory, holding that Unvert had income under the tax benefit rule: he recovered an item previously beneficially deducted.127

Analyzed properly Unvert did not have income. He collected an amount to which he was entitled. Collection of a note is a taxable event.128 Usually the event produces no taxable income because the taxpayer has a basis equal to the amount collected. Similarly, Unvert should have recognized no income because he properly should have created a capital account equal to the amount he thought he was paying in interest. Thus, when he recovered that same amount, he would have had no accession to wealth and no realization in excess of basis. The Tax Court need not have spoken in terms of the tax benefit rule or any supposed erroneous deduction exception thereto.

Because the statute of limitations for the year of deduction by Unvert was closed at the time of discovery, neither the government nor Unvert could properly correct the erroneous deduction of "interest" payments. However, the non-recognition of income on the recovery could give rise to a section 1312(7)129 circumstance of adjustment such that sections 1311130 and 1314131 would permit correction of the earlier deduction. In such an event the correction would be full rather than the partial type created by the tax benefit rule.

d. Application of Mitigation

Determining whether the mitigation provisions apply requires the application of seven general factors of mitigation. In addition, the fourth factor - the circumstance of adjustment - has in this instance four additional specific sub-factors.

The first requirement provides that an error must have occurred with regard to the year in question.132 Unvert incorrectly deducted payments during the early year, which he

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127 Id. at 486.

128 I.R.C. ' 1271(a)(1). Section 1271(a)(1) provides that "[a]mounts received by the holder on retirement of any debt instrument shall be considered as amounts received in exchange therefore." Id.

129 I.R.C. ' 1312(7).

130 I.R.C. ' 1311.

131 I.R.C. § 1314.

132 I.R.C. ' 1311(a). Section 1311(a) refers to the error requirement. Id. Section 1312 lists the seven circumstances of adjustment and notes that each circumstance depends not upon mere inconsistencies, but rather upon erroneous treatment in the instant year. I.R.C. ' 1312.
should have known were not properly deductible. Therefore, Unvert made an erroneous deduction and the first factor is met.

The second requirement of mitigation provides that correction of the error must be barred. Unvert erroneously deducted the payments during 1969, a year for which the statute of limitations on assessments ran on April 15, 1973. The IRS completed an audit of his 1970 and 1971 returns in August of 1973, but apparently never audited his 1969 return. Therefore, the statute of limitations barred correction of the erroneous deduction.

The third requirement of mitigation provides that a determination must exist and must require treatment that is inconsistent with the treatment in question. This requirement would have been met if the Unvert litigation had resulted in his not being taxed on the refund, and thus had not applied the tax benefit rule. The court decision would, in this instance, fulfill the "determination" requirement. Not taxing Unvert on the recovery - because he retained an unreduced cost basis - would have been inconsistent with his having deducted the payments. Thus, when the Ninth Circuit affirmed the Tax Court, the third requirement of mitigation was met.

The fourth mitigation requirement demands that one of seven possible circumstances of adjustment set out in section 1312 must exist. Section 1312(7) provides the appropriate circumstance for the facts. Section 1312(7) has four sub-factors.

First, the determination must establish the basis of property. Unvert acquired a basis in the right to the refund even though he was unaware of the right. Section 1012 provides a cost basis for assets. The court could have determined that Unvert had a basis in the refund equal to the amount of the refund. Thus, the court decision could have established the basis of property and the requirement would have been met.

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133 Unvert, 656 F.2d at 484.

134 I.R.C. § 1311(a). Section 1311(a) provides that the bar to correction of the error must result from "the operation of any law or rule of law." Id. Treasury regulations explain that "rule of law" includes the doctrine of res judicata. Treas. Reg. § 1.1311(a)-2(a) (1990). In some instances, not involving the facts, the time when correction is barred is also crucial. I.R.C. § 1311(b)(2).

135 Unvert, 656 F.2d at 484.

136 I.R.C. § 1311(a), 1313(a). The determination may take the form of a judgment, a closing agreement, a disposition of a refund claim, or a special agreement with regard to mitigation. Id. § 1313(a). Significantly, it need not note the error nor even discuss the inconsistent treatment. It must merely do something that is in fact inconsistent - in one of the seven circumstances listed in section 1312 - with the erroneous treatment.

137 I.R.C. § 1312.


139 I.R.C. § 1012.
Second, the particular error must fit the description of one of three types of errors listed in the statute.\textsuperscript{140} Section 1312(7)(C)(iii) provides, "there was an erroneous deduction of an item properly chargeable to capital account or an erroneous charge to capital account of an item properly deductible."\textsuperscript{141} Unvert erroneously deducted as interest a payment which legally amounted to a deposit. The item was properly chargeable to a capital account denominated as a deposit. This account represents the right which the court should have determined had a cost basis equal to the amount transferred. Thus, the requisite error occurred.

Third, the particular error must occur with respect to one of three particular types of taxpayers. Section 1312(7)(B)(i) applies to "the taxpayer with respect to whom the determination is made."\textsuperscript{142} Unvert would have served the role both as the determination taxpayer and as the taxpayer who erroneously deducted the payments. Thus, he would satisfy the requirement.

Fourth, the particular error must be in "respect of" any transaction on which the basis established by the determination depends.\textsuperscript{143} If properly decided, the determination (the court decision) would have established the asset basis (the right of return) as a cost basis. Thus, the basis would have depended on the transaction in which Unvert transferred money. In addition, the original erroneous deduction of the payments would have been "in respect of" that transaction. Thus, the requirement would have been met.

The fifth mitigation requirement appears in section 1311(b)(3),\textsuperscript{144} which insists that the proper relationship must exist at the proper time between the party who obtained the determination and the party with respect to whom the error occurred. This factor overlaps

\textsuperscript{140} Section 1312(7)(C) provides:

With respect to a taxpayer described in subparagraph (b) of this paragraph -- (I) there was an erroneous inclusion in, or omission from, gross income, (ii) there was an erroneous recognition, or nonrecognition, of gain or loss, or (iii) there was an erroneous deduction of an item properly chargeable to capital account or an erroneous charge to capital account of an item properly deductible. \textit{Id.}

\textsuperscript{141} I.R.C. ' 1312(7)(C)(iii).

\textsuperscript{142} I.R.C. ' 1312(7)(B)(i).


\textsuperscript{144} I.R.C. ' 1311(b)(3). In most instances the determination party and the error party are one and the same and, thus, obviously meet the relationship requirements. For circumstances involving two persons, the Code defines permissible relationships and the times during which those relationships must exist. I.R.C. ' 1313(c).
with the third requirement of the section 1312(7) circumstance of adjustment - the particular error must occur with respect to a particular taxpayer. Because Unvert would have characterized both the error taxpayer and the determination taxpayer, the requirement would have been met.

The sixth requirement demands that the determination must adopt a position maintained by a particular party. Under section 1311(b), because the adjustment would result in a deficiency, the determination must adopt the position maintained by the taxpayer, Unvert. Unvert argued to the court that he had no income because he was merely recovering capital. That was another way of maintaining that he had a basis in the right to the refund equal to its cost. Thus, had the court agreed with him, and thereby not applied the tax benefit rule, it would have adopted the position of the taxpayer and the sixth requirement would have been met.

Finally, the seventh requirement for mitigation provides that the position adopted must be inconsistent with the prior erroneous treatment. Just as the determination must result in a circumstance that is inconsistent with other treatment, the adopted position also must be inconsistent with the error. Unvert's argument that he merely recovered capital was inconsistent with his prior deduction. Therefore, the seventh requirement would have been met.

