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TAXATION-FEDERAL INCOME TAX-ACCOUNTING FOR MONEY MISTAKENLY RECEIVED UNDER A CLAIM OF RIGHT

Allan Neef
University of Michigan Law School

TAXATION—FEDERAL INCOME TAX—ACCOUNTING FOR MONEY MISTAKENLY RECEIVED UNDER A CLAIM OF RIGHT—The plaintiff taxpayer, as the general manager of a manufacturing corporation, received a bonus of approximately $22,000 for the 1944 calendar year, pursuant to a percentage-of-net-profits bonus arrangement. In 1946, a state court found that this bonus had been erroneously computed, and that the terms of the agreement only called for a payment to the plaintiff of about $11,000 for the prior year. As a result of this adverse judgment, the plaintiff repaid the excess to the corporation, and filed an amended tax return and a timely claim for a refund of the prior tax on such amount with the Commissioner of Internal Revenue. Although the Commissioner disallowed the claim, the Court of Claims ruled that the plaintiff was entitled to a refund.[1] On certiorari to the Supreme Court to review the Court of Claims ruling, *held,* with Justice Douglas dissenting, that the claim was properly disallowed by the Commissioner. *United States v. Lewis,* 340 U.S. 590, 71 S.Ct. 522 (1951).

Under the annual system of tax accounting, revenue received under a claim of right and without restriction as to its disposition constitutes current income to the recipient, even though his right to the money is contingent or contested.[2] This so-called claim-of-right doctrine is based on the premise that federal revenues cannot await the final determination of all possible or probable events which may alter the taxpayer's true economic situation; instead, tax liability must be fixed by reference to the individual's current position.[3] Carried to its ultimate conclusion, this theory of when income is taxable would preclude later inquiry into the original determination, even though it were eventually to be concluded that the recipient was not entitled to the money; the taxpayer would have only the cold comfort of a possible deduction when he restored the amount mistakenly received. Such an extension of the claim-of-right doctrine is probably not necessary, and works an obvious injustice to the taxpayer, requiring him to submit passively to a tax on money which does not belong to him. It is the result, however, which the federal courts have held themselves bound to reach[4] ever since the Supreme Court, in originally announcing the basic doctrine, suggested such a result in its concluding thought.[5] Although this mongrel dogma[6] was dictum,[7] that fact has not deterred the courts, other than the Court of Claims, from its strict application. One major qualification to the claim-of-right doctrine has been recognized by the Supreme Court, however: even though the

[1] Lewis v. United States, (Ct. Cl. 1950) 91 F. Supp. 1017.

[2] North American Oil Consolidated v. Burnet, 286 U.S. 417, 52 S.Ct. 613 (1932).

[3] Burnet v. Sanford & Brooks Co., 282 U.S. 359, 51 S.Ct. 150 (1931); Heiner v. Mellon, 304 U.S. 271, 58 S.Ct. 926 (1937); North American Oil Consolidated v. Burnet, supra note 2.

[4] For example, see Saunders v. Commissioner, (10th Cir. 1939) 101 F. (2d) 407, 22 A.F.T.R. 460; Haberkorn v. United States, (6th Cir. 1949) 173 F. (2d) 587, 37 A.F.T.R. 1175; cases listed by court at p. 589 of Haberkorn decision. The Court of Claims has taken a contrary position however. See, for example, Lewis v. United States, (Ct. Cl. 1950) 91 F. Supp. 1017.

[5] North American Oil Consolidated v. Burnet, supra note 2, at 419.

[6] The conclusion reached is apparently derived from applying the deduction for individual losses provisions of I.R.C. §23(e) to the taxable year concept of Burnet v. Sanford & Brooks Co., supra note 3, although the court did not place its reasoning on this point in the record.

[7] Since the facts of the North American Oil Consolidated v. Burnet case, supra note 2, did not involve any liability on the part of the taxpayer to return the contested funds, which the corporate taxpayer was finally adjudged entitled to retain, the Court's statement of what would have been the result had the taxpayer lost the litigation was obiter.

requisite bona fide claim of right is present, the gain does not constitute taxable income if the recipient is under a definite and unconditional obligation to repay or return the funds at some future date.[8] Thus the borrower,[9] the embezzler,[10] and the agent[11] are removed from the reach of the tax collector. The Court of Claims seized on this distinction to escape the application of the claim-of-right dictum to the taxpayer who receives funds under the mistaken belief that he is entitled to them.[12] Since the recipient of income under a mistake of fact is in reality under an unconditional obligation to return it, even though he is not aware of such an obligation at the time of its receipt, he might be regarded as receiving a temporary advance,[13] or as holding the funds for the rightful owner under a constructive trust.[14] On the other hand, the obligation to repay does not arise until the mistake is discovered and made known to the taxpayer; in the interim he has an unqualified bona fide claim of right to the funds. Therefore, the obligation-to-repay exception does not strictly apply to the situation. The result is that the honest man who receives money under a mistake and immediately restores it when the mistake is discovered must pay an income tax upon it, whereas the person who embezzles money, and quite likely does not restore it, owes the government no tax.[15] Although "moral turpitude is not a touchstone of taxability,"[16] such a result is difficult to justify on public policy grounds. While the money is correctly taxable at the time of its receipt, the annual system is not so rigid as to require assessment or preclude refund of taxes upon sums which the recipient is not allowed to retain. Indeed, the amendment of prior returns to correct other types of mistakes, and to take care of other events that arise in the future,[17] is allowed without endangering the severability of the taxable year or unduly interfering with the practical administration of the federal revenue system.[18] It is submitted that the claim-of-right doctrine should

[8] Commissioner v. Wilcox, 327 U.S. 404, 66 S.Ct. 546 (1946). This decision is criticized in 44 MICH. L. REV. 885 (1946).

[9] Ibid.

[10] Ibid.

[11] Commissioner v. Turney, (5th Cir. 1936) 82 F. (2d) 661.

[12] For example, see Lewis v. United States, supra note 4; Gargaro v. United States, (Ct. Cl. 1947) 73 F. Supp. 973. That the otherwise universal view was the other way, see Haberkorn v. United States, (6th Cir. 1949) 173 F. (2d) 587, 37 A.F.T.R. 1175, and the dissent in Lewis v. United States above.

[13] For an example of this approach, see Eakins v. United States, (D.C. N.Y. 1930) 36 F. (2d) 961. Haberkorn v. United States, supra note 4, rejects this contention.

[14] Greenwald v. United States, (Ct. Cl. 1944) 57 F. Supp. 569, adopts this approach, which is discussed at length in 7 INST. FED. TAX. 1427 (1949).

[15] This is the factual result of Commissioner v. Wilcox, 327 U.S. 404, 66 S.Ct. 546 (1946), which laid down the obligation-to-repay exception.

[16] Id. at 408.

[17] For example, the carry-back provisions of I.R.C. §§23(s) and 122, and the renegotiation provisions of I.R.C. §3806. This later provision is discussed in connection with the claim-of-right doctrine in 61 HARV. L. REV. 710 (1948).

[18] Treas. Reg. 111, §29.322-3.

have been restricted to its original function of determining to which period income is to be attributed for tax purposes, and should not have been extended to preclude a correction of the return resulting in a more accurate reflection of the taxpayer's true economic position.[19]

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[19] It should be noted, however, that any practical recognition of such a right to amend returns would require a revision of the present three year statute of limitations. I.R.C. §322(b), 26 U.S.C. (1946) §322(b); Treas. Reg. 111, §29.322-7.