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INCOME TAX—Recovered Property Previously Deducted Included in Gross Income in Year of Recovery—*Alice Phelan Sullivan Corp. v. United States**

In 1939 and 1940 the corporate taxpayer claimed as charitable deductions the value of two parcels of realty which it had donated to a charitable organization subject to the condition that they be used solely for religious or educational purposes. Having decided not to use the gifts in the manner specified, the donee reconveyed them to the taxpayer in 1957. The taxpayer failed to reflect this recovery in its gross income for that year. The Commissioner of Internal Revenue, however, determined that under section 111 of the 1954 Internal Revenue Code (Code)[1] the taxpayer's gross income

* CCH 1967 STAND. FED. TAX REP. (67-2 U.S. Tax Cas.) ¶ 9570 (Ct. Cl. July 20, 1967) [hereinafter cited as principal case].

1. INT. REV. CODE of 1954, § 111. The taxpayer had received a tax saving from the

reported in its 1957 tax return should have included each piece of recovered property valued as of the year of deduction. The taxpayer paid a deficiency assessment and then sued for a partial refund of this assessment in the Court of Claims, relying on that court's earlier decision in *Perry v. United States*[2] to establish that an overpayment had been made to the extent that the taxes on the recovered property exceeded the actual tax savings from the charitable deductions in 1939 and 1940.[3] On a motion by the Commissioner for summary judgment, *held, Perry v. United States*[4] is overruled and the taxpayer's petition is dismissed. To the extent that a taxpayer is able to utilize a deduction to reduce his taxable income, a subsequent recovery of the property giving rise to the deduction must be included in his gross income for the year of recovery and taxed at the then current rates. By this decision, the Court of Claims conformed its result on this issue to that of other courts which have faced the same question.[5]

There are two primary accounting approaches to the computation of income tax: the transactional method and the annual method. The transactional accounting approach treats each transaction separately; thus, the income from each transaction is deter-

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prior use of the realty as charitable deductions to which, in the light of the subsequent recovery of the realty, it is no longer entitled. To prevent unjust enrichment of the taxpayer the benefit of such a deduction must be offset. Under § 111, the usual method of adjustment is to include in gross income for the year of recovery the amount of the prior deduction which was recovered, subject to the limitation that any part of the deduction which did not result in a reduction of taxes in the prior year is not included. *See* Plumb, *The Tax Benefit Rule Today*, 57 HARV. L. REV. 129, 176 (1943). Although § 111 refers only to recovery of "bad debts, prior taxes and delinquency amounts," the Supreme Court in Dobson v. Commissioner, 320 U.S. 489 (1943), impliedly recognized that the rule was not restricted to these specific situations. The rule is now applied to the recovery of "all other losses, expenditures and accruals . . . made the basis of a deduction . . . ." Treas. Reg. § 1.111-1(a) (1956). For leading articles on the tax benefit rule in general, *see* Plumb, *The Tax Benefit Rule Today*, 57 HARV. L. REV. 129 (1943); Plumb, *The Tax Benefit Rule Tomorrow*, 57 HARV. L. REV. 675 (1944); Tye, *The Tax Benefit Rule Reexamined*, 3 TAX L. REV. 329 (1948).

2. 160 F. Supp. 270 (Ct. Cl. 1958).

3. The deductions taken in 1939 and 1940, were $4,243.49 and $4,463.44 respectively. Since the tax rates then in effect were 18% (1939) and 24% (1940), the total tax saving realized from the deductions was $1,877.49. The Commissioner included the full value of each parcel as of the year it was donated, totalling $8,706.93, in the corporation's income for 1957, which was taxed at a rate of 52%. The taxpayer contended that it was liable only to the extent of the tax saving in the prior year and thus claimed a refund of $2,650.11—the deficiency assessment for 1957 of $4,527.60 less the prior tax saving of $1,877.49. In effect, this method of adjustment taxes the income from the recovered property at the rates applicable in the years the deductions were taken.

4. 160 F. Supp. 270 (Ct. Cl. 1958).