Thus, had the court adopted Unvert's position, the mitigation provisions would have applied. Unvert would not have had 1972 income under the tax benefit rule; however, under section 1314 the government would have had one year from the date of the determination to seek a deficiency for 1969. Such a correction would have been more complete than the partial correction that actually resulted from the Unvert decision. Mitigation would have restored the erroneous deduction in 1969, with all of its various collateral effects. In addition, Unvert would have owed interest since the due date for the 1969 return.

d. The Difficulty With Applying Mitigation

A catch to the scenario exists. For mitigation to reach fruition, a determination must occur - the third requirement. Without the determination, the mitigation provisions would not apply and therefore, correction of the error would not be available. Section 1313(a) provides that a determination may be: (1) a final court decision; (2) a closing agreement; (3)

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145 I.R.C. ' 1311(b)(1). If the adjustment mandated by mitigation is credited or refunded, the adopted position will have to be that of the Secretary. If, however, the adjustment is assessed or collected, the position will have to be that of the determination taxpayer.

146 I.R.C. ' 1311(b). The position adopted need not be inconsistent with another position that supported the error; rather the position need be inconsistent only with the fact of the error, regardless of whether the taxpayer or his related party argued anything in the error year. Thus, two positions need not exist. Significantly, the determination need not note the inconsistency.

147 I.R.C. ' 1314.
a final disposition for a refund claim; or (4) a signed agreement between the taxpayer and the Secretary pursuant to particular regulations. Had the government properly understood that mitigation was the correct solution for Unvert's errors, it would never have sought to apply the tax benefit rule. Thus no litigation, refund claim, or agreement would have resulted. Without one, no determination would have occurred and therefore mitigation could never have applied.

Had the government realized during litigation that it would be better off losing the case and then seeking mitigation, two possibilities might have occurred. One, the government could have conceded the tax benefit issue, in which case the court would not have adopted the position of the taxpayer but rather would have adopted the position of the government. Thus, the sixth requirement of mitigation - the adoption of the position offered by a particular party - would have failed. Therefore correction by way of mitigation would not have been possible.

Alternatively, the government could have argued the case hoping to lose it. This would have been misleading to the court and thus unethical. Without the misleading and losing argument, again the sixth requirement - adoption of a position offered by a particular party - would have failed and mitigation would not have applied. The mitigation provisions, therefore, do not apply often. They are complex and subject to many exceptions. Congress intended this result. Congress also intended that mitigation provide the sole exception to the harshness of the statute of limitations in cases to which the statute of limitations generally applies. Application of the tax benefit rule to cases in which mitigation is not appropriate - either because the case lacks a proper determination or because the case lacks the adoption of the correct position - would do great violence to the mitigation statutes. Such application of the Rule would amount to a judicial overruling of the clear, specific legislative requirements for avoiding the statute of limitations protection.

e. Other Examples of Missed Mitigation

Unvert is not the only case in which the government argued the wrong correction device and, as a result, hurt itself. Some of the "erroneous deduction exception" cases would follow the pattern of Unvert. For example, the Tax Court in Canelo effectively determined that Canelo had an unadjusted basis in his right to reimbursements. As a result and pursuant to section 1314, the government had one year in which to seek mitigation of
the year in which Canelo erroneously deducted the client advancements. The government failed to do so.

Another famous example of missed mitigation is the case of Philadelphia Park Amusement Co. v. United States.153 The taxpayer in that decision received a franchise to operate a railway. It then built a bridge to be used by the streetcars. In 1934, the company exchanged the bridge for an extension of the franchise. Apparently, the company did not report the taxable gain resulting from the exchange. Twelve years later - long after the year of the unreported gain closed - the company deducted a loss from the abandonment of the extended franchise.

The central issue before the court was the determination of the company's basis in the extended franchise. The court properly explained that the company had a cost basis in the bridge. Interestingly, the court defined "cost basis" with the following language: "To maintain harmony with the fundamental purpose of these sections, it is necessary to consider the fair market value of the property received as the cost basis to the taxpayer."154 Because the court could not value the property received - the extension - it directed the trier of fact to consider the value of the property exchanged, the bridge. From this language came the popular importance of the decision: that if one side of a taxable exchange cannot be valued, while the other side can be valued, the taxpayer should presume the two to be equal.

The remarkable part of the decision, however, is the above quoted language that effectively maintains that cost equals what is received rather than what is given up. Why would the court have made such an apparently preposterous statement? It did so to maintain the integrity of the taxable year.

Consider another popular, but mistaken, view: new basis in a taxable exchange equals the basis given up plus the gain recognized. Mathematically, that appears consistent with the court's view that new basis equals the value received. This appears true because the gain recognized (C) should be the difference between the value received (A) and the basis given up (B). If A - B = C, then B + C = A.

However, what is true for grade-school algebra does not hold true for tax law. The court properly suggests that B + C does not necessarily equal A. Why? Because the gain (C) may not have been reported (recognized), as apparently it was not by Philadelphia Park. Because the basis is a function of what was "proper" rather than what happened, an erroneous non-recognition cannot bind a future determination of basis.

That realization, however, fits neatly with the circumstance of adjustment found in subsection 1312(7). The Claims Court's determination of Philadelphia Park's basis adopted

154 Id. at 188.
a position of the taxpayer that was inconsistent with the non-recognition of gain in the reporting of the transaction - the acquisition - on which such basis depended. Thus, the government could have sought mitigation of the statute of limitations barring correction of 1934, the year of non-recognition.

**f. Summary**

The mitigation provisions generally are applicable to tax benefit scenarios that involve erroneous deductions, exclusions, or additions to basis. Section 1312(7) lists such mistakes as circumstances of adjustment. However, the myriad exceptions and complexities of the mitigation provisions often will preclude ultimate correction. Nevertheless, because the mitigation provisions provide a correction device applicable to the Unvert scenario, the court should not apply the tax benefit rule. Otherwise, when the court applies the Rule, section 1312(7) can never apply because the proper determination requirement of section 1312(7) can never occur. Thus, application of the Rule to unreasonable mistakes of fact and mistakes of law precludes the use of an important code provision. Such a result is inconsistent with the general proposition that courts construe statutes such that they have application.

To conclude the argument, the inclusionary arm of the tax benefit rule must not apply to unreasonable mistakes of fact and mistakes of law. Thus: 1) Unvert and Hughes were incorrectly decided, and 2) the Tax Court’s historical erroneous deduction exception to the tax benefit rule is correct.

**3. CLASS C: PROPER DEDUCTIONS**

**a. Background**

"Proper Deductions" involve those cases in which the deduction is correct both under the facts reasonably available at the time and also under all subsequent information. Traditionally, the tax benefit rule did not apply to the recovery of an amount previously deducted properly. Instead, such a recovery would have been an unrelated event, which would have been includible or excludable based on the application of section 61 and the various exclusion sections.

