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Taxation-Federal Income Tax-Accrual of State Property Taxes Paid Under Protest

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TAXATION—FEDERAL INCOME TAX—ACCRUAL OF STATE PROPERTY TAXES PAID UNDER PROTEST—During the years 1946 to 1950 a local tax upon respondent's real property was assessed at one hundred dollars.[1] Respond-

[1] The parties, for the purpose of the suit, adopted a simplified example based upon an assessment of $100. Actually, hundreds of parcels of property were involved, and the amount of the claim was substantial.

ent paid the full assessment to avoid interest penalties and seizure and sale of the property under tax liens, but contested the assessment in the state court, denying any liability greater than eighty-five dollars. In each of the preceding years, complying with a private ruling directed to it by the Commissioner,[2] respondent had deducted the full one hundred dollars, and, when in 1951 the tax was fixed by the state court at ninety-five dollars, respondent included the five-dollar refund in its gross income. Respondent then instituted this action to recover an alleged overpayment of income tax in 1951, claiming that ten dollars of the one hundred-dollar deduction taken in each year should have been deferred until 1951, and that the five-dollar refund should be excluded from that year's gross income. The district court disagreed with respondent's contentions and accepted the view of the Commissioner that the whole amount of the assessed tax accrued, and thus was properly deducted, in the year in which it was paid and that the five-dollar refund represented income to the taxpayer in 1951.[3] The Second Circuit reversed on both counts.[4] On certiorari, *held*, affirmed. The remittance of the property tax, under protest, was not a type of payment which would serve to accrue the contested portion of the tax before respondent's liability had been determined by the state court. *United States v. Consolidated Edison Co.*, 366 U.S. 380 (1961).

The Court long ago established the rule in *United States v. Anderson*[5] that all events which ultimately fix a taxpayer's liability for an expense must occur before the item can be accrued for deduction purposes. This "all events" test uniformly has been held to include taxes.[6] And where a tax has not been paid and the taxpayer is denying liability for it, most courts have not allowed accrual until the year in which the contest is finally settled.[7] This result has been reached in accordance with the policy laid down by the Court in the *Anderson* case that a taxpayer should not be allowed to accrue an expense and at the same time actively deny liability for it. But where, as in the principal case, payment had been made prior to the final disposition of a contest involving the determination of liability, the decisions were in conflict. The fact of payment and, more importantly, the nature of the payment caused much of this difference in opinion. A

2 Principal case, 366 U.S. 380, 384 n.2 (1961).

3 Consolidated Edison Co. v. United States, 4 Am. Fed. Tax R.2d 5837 (S.D.N.Y. 1959).

4 Consolidated Edison Co. v. United States, 279 F.2d 152 (2d Cir. 1960).

5 269 U.S. 422 (1926).

6 "It is settled by many decisions that a taxpayer may not accrue an expense the amount of which is unsettled or the liability for which is contingent, and this principle is fully applicable to a tax, liability for which the taxpayer denies, and payment whereof he is contesting." Security Flour Mills Co. v. Commissioner, 321 U.S. 281, 284 (1944).

7 See, *e.g.*, Dixie Pine Prods. Co. v. Commissioner, 320 U.S. 516 (1944); Security Flour Mills Co. v. Commissioner, 321 U.S. 281 (1944).

tentative payment may be made in several situations. It may be required as a suspense account deposit, as a prerequisite to appeal[8] or, as in the principal case, it may be induced by a desire to avoid interest penalties. These might be called *conditional* payments. The critical factor in a conditional payment is that the taxpayer intends, at the time of payment, later to contest his liability for the expense item. On the other hand, a truly *unconditional* payment might be made wherein a taxpayer pays an item with an honest belief in his liability for the full amount only to find later that he may have been over-assessed.

In the cases involving conditional payments it had been repeatedly held, contrary to the view in the principal case, that such a remittance acts to accrue the expense at the time of payment.[9] The Court of Claims in a leading decision said that accrual may precede payment, but will not survive it.[10] This rule was followed in an earlier *Consolidated Edison* decision,[11] involving essentially the same facts as those in the present case. The fact that this earlier decision was directly opposed to the holding on appeal in the present case surely influenced the Court to grant certiorari in order to resolve the conflict.

In the principal decision, the Court laid heavy emphasis upon the word "payment." Read strictly, the holding was simply that a payment made with a concurrent intention to contest the liability would not be enough to accrue the expense. But the Court did not decide when accrual would occur in the case of a truly unconditional payment followed by a later decision to contest the liability.[12] Such a question becomes important when considered in the light of the significance to the taxpayer of proper timing of his deductions. In the present case it was advantageous for the taxpayer to take the deduction in the later year because of excess profits tax rates. However, this was an unusual situation. Normally, because of the flat tax rate applicable to corporations, deferral of the deduction will not result in a tax saving and the corporate taxpayer will desire to take the deduction at the earliest possible time. On the other hand, an individual

8 See, *e.g.*, United States v. Texas Mexican Ry., 263 F.2d 31 (5th Cir. 1959); Rose v. United States, 256 F.2d 223 (3d Cir. 1958).