5. *See* Estate of William H. Block, 39 B.T.A. 388 (1939), *aff'd sub nom.* Union Trust Co. v. Commissioner, 111 F.2d 60 (7th Cir.), *cert. denied*, 311 U.S. 658 (1940); National Bank of Commerce, 40 B.T.A. 72 (1939), *aff'd*, 115 F.2d 875 (1940), 3 P-H 1967 FED. TAX SERV. ¶ 8534, at 8501; 1 CCH 1967 STAND. FED. TAX REP. ¶ 1131.01, at 19,248.

mined only upon completion of the transaction.[6] In contrast, under the annual approach, taxable income is computed on the basis of the income and expenses resulting from all of the taxpayer's transactions during a single year, including transactions not completed in that year. The annual approach thus makes it possible to recognize income in one year on a transaction that ultimately results in an over-all loss. The Supreme Court in *Burnet v. Sanford & Brooks Co.*[7] chose to adopt the annual accounting approach, apparently because of its comparative ease of application and its production of revenue to the government at regular intervals.[8] Since the *Burnet* decision, the concept of accounting for items of income on an annual basis has become firmly entrenched as a basic principle by which the courts interpret and implement our tax laws.

The court in the principal case believed that the annual accounting principle dictated the inclusion of the value of the previously deducted property in the gross income of the year of recovery.[9] How-

6. Bartlett v. Delaney, 173 F.2d 535, 536 (1st Cir. 1949), *aff'g* 75 F. Supp. 490 (D. Mass. 1948), *cert. denied,* 338 U.S. 817 (1949).

7. 282 U.S. 359 (1931).

8. "It is the essence of any system of taxation that it should produce revenue ascertainable, and payable to the government, at regular intervals. Only by such a system is it practical to produce a regular flow of income and apply methods of accounting, assessment, and collection capable of practical operation." *Id.* at 365. This was contrasted with the transactional method which would postpone "the assessment of the tax until the end of a lifetime, or some other indefinite period . . . ." *Id.* Other expressions of preference for the annual accounting principle as opposed to the less definite transactional approach are abundant. *See, e.g.,* Murray v. Commissioner, 232 F.2d 742, 745 (9th Cir. 1956); Brown v. Commissioner, 63 F.2d 66 (9th Cir. 1933), *aff'd,* 291 U.S. 193 (1934); F. B. Fawsett, 23 B.T.A. 1148, 1152 (1931), *aff'd,* 63 F.2d 445 (7th Cir.), *cert. denied,* 290 U.S. 641 (1933). *See also* Surrey, *Symposium on Law and Accounting,* 36 IOWA L. REV. 191 (1950). Quasi-transactional methods which attempt to superimpose the transactional theory upon the annual system of accounting by requiring a prior return to be amended in light of subsequent events have also been rejected by the courts on the grounds of administrative inconvenience and a lack of finality in income tax liability. Healy v. Commissioner, 345 U.S. 278 (1953); Estate of William H. Block, 39 B.T.A. 338 (1939), *aff'd sub nom.* Union Trust Co. v. Commissioner, 111 F.2d 60 (7th Cir.), *cert. denied,* 311 U.S. 658 (1940); Webster, *The Claim of Right Doctrine; 1954 Version,* 10 TAX L. REV. 381 (1955); Surrey & Warren, *The Income Tax Project of The American Law Institute: Gross Income, Deductions, Accounting, Gains and Losses, Cancellation of Indebtedness,* 66 HARV. L. REV. 761, 795 (1953).

9. "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." Principal case at 84,847. At one time, the courts amended the prior return to disallow the deduction where this was not precluded by the statute of limitations. F. B. Elliott Co., 45 B.T.A. 82 (1941). But in Security Flour Mills Co. v. Commissioner, 321 U.S. 281 (1944), the Supreme Court stated that the annual accounting principle precluded the allocation of income to a year other than the year of actual receipt (or, for an accrual basis taxpayer, the year in which the right to receive income became final), and thereafter courts construed this to mean that such amendment was no longer possible even if the statute of limitations were not a bar. Lexmont Corp., 20 T.C. 185 (1953); 2 J. MERTENS, LAW OF FEDERAL INCOME TAXATION § 12.23, at 99 (1961).

ever, this decision may be inequitable to the taxpayer whose tax rate has escalated, since he will have to pay more taxes because of the recovery than he saved by virtue of the deduction.[10] In *Perry v. United States*,[11] the Court of Claims had attempted to remedy this inequity by ruling that the tax upon recovery of a previously deducted item should equal the actual reduction of tax liability in the year the deduction was taken. This result insured that neither the taxpayer nor the government would suffer as a result of the recovery.[12] The rule adopted by the *Perry* court was quickly criticized as violating the annual accounting principle.[13] In the principal case, the Court of Claims reacted to this criticism by overruling its decision in *Perry* and resurrecting the single year concept.[14] It is submitted, however, that although incorrect as a matter of statutory interpretation, the *Perry* rule is desirable in that it retains most of the practical advantages of the annual accounting principle while providing a more accurate reflection of the taxpayer's true income position.