The Supreme Court in Bliss Dairy expanded the Rule to apply to actions or transactions inconsistent with prior proper deductions. Recall that prior tax benefit cases had applied the Rule to two general circumstances: (1) those in which the taxpayer erroneously deducted an item, and (2) those in which the taxpayer "reasonably" deducted an item and thus unknowingly created a zero basis in his right to the return of that item. As explained above, the Internal Revenue Code provides adequate remedies to cover recoveries or inconsistencies in both circumstances without the tax benefit rule. The Court

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155 I.R.C. § 61. Section 61 includes "all income from whatever source derived." *Id.*

156 *Bliss Dairy,* 460 U.S. at 370. *Bliss Dairy* was the companion case to *Hillsboro,* 460 U.S. at 370.
expanded the Rule to apply to a third circumstance in which the taxpayer properly deducts an item for which the code contains no special provision for treating recoveries or inconsistent actions.\textsuperscript{157}

\textbf{b. The Cause of the Problem}

Without the tax benefit rule, and the expansions of it, such recoveries or inconsistencies would be judged by the standards of section 61 and the various exclusion sections. However, by definition, a proper deduction is just that - proper. The Code contains no general provision to correct items that are not incorrect. Understandably, however, the Court felt that some provision is necessary to prevent taxpayers from benefiting from a deduction when ultimately the deduction is not justified.\textsuperscript{158}

Why does this problem exist? The root lies in the use of the tax system to achieve social and economic policy.\textsuperscript{159} If all deductions and exclusions rested on economic realities, no general correction provision would be necessary. True errors - if not barred by the statute of limitations - would be correctable through amended returns, notices of deficiency, and mitigation. Unjustified but proper deductions would not occur and thus would never require correction.\textsuperscript{160} Instead, the United States has a tax system containing many policy-oriented provisions. Frequently, the consequences of such provisions transcend a year-end. Consequently, a taxpayer may benefit from a proper deduction that later proves to have been unjustified, although still proper.

The distinction between "unjustified" and "erroneous" is important. A deduction motivated by economic reality is inherently "justified" - economically the taxpayer suffers a loss or a cost and thus has less economic income. In contrast, a deduction motivated by social or economic policy is "justified" only if the particular social or economic policy is somehow furthered by the taxpayer action, inaction, or transaction.

\textsuperscript{157} \textit{Id.} at 397.

\textsuperscript{158} \textit{Id.} at 383. The Court explained that not all inconsistencies would be "fundamental." \textit{Id}. Although the Court did not use the term "unjustified," its explanation of the difference between "unexpected events and inconsistent events" implies such a meaning. \textit{Id.} at n.15.

\textsuperscript{159} For a more complete discussion of the perils resulting from the use of the tax system to achieve policy -- as opposed to revenue raising - goals, Willis, \textit{Masks, Magic and Games: The use of Tax Law As a Policy Tool, 4 Am. J. Tax Pol'y 41} (1985); Hoeflich, \textit{Of Reason, Gamesmanship, and Taxes: A Jurisprudential and Games Theoretical Approach to the Problem of Voluntary Compliance, 2 Am. J. Tax Pol'y 9} (1983).

\textsuperscript{160} If the tax system allowed deductions only if they represented actual economic costs, then all deductions would be justified at the time taken. This would be true both of cash and accrual method taxpayers: cash taxpayers would take deductions when they were paid, and accrual taxpayers would take deductions when incurred. Neither would take a deduction based on a mere promise of future economic costs. Thus unjustified deductions would not occur. Naturally, inconsistencies resulting from recoveries of amounts deducted and discharge of indebtedness would remain possible; however, correction devices other than the tax benefit rule could adequately deal with such matters.
Initially, a policy deduction is allowed based on the taxpayer's promise - implicit or explicit - that he will do, or has done, something which Congress felt would help achieve the particular social or economic policy. Whenever the promise and its fulfillment transcend a year-end, problems can occur. The taxpayer may have fully intended to complete his action or transaction or to continue in his inaction, but nevertheless he may fail in a later year. Nevertheless, he would have received the tax benefit in the prior year of the promise. Unless the Code contains an appropriate correction device, the taxpayer may thus receive the benefit without ever fulfilling the promise.

c. Further Examples

For example, accelerated depreciation exists partially to encourage investment.¹⁶¹ The benefits of the provisions accumulate over the early years of an asset's life. Then, in the later years, the taxpayer suffers correspondingly reduced depreciation. Such a system is justifiable because the taxpayer receives a benefit in exchange for the promise to invest in particular property for business purposes. A correction device is necessary in this area because the accelerated depreciation exceeds economic reality. Without such a device, a taxpayer could benefit from his promised investment even though he failed to continue the investment. If, instead, depreciation were limited to economic losses, no particular correction device would be required because the taxpayer necessarily would suffer the loss before he received the tax benefit. In other words, the benefit would not provide a reward for a mere promise.

The Code contains partial correction devices to account for taxpayers who "promise" to invest in particular business property but later break the promise. Generally, the basis mechanism reduces the taxpayer windfall because the taxpayer loses basis as he takes depreciation.¹⁶² In addition, Congress added the recapture provisions of sections 1245 and 1250 to prevent further windfall. Significantly, such recapture did not exist in the early years of accelerated depreciation.¹⁶⁵ However, when Congress saw the potential

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¹⁶¹ I.R.C. ' 168; see, e.g., S. REP. NO. 144, 97th Cong. 1st Sess. 12, at 13, reprinted in U.S. CODE CONG. & ADMIN. NEWS 105: "[A] restructuring of depreciation allowances for tax purposes would be an effective way of stimulating capital formulation."

¹⁶² I.R.C. ' 1016(a)(2).

¹⁶³ I.R.C. ' 1245.

¹⁶⁴ I.R.C. ' 1250.

unjustified benefit to taxpayers who disposed of depreciated assets, it enacted the recapture provisions. These provisions do not fully correct for the "unjustified" benefit; instead, they partially correct only by affecting the character of gain on disposition.

An additional example involves the investment tax credit provisions. Enacted to reward taxpayers who invest as Congress desires, they, too, contain a recapture correction device. Taxpayers who dispose of the credit property early are forced to recapture a portion of the prior credit. As with accelerated depreciation recapture, this correction device is necessary because the taxpayer benefit is created in exchange for a mere promise: the taxpayer receives a benefit when he promises to invest for a particular term. If the investment later proves to be shorter than promised, the Code takes part of the benefit back.

The Crane v. Commissioner and Commissioner v. Tufts scenarios provide another example. The courts, through Crane and its progeny, gave taxpayers a benefit - the inclusion of non-recourse debt in basis - in exchange for promised investment. Such a basis inclusion is not justified by economic reality because such a taxpayer has not yet actually invested in the asset to the extent of the non-recourse debt. Rather than reverse Crane, the Supreme Court recaptured the benefit upon disposition of the investment: the debt, which really was not an investment, and thus not properly included in basis, becomes an amount realized on disposition even though in reality it is not always an accession to wealth.

The last example involves section 179. Congress therein awarded taxpayers with an expense deduction for certain capital items in exchange for promised investment. Originally, regulations provided merely that taxpayers who did not continue their promise of investment for two years had to recapture a portion of the benefit. In 1986 Congress

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166 I.R.C. ' ' 38, 46-49.
167 I.R.C. ' 47.
168 331 U.S. 1 (1947).
170 See supra note 117.
171 See Bittker, supra note 118, at 278.
172 Tufts, 461 U.S. at 313. The Court explained that the "economic benefit theory" did not justify the decision. Id.
173 I.R.C. ' 179.
expanded the recapture provision to apply to any case in which the section 179 property ceased to be applicable property "at any time."175 Once again, the correction device was necessary because the initial benefit rested on a taxpayer promise rather than upon economic reality. Thus, correction was mandated whenever the promise became unfulfillable.

d. Application to Bliss Dairy

Were it not for policy-oriented deductions the Rule would be unnecessary: in relation to non-policy-oriented deductions, general internal revenue code provisions provide adequate correction devices consistent with annual accounting. Policy-oriented deductions, however, are common. They are the product of both congressional and judicial policy. Arguably every such case requires a correction device because inherently a policy-oriented deduction rests on a taxpayer promise. Instances that do not transcend a year-end are easily resolvable: denial of the deduction if the promise is unfulfilled. Other instances, however, demand correction.