9 See, *e.g.*, Guantanamo & W.R.R., 31 T.C. 842 (1959); Lehigh Valley R.R., 12 T.C. 977 (1949).

10 Chestnut Sec. Co. v. United States, 104 Ct. Cl. 489, 494-95, 62 F. Supp. 574, 576 (1945). See G.C.M. 25298, 1947-2 CUM. BULL. 39.

11 Consolidated Edison Co. v. United States, 133 Ct. Cl. 376, 135 F. Supp. 881 (1955), *cert. denied*, 351 U.S. 909 (1956).

12 Such a determination was not necessary to the Court's decision. The Court incidentally mentioned the problem, saying: "Of course, an unconditional 'payment' made by a taxpayer in apparent 'satisfaction' of an asserted matured tax liability is, without more, plain and persuasive evidence, at least against the taxpayer, that 'all the events [have] occur[red] which fix the amount of the tax and determine the liability of the taxpayer to pay it'. . . ." Principal case at 391.

taxpayer, subject to the progressive rate structure, is often able to effect a substantial tax saving by deferring or accelerating deductions to a year of higher profits.

Although few cases have reached the courts in which there has been a truly unconditional payment, at least one case has directly held that an unconditional payment of a tax does not accrue the expense if the liability is later contested.[13] In that case the court rejected the theory that a payment amounts to an admission of liability, and thus accrues the expense. The court felt that there should be no distinction between an unconditional payment and one which is made with a concurrent intention to contest the liability; that neither should operate to accrue the expense before determination of the contest. This amounts to a significant extension of the "all events" test which the court attempted to justify on the ground that the point in time at which the taxpayer forms an intention to contest the liability is not important. The view that an unconditional payment, followed by a later decision to contest the liability, does not accrue an expense requires a broad interpretation of the holding in the principal case. Whether such an extension of the "all events" test is justifiable might well turn on the significance of two factors: the fundamental policy consideration underlying the "all events" test, and the problem of difficulty of proof with regard to good faith.

The "all events" test rests upon the premise that a taxpayer should not be allowed to accrue an expense item and take a deduction for it when at the same time he is loudly protesting in a court of law that he does not in fact owe it. But if the test is extended to the point where a decision to contest the liability, made after an unconditional payment, will re-open and postpone an earlier accrual, a situation arises which is in discord with that very premise. Upon making such an unconditional payment the taxpayer would have accrued the expense and taken the deduction for it, since all the events which fix the liability would ostensibly have occurred. But, if in a later year the taxpayer decided to contest his liability for the expense, he would be permitted, and indeed required, to re-open the return of the earlier year and postpone the deduction, thus canceling the accrual effect of what had originally been an unconditional admission of liability. This is the very type of inconsistent conduct which the "all events" test seeks to prevent.

The question of the taxpayer's good faith presents a second problem. If the court holds that an unconditional payment with a subsequent decision to contest requires a re-opening and postponement of the earlier accrual, a taxpayer might try to postpone a disproportionately large amount

[13] Standard Oil Co. v. United States, 51 Am. Fed. Tax R. 1688 (N.D. Ohio 1956). *Cf.* Pierce Estates v. Commissioner, 195 F.2d 475 (3d Cir. 1952); Cooperstown Corp. v. Commissioner, 144 F.2d 693 (3d Cir. 1944), *cert. denied*, 323 U.S. 772 (1944).

to the later year. Since deduction of the entire contested amount would be postponed, a dishonest taxpayer could increase the size of this deduction by merely over-asserting his claim when contesting the liability. But the question of good faith does not end here. What if the taxpayer were to make what appears to be an unconditional payment, while in reality he intends full well to contest the expense? If the element of bad faith could be proved, the court might well hold that the payment does not accrue the expense, on the authority of the principal case. But such proof may be very difficult to obtain. Thus, if the court were to hold that a truly unconditional payment does accrue the expense, a taxpayer with a valid ground for contesting the liability might nevertheless be able to accelerate the deduction to an earlier year by making what appears to be an unconditional payment.

Thus, a court is faced with a problem of good faith no matter what effect is given to an unconditional payment followed by a later decision to contest the liability. A holding that such a payment does not accrue the expense may allow the unscrupulous taxpayer to postpone deduction of a greater amount than he should, while a holding that such a payment does accrue the expense opens up the possibility of a wrongful acceleration of the deduction. A clearer ground for resolution of the problem is found in the basic policy underlying the "all events" test. And an examination of this policy indicates that an unconditional payment, even though followed by a later decision to contest the liability, should nevertheless accrue the expense.

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