No such general correction device exists in the Code. As shown above, specific devices exist in many areas - depreciation, investment tax credit, and section 179 recapture. The Bliss Dairy176 opinion is quite broad. It not only traces the history of the inclusionary arm of the tax benefit rule, but it also attempts to formulate a general summary of the tax benefit rule. Nevertheless, the core meaning of the case rests on the fact it applies to a proper deductions factual scenario. The Bliss Dairy attempt to provide a general rule of correction, however, is subject to criticism on six counts.

First, the Bliss Dairy holding is not limited to policy-oriented deductions and credits. Instead it applies generally, even to areas in which the basis mechanism or mitigation provisions provide the same or a better solution.

Second, the Court corrects a problem that Congress chose not to address. Congress allowed deductions for ordinary and necessary business expenses.177 It did not provide for recapture of those deductions by corporations liquidating under former section 337.178 For the Court to correct such a "proper" deduction subjects the Court to the charge of legislating. The precedence of a Tufts179 judicial correction device does not rebut the "legislating" charge. Tufts was a correction of a judicially created error.

175 I.R.C. ' 179(d)(10) (emphasis added).
176 Bliss Dairy, 460 U.S. at 370. Bliss Dairy was the companion case to Hillsboro, 460 U.S. at 370.
177 I.R.C. ' 162.
179 Tufts, 461 U.S. at 300. Interestingly, Justice O'Connor, who authored the Hillsboro and Bliss Dairy opinions, concurred in Tufts, explaining her reticence at applying such a broad rule. She concurred because too many cases before had approved Crane and thus the Court was not writing on a clean slate. Tufts, 461
Significantly, depreciation, investment tax credit (I.T.C.), and section 179 recapture provisions each took congressional action. Each is subject to limitations: I.T.C. and section 179 recapture historically applied only for a short period, and depreciation recapture applies only to a disposition. Arguably Congress chose not to apply correction in instances not specifically covered by the few existing correction provisions. Therefore, the Court opens itself to the charge of legislating when it corrects an error Congress chose to leave untouched. Recognition of Congress's special concern for the statute of limitations supports the view that Congress wanted to leave untouched those errors it failed specifically to correct.

In partial defense of the Court's holding, the anomaly resulted partly from a judicially created error, not just from congressional inaction. Bliss Dairy - a cash method taxpayer - deducted the cattle feed before the cows ate it. This was proper because of the judicially created Zaninovich rule. Generally, expenses are currently deductible if they do not create a life substantially beyond the end of the tax year. Zaninovich v. Commissioner defined "substantially" as one year. Thus, cattle feed purchased by a cash method taxpayer is deductible if the taxpayer expects it to be eaten within one year after the end of the taxable year of purchase. The rule is a policy-oriented deduction based on administrative convenience rather than economic reality. Thus, as with other policy deductions, it creates the need for a correction device. Because the need is judicially created, perhaps it is appropriate for the solution to be judicially created as well.

Third, the Bliss Dairy facts were a poor vehicle for the formulation of such important policy. Bliss Dairy adopted its plan of liquidation two days after the end of the taxable year in which the cattle feed was purchased. Under the annual accounting system, the feed was deductible based on the information reasonably existing at the end of the year of purchase. What happened two days later would not be relevant, except to the extent that it is evidence of what the taxpayer could and should reasonably have known. Rather than broad statements concerning the tax benefit rule, the Court could have limited Zaninovich. Perhaps Bliss Dairy did not know on June 30 that it would adopt a plan of liquidation on

U.S. at 317_20 (O'Connor, J., concurring).

180 Zaninovich v. Commissioner, 616 F.2d 429 (9th Cir. 1980).


182 616 F.2d 429, 432 (9th Cir. 1980).

183 The Court in Hillsboro cited Zaninovich favorably. Hillsboro, 460 U.S. at 384. The dissent questioned the validity of the deduction, noting that the Commissioner also questioned whether the Bliss Dairy deduction was proper, and that the courts are split on the issue. Id. at 420 n.31 (Stevens, J., concurring in part and dissenting in part).

184 Id. at 374.
July 2; however, the company probably knew. If so, then either Zaninovich did not apply to permit the deduction or Zaninovich should have been limited.

Fourth, the Court in initially describing the Bliss Dairy problem confused the tax benefit rule with the basis mechanism. This casts doubt on the Court's understanding of the area. The opinion stated:

The problem in Bliss Dairy is more complicated. Bliss took a deduction under section 162, so we must begin by examining that provision . . . . The deduction is predicated on the consumption of the asset in the trade or business . . . . 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 . . . so he would recognize the full amount of the proceeds on sale as gain.185

Strictly, the deduction was under the Zaninovich interpretation of sections 461 and 162. The Court should have so noted, because Zaninovich is the root of this problem. More importantly, the Court noted that as a result of a sale following a section 162 expense, the taxpayer would lose his deduction.186 But that is surely incorrect in some instances. The deduction would stand as a proper deduction if based on reasonable information, assuming the correctness of Zaninovich. The Court is correct in the next clause, "for the basis of the asset would be zero . . . so he would recognize the full amount of the proceeds on sale as gain."187 This is true, again assuming a proper deduction. However, the use of the word "for" is puzzling. The clause about gain on sale because of a reduced basis is correct, but it is not support for nor does it cause the taxpayer to "lose his deduction." Instead, the section 1016 basis mechanism would apply, as discussed earlier.188

Perhaps Bliss Dairy should have lost the deduction. If it indeed misapplied, then that would be the proper result. No gain would result, however. Or, perhaps we need a better-crafted tax benefit rule that causes the loss of an unjustified deduction. Such a rule would require a re-determination of a prior year's taxes. It would not involve gain. In this context the two concepts - loss of a deduction and recognition of gain - are mutually exclusive. They are neither synonymous nor supportive of each other.

Apparently the Court did not fully consider the distinction between the loss of a deduction and the measurement of gain as a function of basis, which in turn was a function of the prior deduction. Not only are they antithetical, but they also can achieve very different results. Loss of a deduction results in full correction. Recognition of gain in this context results in partial correction. The distinction of the concepts as well as their effects is at the

185 Id. at 395 (emphasis added) (citations omitted).
186 Id.
187 Id.
188 See supra text accompanying notes 163-66.
heart of the tax benefit problem. The Court's confusion of the two destroys much of the
opinion's credibility.

Fifth, the decision is not limited to judicially created policy deductions. On its face, the
opinion would apply as well to cases in which Congress adopted a policy-motivated
deduction accompanied by a partial correction device. For example, a taxpayer who
benefited from accelerated depreciation and who ceased to use the asset for business
purposes, but did not dispose of it, would not be subject to recapture under the statute.\textsuperscript{189} However, under the Court's holding in \textit{Bliss Dairy}, recapture could result in this situation.\textsuperscript{190} Nevertheless, for the Court to expand the narrowly drawn recapture statute in this instance
would not seem appropriate. Similarly, prior to 1976, if a taxpayer ceased to use section
179 property more than two years after taking a section 179 deduction, no recapture was
necessary.\textsuperscript{191} Congress deleted the time limit in 1986.\textsuperscript{192} Arguably, however, \textit{Bliss Dairy}
would have repealed the time limit, even without Congressional action.

Sixth, the correction method chosen is a poor method. The mitigation provisions\textsuperscript{170}
and section 1341\textsuperscript{171} provide superior models for a correction device than does the historical
inclusionary tax benefit rule. Thus, if the Court so felt the need to legislate, it should have
acted as a better legislature and thus formulated a more complete correction device.

\textbf{E. PROPOSALS}

The tax benefit rule should be restricted to judicially created policy deductions.
Other applications are either unnecessary or should be left to Congress. When applicable,
the Rule should apply much like equitable recoupment: two wrongs make a right. To the
extent tax was saved in a prior period, the current tax should be increased. This would be
an equitable increase in tax rather than in income. Congress should provide a correction
device for all policy-motivated deductions or credits. Ideally, such provisions would operate
like a reverse section 1341: to the extent the taxpayer saved tax, he would correct by
paying more. Or, Congress could create an eighth circumstance of adjustment under
section 1312, and thus actually re-open the prior "error" year.

\textsuperscript{189} Sections 1245 and 1250, which deal with depreciation recapture, are triggered by a "disposition." I.R.C. \textsuperscript{\texttt{1245}(a); 1250(a).} A mere change in use generally would not be a sufficient trigger. Compare, however, section 1245(b)(7)(B), under which a mere change in use would be a trigger. I.R.C. \textsuperscript{\texttt{1245(b)(7)(B).}}

\textsuperscript{190} Although the Court did not address whether a "change in use" would be a "fundamentally inconsistent event," no apparent reason exists why it would not be.

\textsuperscript{191} I.R.C. \textsuperscript{\texttt{179(d)(10) (1985).}}

\textsuperscript{192} Pub. L. No. 99-514, \textsuperscript{\texttt{202(c) reprinted in 1986 U.S. CODE CONG. & ADMIN. NEWS 514.}}

\textsuperscript{170} I.R.C. \textsuperscript{\texttt{1311-14.} For a discussion of these provisions, see supra text accompanying notes 182-201.}

\textsuperscript{171} I.R.C. \textsuperscript{\texttt{1341.} For a discussion of this provision, text accompanying notes 124-43.}
F. APPLICATION TO OTHER SITUATIONS AND CASES

1. *Rojas v. Commissioner*¹⁹³

The Tax Court applied the Tax Benefit Rule in this controversial¹⁹⁴ 1988 decision, later affirmed by the Ninth Circuit.

Like *Bliss Dairy*, *Rojas* involved agricultural deductions preceding a tax-favored section 337 liquidation. In contrast to the unconsumed-but-nevertheless-expensed Bliss Dairy cattle feed, *Rojas* involved consumed-and-expensed fertilizer.¹⁹⁵ The Tax Court distinguished *Bliss Dairy* on the issue of consumption. In the eyes of the Tax Court, expensed-and-consumed items are not subject to the Rule even if the investments connected to the expense - here the crops - are distributed in a tax-free liquidation.¹⁹⁶ Although some commentators criticize the decision as mere form over substance,¹⁹⁷ it is actually consistent with the theories discussed herein.

The *Bliss Dairy* expense was proper but artificial because it resulted from the policy rule of *Zaninovich*.¹⁹⁸ It demanded a correction device because the taxpayer did not fulfill its promise of business use or consumption. In contrast, the *Rojas* expenses arguably were partially unreasonable mistakes and partially proper. To the extent the taxpayer knew at the time of the expense that it would liquidate and thus not realize the income, the expense should have been capitalized because it would not have been incurred in the ordinary course of a trade or business. To that extent, deduction was an unreasonable mistake. As such, it would be correctable by an amended return or a notice of deficiency.

On the other hand, because the Commissioner stipulated that all the expenses were incurred in the ordinary course of a trade or business (which includes the notion of continuity), all the expenses were legally proper. The fact that no income attributable to those expenses may ever have been actually generated by the taxpayer is immaterial and is a natural consequence of annual accounting, *Sanford & Brooks*,¹⁹⁹ and *North American*

¹⁹³ *Rojas v. Commissioner*, 901 F.2d 810 (9th Cir. 1990).


¹⁹⁵ *Rojas*, 901 F.2d at 1100.

¹⁹⁶ *Id.* at 1109.

¹⁹⁷ Burke & Friel, *supra* note 194, at 94-95.

¹⁹⁸ *Zaninovich v. Commissioner*, 616 F.2d 429 (9th Cir. 1980).

¹⁹⁹ *Sanford & Brooks*, 282 U.S. at 359.
Admittedly, however, the government could have attacked the expenses as not justified. This plausible argument rests on citation to Commissioner v. Idaho Power Co., which required that depreciation expense attributable to vehicles used in construction of a building was non-deductible and instead must be capitalized. Arguably, the consumed fertilizer in Rojas was analogous to the truck depreciation in Idaho Power.

Indeed, fertilizer contributes to the value existing in the resulting crops, just as the use of the vehicles contributed to the value of the resulting building. But that argument can be made with regard to any business expense that is attributable to future income, whether from sales of products or sales of services. Idaho Power was a proper decision because it required the clear reflection of income: a current depreciation deduction grossly distorted current income and did not coincide with the future income from the building, if any. Significantly, the court did not base its decision on a purported need for transactional accounting. Rather, the court rested on the ordinary and necessary nature of the expenses, as stipulated by the government. To expand the Idaho Power holding to control Rojas would result in transactional accounting - a true and complete match of income and relevant expenses. While arguably meritorious, this is not consistent with the system adopted by Congress.

In contrast to Idaho Power, deduction of the Rojas fertilizer did not distort income, and the government did not argue that it failed to clearly reflect income. If it had so argued, then the proper solution would have been to deny the deduction - not to apply the tax benefit rule.

Still, the government understandably felt that someone "got away" with something. That was because section 337 then permitted tax-free liquidations favorable to the

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201 See, Burke & Friel, note 194, at 95.
203 Id. at 19.
204 Burke & Friel, note 194, at 95.
206 Id. at 14-15.
207 Rojas, 90 T.C. at 1096. The government initially argued that the corporation should have accrued the future crop income to match with the fertilizer deductions. The government later abandoned the argument in favor of the tax benefit rule. Id.
corporation and the shareholders. Section 337 provided a Congressional policy-oriented subsidy. It was not an “error” and required no correction. Congress, in 1986, changed the policy by repeal \(^{208}\) of the General Utilities \(^{209}\) doctrine. Arguably, that was a wise move. But it was the prerogative of Congress, not the courts. The Tax Court wisely avoided misusing the tax benefit rule to partially accomplish the result Congress achieved by repeal. Later the Ninth Circuit affirmed. \(^{210}\)

2. **Allan v. Commissioner** \(^{211}\)

The Tax Court, affirmed by the Eighth Circuit found that the Tax Benefit Rule and *Commissioner v. Tufts* \(^{212}\) are antagonistic rather than consistent. \(^{213}\) Several commentators have criticized this conclusion. \(^{214}\) Arguably the Court was only half-correct in its analysis. The key to understanding the problems presented by *Allan* involves first understanding the policy choices made, the promises broken, and thus the specific errors needing correction.

a. The Facts

*Allan* involved an accrual-method partnership that invested in real estate subject to non-recourse debt. The partnership defaulted on the debt. Pursuant to the terms of the note, accrued interest owed to the mortgagee and real estate taxes, which were paid by the mortgagee, were added to principal. The partnership nevertheless deducted the liabilities for interest and taxes. Eventually, the property was foreclosed and the liability discharged. \(^{215}\)


\(^{210}\) 901 F.2d 810 (9th Cir. 1990).

\(^{211}\) Allan v. Commissioner, 86 T.C. 655 (1986), aff’d, Allan v. Commissioner, 856 F.2d 1169 (8th Cir. 1988). The text discussion focuses on the Tax Court opinion because it dealt with both the deduction for taxes paid as well as the deduction for interest accrued. On appeal, the government conceded the character issue as to the real estate taxes. 856 F.2d at 1173. Therefore, the appellate decision dealt only with the interest issue.

\(^{212}\) Tufts, 461 U.S. at 300.

\(^{213}\) See Allan, 86 T.C. at 666-67.

\(^{214}\) Cunningham, Characterization of Income Recovered Under the tax benefit Doctrine, 7 VA. TAX REV. 121 (1987) [hereinafter Cunningham I]; Ms. Cunningham wrote a second article on the same topic, criticizing the Eight Circuit affirmation of Allan, Cunningham, Reprise: Characterization of Income Recovered Under the tax benefit Doctrine, 43 TAX LAW. 121 (1989) [hereinafter Cunningham II].

\(^{215}\) Allan, 86 T.C. at 666-67.
Pursuant to *Tufts*, the taxpayer maintained that the discharged principal, including the capitalized interest and taxes, generated an amount realized and, thus, capital gain. The government insisted that the discharge was fundamentally inconsistent with the prior accrued deductions and, thus, generated ordinary income. The Tax Court held for the taxpayer, finding that overshadowed the tax benefit rule.

**b. Identification of Policy Choices and Errors**

The Tax Court, which has a history of good decisions in the tax benefit area, was partially correct for the wrong reasons. Both *Tufts* and the tax benefit rule are error correction devices. Both are correctly the result of judicially adopted policy errors. *Tufts* was necessary because it counterbalances the judicial error (arguably from the *Crane* decision) which allows non-recourse debt to enter basis. The Supreme Court chose not to overrule *Crane* and thus had to create *Tufts*. Properly viewed, the tax benefit rule is simply a broad term for a variety of devices used to correct errors generated by judicial policy choices.

In *Allan*, two policy choices occurred. The first policy choice involved the deduction for accrued taxes which were owed by the taxpayer, but paid by a third party under circumstances in which the taxpayer had no real obligation to reimburse the third party. The actual choice, however, was not the allowance of the deduction - which was proper - but rather the decision not to recognize income from the non-recourse borrowing. The second policy choice involved the allowance of a deduction for accrued interest that the taxpayer had not paid and did not economically owe because the liability to pay the interest was non-recourse.

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216 *Tufts*, 461 U.S. at 300.

217 *Allan*, 86 T.C. at 659. The Tax Court in characterized the relief of debt as resulting in capital gain, relying on its prior decision in *Estate of Delman v. Commissioner*, 73 T.C. 15 (1979), and on the Supreme Court’s *Tufts* decision. Id. at 663. In so doing, the court explained, "The inclusion of the amount of the nonrecourse debt in the amount realized pursuant to *Tufts* is not based on the cancellation of indebtedness doctrine." *Id.* That is true, but not the whole truth. The *Tufts* Court at footnote 11 explained, "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." *Tufts*, 461 U.S. at 312.

218 *Allan*, 86 T.C. at 664-66.

219 *Allan*, 86 T.C. at 666-67.

220 I.R.C. section 163(a) allows a deduction for interest "paid or accrued." The notion of accrual is the all-events test, which is met "if all events have occurred which determine the fact of liability and the amount of such liability can be determined with reasonable accuracy." I.R.C. § 461(h)(4). A taxpayer who owes non-recourse interest can hardly be said to have met the "fact of liability" test. However, as in *Crane* and *Tufts*, the courts understandably may pretend that the test is met. The consequence is a needed correction device if ultimately the taxpayer never pays the debt.
b. Policy Choice One - the Taxes

Consider the following two examples that demonstrate the nature of the policy choice:

(1) Example Five

- Taxpayer A owes taxes to the Government, but lacks the funds to pay them. Taxpayer A borrows cash from Third Party and uses the money to pay the Government. Taxpayer A secures his obligation to Third Party with a recourse mortgage on Whiteacre.

Taxpayer A in Example Five may properly deduct the taxes, whether he uses the cash or accrual method of tax accounting. The deduction is ordinary as opposed to capital. If Third Party discharges A's debt, A has ordinary income, subject to sections 108221 and 1017222. If A sells Whiteacre to raise funds to pay the debt, A has potential capital gain223 on the sale. Similarly, if Third Party obtains Whiteacre in fulfillment of the debt, A has an amount realized equal to the recourse debt released. This, too, potentially results in capital gain224 subject to sections 1245225 and 1250.226

In whatever manner A satisfies the debt, he has income, or amount realized, equal to the prior deduction. However, the character of the income will vary depending on how A discharges the debt. If A pays the debt, using employment income, he has ordinary income from wages. If A sells unrelated capital assets to generate funds to pay the debt, he has potential capital gain from the unrelated sales. If A uses funds given to him, he has tax-free income under section 102.227 If the debt is canceled, A has ordinary income from the discharge. If instead A sells or transfers Whiteacre to pay the debt, the amount realized and potential income are capital gain or loss.

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221 I.R.C. ' 108 (taxing discharges of indebtedness as ordinary).

222 Section 1017 paired with section 108, permits exclusion of discharge of indebtedness income in some cases in which the taxpayer elects to give up a tax attribute. See I.R.C. ' 108(a)-(b), 1017(a).

223 I.R.C. ' 1221, 1222. Actually the taxpayer would have an amount realized from the sale, which may result in a gain or loss. The alternative scenario would result in a capital loss, but the analysis would be the same.

224 I.R.C. ' 1221, 1222.

225 I.R.C. ' 1245.

226 I.R.C. ' 1250.

227 I.R.C. ' 102.
If the ultimate income is either capital gain or excludable, the apparent fundamental inconsistency between the characters of the income used to satisfy the debt and the prior ordinary deduction should not be disturbing. A's tax deductions and recognition of income are each consistent with economic reality. No correction device should be applicable because none would be necessary. In fact, A might use funds generated by a tax-favored transaction to pay obligations that generated ordinary deductions. But, so what? That is always a potential consequence of section 1202: tax-favored income can properly be used to pay ordinary deductible obligations. For example, a taxpayer may use capital gain profits from the sale of stock to pay interest on a home mortgage loan. The gain is preferentially taxed, while the expense is fully deductible against ordinary income. That is a consequence of sections 1202, 102, 1(j). The tax benefit rule should be irrelevant.

(2) Example Six

Taxpayer B owes taxes similar to those owed by A and also lacks funds. Taxpayer B borrows cash from Third Party but only gives Third Party a non-recourse obligation secured by a mortgage on Blackacre.

Example Six should be viewed similarly. Taxpayer B used non-recourse funds to pay an ordinary obligation. Again, whether B used the cash or accrual method should not matter because the debt is both actually owed and actually paid. However, the non-recourse borrowing raises difficult issues. Critically, Taxpayer B actually pays the taxes to the government, whether he writes the check or whether Third Party does it for him.

Traditionally the United States tax system has viewed the non-recourse borrowing of funds as non-income-producing. It is well settled that recourse borrowing does not generate income because it is counter-balanced by an obligation to repay. Non-recourse borrowing, however, does not have the same counter-weight.

Economically, non-recourse borrowing could be viewed as income-producing because it often essentially accelerates gain from the future disposal of the property. However, this acceleration occurs only if the taxpayer ultimately disposes of the property in a transaction related to the satisfaction of the non-recourse debt. If, instead, the taxpayer

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228 I.R.C. ' 1202 (1986). This section provided for a deduction equal to 60% of a taxpayer's net capital gain. Although this tax-favored treatment of capital gains does not now exist, such treatment has been proposed consistently. In addition, section 1(j) subjects net capital gain to a preferential maximum 28% rate.

229 I.R.C. ' 1202.


231 I.R.C. ' 1(j).

232 See Bittker, note 118.
pays the debt and retains the property, no acceleration would really have occurred. Thus, any prior treatment of the non-recourse debt as real taxpayer investment would be justified. Therefore, it is appropriate to defer recognition of the potential accelerated gain until we know whether any gain really occurred.

Two scenarios are possible to illustrate the acceleration of income potential from non-recourse debt.

(a) Scenario One: Non- \textit{Tufts}

- Taxpayer borrows money non-recourse and spends it on matters unrelated to the acquisition of the property securing the debt. Ultimately, taxpayer sells the property for an amount in excess of the non-recourse liability.

Any gain resulting from the Scenario One transaction is real in the sense that taxpayer actually pockets the excess. Similarly, in the taxpayer's eyes the non-recourse debt is also real in that he had a motive to pay it.

In such a scenario, deferral of income recognition from the borrowing year to the disposition year is a timing policy choice. The character of such real income should be capital because that is what the facts ultimately justify. The income from the borrowing year is initially deferred for two reasons. First, to see if an acceleration really occurred; \textit{i.e.}, did the borrower ultimately pay the debt by disposing of the property. Second, if acceleration occurred, to see if the accelerated income is real. If it is, then the use of the funds in the borrowing year should be irrelevant. In such a scenario, Taxpayer B essentially stands in the same position as Taxpayer A because he ultimately would have a true incentive to pay the non-recourse debt. Thus, B should have the same opportunity as A would to use tax-favored income to pay expenses which are deductible in full.

(b) Scenario Two: Modified

- Taxpayer again borrows money non-recourse and spends it on matters unrelated to the acquisition of the property securing the debt. Ultimately, taxpayer sells the property for an amount less than the non-recourse liability.

Any Scenario Two "gain" would not be economically real, because the taxpayer would not be relieved of an obligation for which he had an incentive to pay. Such future "gain" might be called "fictitious gain."

The Supreme Court properly recognized in \textit{Tufts} that such "fictitious gain" is necessary to counter-balance the prior treatment of the non-recourse debt as real debt. In \textit{Tufts}, the original treatment of the debt as real debt resulted in basis because the taxpayer used the funds to acquire the property. Thus, the \textit{Tufts} recognition of a "fictitious amount realized" is transactionally consistent. Had the \textit{Tufts} taxpayer received an ordinary benefit from the prior inclusion in basis - such as depreciation - sections 1245 and 1250

\footnote{233} I.R.C. \textsection 1245.
would preclude any potential transactional character inconsistency to the extent Congress saw fit.

In the second scenario, as in Allan, the borrowing of the funds non-recourse to pay the taxes was essentially an acceleration of future "fictitious gain." Unlike Tufts, however, this taxpayer used the borrowed proceeds as he saw fit - in this case to pay the ordinary obligations. He did not use the funds to purchase the specific property related to the non-recourse debt.

As shown in Example Five, however, what the taxpayer did with the funds should not matter. Instead, the focus should be on the "gain." In essence, the non-recourse borrowing is a put. The borrower locks in a price at which he can force the lender to buy. In this view, it is still appropriate to defer recognition of any locked-in gain until later because of the possibility that the borrower may still pay the debt, and thus cause the put to evaporate. As above, we would then treat it as if it never happened. If instead the taxpayer transfers the property to satisfy the debt, he then would recognize his locked-in gain, which necessarily would be characterized by reference to the property transferred rather than by reference to the expenditure of the borrowed funds.

Thus, with regard to the taxes in Allan the Tax Court was correct: the deduction was ordinary, while the subsequent gain was capital. However, the reason is not that Tufts overrides the tax benefit rule. Instead, both Tufts and the tax benefit rule apply, because both actually are of the same thing: devices to correct transactional errors resulting from policy choices and broken promises.

With regard to the taxes, the policy choice was not the allowance of the deduction - that was real because the taxes were both actually owed and actually paid. Instead, the policy choice involved deferring the recognition of the accelerated gain until we knew whether it really existed. Once it was apparent, from the foreclosure, that in fact the taxpayer used a "put" to accelerate gain, it was time to recognize it. Critically, the policy choice involved timing rather than character. The locked-in gain was real, although the ultimate paper gain appeared "fictitious."

d. Policy Choice Two: the Interest

Analysis of the interest deduction and subsequent gain is trickier. In this instance, the taxpayer did not really borrow anything, did not accrue anything, and did not pay anything. It was all a fiction. The interest was not owed, because the obligation to pay it

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234 I.R.C. ' 1250.

235 A "put" is a type of option contract which "obligates the seller of the contract to take delivery of the [property] and pay the specified price to the owner of the option within the time limit of the contract." S. BOLten, SECURITY ANALYSIS AND PORTFOLIO MANAGEMENT 493 (1972). Analogizing the non-recourse obligation to a put, the borrower would own the option to force the lender to buy the property for the amount of the debt.
was non-recourse.\(^{236}\) In contrast, the obligation to pay the taxes to the government was real. Similarly, the taxpayer did not pay the interest; instead the taxpayer merely promised (to the extent that a non-recourse promise is a promise) to pay it later. In contrast the taxes were actually paid, albeit with funds borrowed non-recourse. Also, no funds were really borrowed with respect to the interest. On paper the principal increased, but the taxpayer did not promise to pay it and the lender did not disburse any money. In contrast, with regard to the taxes, the lender actually disbursed the funds.\(^{237}\)

\[\text{(1) The Cause of the Dilemma: A Problem}\]

The "interest" aspect of raises the familiar problem illustrated by the \textit{Burgess v. Commissioner}\(^{238}\) and \textit{Bettelstein v. Commissioner}\(^{239}\) cases. Both involved cash method taxpayers, which presents some difficulty relating them to \textit{Allan}, which involved an accrual method taxpayer.\(^{240}\) Nevertheless, the cases are relevant.

Burgess owed interest which was due and which was deductible if paid. He borrowed additional funds from the lender to whom he owed the interest. He deposited them in an account that included other monies, he waited a short period of time, and then he paid them to the lender to satisfy the interest obligation.\(^{241}\) Over the objections of the government, the Tax Court allowed Burgess an interest deduction.\(^{242}\) The holding rested on the fact that he actually paid the interest, albeit with funds borrowed from the person to whom he owed the interest. Had he borrowed the money from an unrelated third party, no one would question the deduction.

\textit{Bettelstein} involved very similar facts, with a critical difference. Bettelstein borrowed the money and immediately repaid it as interest: he merely exchanged checks. There was no other money to mix it with and no time lag.\(^{243}\) In a narrowly divided opinion, the Fifth Circuit denied the deduction\(^{244}\)

\(^{236}\) \textit{Allan}, 86 T.C. at 658.

\(^{237}\) \textit{Id.} at 657. On appeal, the government correctly argued that the advances for interest did not create a "true loan." \textit{Allan}, 856 F.2d at 1173. The court found otherwise. \textit{Id.} at 1173-74.

\(^{238}\) 8 T.C. 47 (1947).

\(^{239}\) 631 F.2d 1182 (5th Cir. 1980).

\(^{240}\) \textit{Allan}, 86 T.C. at 658.

\(^{241}\) 8 T.C. at 48.

\(^{242}\) \textit{Id.} at 50.

\(^{243}\) \textit{Bettelstein}, 631 F.2d at 1183.

\(^{244}\) \textit{Id.} at 1184-85. Twenty-four judges considered the decision at the Fifth Circuit. \textit{Id.} at 1182-83. Fourteen joined the majority opinion denying the deduction, while ten dissented. \textit{Id.} at 1185. Remarkably the
These two cases have long puzzled students and practitioners. They appear to draw an arbitrary line. That is a fair analysis, because they do draw an arbitrary line. However, the line is necessary and at the proper place. Why? Because of the policy choice which permits the cash method of accounting.\(^{245}\) Inherently the cash method is flawed. It is less transactional than the accrual method, because it merely looks at receipts and payments, rather than earning and owing. It does not even attempt to satisfy the matching principle of accounting. Yet, the United States' tax system allows it because of its simplicity.

Because the cash method depends upon payment as the key factor in deductions, it necessarily permits deduction of expenses paid with borrowed funds: they are actually paid. However, it also necessarily does not permit deduction of expenses that the taxpayer merely promises to pay: they are not paid. That presents the dilemma of drawing a line between a payment and a promise. If a third party lends the funds used to make the payment, then we can easily recognize the payment because it is real. However, when the lender of the funds is also the recipient of the payment, reality is less clear. The court understandably felt that time, combined with pre-existing funds, adds enough reality to such a transaction; thus, the decision. Likewise, the mere form of exchanging checks with no substance whatever lacks almost all reality; hence, the Battelstein decision.

(2) Relationship to Allan

Although Allan involved an accrual taxpayer, the problem is similar. The taxpayer did not pay anything because there was not even the semblance of exchanged checks. Critically, the taxpayer also did not owe anything because the obligation was non-recourse. Had the taxpayer borrowed the funds from a third party, that would have been sufficient substance to recognize the interest obligation: if he had been willing to borrow real funds to pay the interest, then the interest obligation likewise must have been real. However, the Allan taxpayer did not do so.

For some reason, not explained in the Allan decision, the government did not question the accrual of the interest deduction. While that could be viewed as an error and correctable as an error (through an amended return or notice of deficiency), it is also viewable as a policy choice. The tax system views the obligation to pay the interest as real, if the taxpayer promises that it will ultimately pay the interest. Critically, however, the tax system need not recognize the capitalization of the interest as a payment. As in Battelstein that is a paper transaction without any substance.

Therefore, the interest deduction and alleged capitalization does not generate a Tufts issue on foreclosure. In reality, the interest was not capitalized - it was deferred. The

\(^{245}\) I.R.C. \(\text{ }\) 446(c)(1). This provision permits the cash method of accounting.
ultimate release of the obligation constituted a broken promise by the taxpayer: the
government allowed the taxpayer a deduction on the promise the taxpayer would pay the
interest, but the taxpayer never paid the interest. Thus, under the tax benefit rule, it must
"repay" the deduction by recognition of ordinary income. Had, instead, the taxpayer fulfilled
the promise either by paying the interest in cash or by surrendering property with sufficient
value to pay the interest, then the promise would not have been broken. In such a case,
any amount realized would have been capital.

e. Summary of Analysis

With regard to the taxes, the deduction and capitalization were proper. The policy
choice involved merely the timing of the accelerated income, if any. The character was
necessarily capital gain because it involved deferred accelerated gain from the sale of a
capital asset. Crane and Tufts were the proper correction devices. Because Crane would
treat the debt as real initially, Tufts treats it as real at the end of the transaction.

With regard to the interest, the deduction was questionable and the capitalization
was improper. The policy choice involved allowing the deduction in exchange for the
promise that the interest would be paid. Because it was never paid, the proper correction
device is the tax benefit rule that would create income to offset the deduction. Necessarily it
would be of the same character.

f. Crane and the Forgotten Footnote 6

To be complete, an analysis of Allan should at least observe the remarkably similar
facts of Crane246 perhaps the most important of all tax cases. Crane inherited property
subject to non-recourse debt, which included capitalized unpaid interest owed by the
decedent. A cash method taxpayer, Crane deducted some subsequent interest she paid
and also capitalized other interest she did not pay.247

When she sold the property, the purchaser assumed not only the principal debt but
also the capitalized interest originally owed by the decedent as well as that owed by
Crane.248 These facts differ from Allan because Crane used the cash method while Allan
used the accrual. Thus, Crane never deducted the interest, as had Allan. That difference,
however, is unimportant because it only relates to the timing of the interest deduction. The
critical issue in Allan was the character of the deduction and the amount realized.

Remarkably, the Supreme Court in footnote six of Crane stated that the amount
realized on the disposition of the property did not include relief of the capitalized interest.249

246 Crane, 331 U.S. at 1.
247 Id. at 3.
248 Id.
249 Id. at 4 n.6.
As the Court explained, the government stipulated that recognition of any income would have necessitated imputation of a deduction, which would have been a wash. The statement is remarkable not only in that the government would stipulate such an incorrect statement, but also that the Court would agree.

Had the assumed interest resulted in gain, such gain would have been capital gain (at least today) and would have been recognized in the year of disposition. The corresponding deduction, however, would have been ordinary, if justifiable at all. Also, it would have been allowable in the year of payment rather than in the year of disposition. Thus, the income and deduction could not, at least not always, wash. A full discussion of Crane’s footnote six is beyond this discussion; however, a reader should at least question whether Crane would be entitled to deduct interest accrued by the decedent and whether such a deduction would arise prior to payment.\(^{250}\) Also, would the assumption of the debt by the purchaser be a sufficient payment?\(^{251}\) Would payment by the purchaser have generated Crane’s deduction? Would the nonrecognition of amount realized on the disposition affect Crane’s subsequent deduction of the interest?\(^{252}\) Would such a deduction despite the prior nonrecognition be a fundamentally inconsistent event under Bliss Dairy?\(^{253}\)

While the above questions are difficult, the Allan Tax Court also chose not to raise them. This criticism is significant because the Tax Court found an ordinary deduction followed by capital gain, while the Supreme Court in a famous case with quite similar facts found a wash. At least a cite distinguishing or finessing footnote six in Crane was warranted.

\[\text{footnote text}\]

\(^{250}\) I.R.C. ‘ 691(b).

\(^{251}\) See Rev. Rul. 78-38, 1978-1 C.B. 67 where the Treasury Department stated that a taxpayer who used a bank credit card to make a charitable contribution was entitled to a deduction in the year the charge was made regardless of when the bank was paid. The Treasury Department reasoned that the credit card holder’s substitution of the bank as the payor was equivalent to the use of borrowed funds to make the charitable contribution.

\(^{252}\) In Cooledge v. Commissioner, 40 B.T.A. 1325, 1328 (1939), the court concluded that a seller of real property was entitled to a deduction for accrued but unpaid interest and taxes when included in the purchaser's assumption of such amounts as part of his amount realized on the sale.