The *Perry* rule may be classified as transactional in approach, since it does not look merely to the net results of a single year but takes into account the total effect on income of a series of related transactions. However, the additional administrative inconvenience of applying that rule, as opposed to annual accounting rule, appears to be slight. To illustrate, under section 111, when a previously deducted item of property is recovered, possible tax liability is not determined until after an examination of the prior return discloses that the deduction resulted in a tax benefit to the taxpayer.[15] This

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10. Conversely, if the recovery is taxed at rates lower than those in effect when the deduction was taken, the treatment would also be inequitable since the taxpayer would be in a better position than it would have been in had it never taken the deduction. *See, e.g.*, Central Loan and Inv. Co., 39 B.T.A. 981 (1939).

11. 160 F. Supp. 270 (Ct. Cl. 1958). For a discussion of the case, *see* Note, 1959 DUKE L.J. 151; Note, 33 TUL. L. REV. 247 (1958); Note, 16 WASH. & LEE L. REV. 248 (1959).

12. Other methods similar to the *Perry* rule have been advocated and rejected. American Dental Co., 44 B.T.A. 425 (1941), *rev'd on other grounds*, 128 F.2d 254 (7th Cir. 1942), *aff'd*, 318 U.S. 322 (1943); Central Loan and Inv. Co., 39 B.T.A. 981 (1939).

13. S. SURREY & W. WARREN, FEDERAL INCOME TAXATION 538 (1960); 1 J. MERTENS, LAW OF FEDERAL INCOME TAXATION § 7.37, at 99 (1962). *See also* note 11 *supra*. The Commissioner refused to follow *Perry*, Rev. Rul. 141, 1959-1 CUM. BULL. 17, and the Court of Claims itself appeared hesitant to rely on *Perry*. Citizens Fed. Sav. & Loan Ass'n v. United States, 290 F.2d 932 (Ct. Cl. 1961).

14. Principal case at 84,847.

15. For example, assume a taxpayer has a gross income of $15,000 in year 1, and in addition has a deductible item valued at $20,000. Under the § 111 tax benefit rule, if he recovers the item in year 2, only $15,000 would be included in his gross income for year 2 since the remaining $5,000 did not result in a tax benefit (*i.e.*, a reduction in tax liability) in year 1. In other words, since only $15,000 of the $20,000 was needed to reduce his taxable income in year 1 to zero, only $15,000 of the recovery is taxed in year 2.

initial determination must be made regardless of whether the *Perry* rule or the rule of the principal case is followed; it is only after a finding that some tax liability exists that the procedures differ. The rule in the principal case would require inclusion of the entire value of the recovered property in the gross income of the year of recovery, if any tax benefit resulted from the prior deduction. Under the *Perry* rule, however, the Commissioner would simply add the actual tax saving produced by the deduction in the prior year to the tax liability for the year of recovery computed without the inclusion of the recovered item in gross income.[16] Thus, the *Perry* rule requires only the one additional calculation of the actual tax saving in the prior year, which does not appear to be prohibitively inconvenient.

Moreover, the *Perry* rule does not force the government to wait for an indefinite period before it realizes any tax revenue. While the *Perry* rule may be regarded as transactional to the extent that it is concerned with the over-all position of the taxpayer after two or more related events, tax liability would still be predicated on annual returns, and thus revenue payable to the government would be produced at regular intervals.[17] In addition, since it requires adjustment in the return for the year of recovery rather than the year of deduction, the *Perry* rule overcomes the traditional objection to "quasi transactional" approaches that they necessitate the reopening and amending of prior returns.[18]

Since the practical advantages of applying the rule of the principal case rather than the *Perry* rule appear slight, it seems strange that the least equitable of the two should be the one adopted. The court in the principal case apparently felt the need for explicit legislative authorization to depart from the rule followed by other courts.[19] Given the court's inhibition, one might ask why, in the

16. It should be noted that this tax benefit rule is itself an exception to the annual accounting principle. Using the same example as in note 15 *supra*, the Commissioner, instead of following the *Sullivan* rule by adding the $15,000 to the taxpayer's gross income in year 2, would determine the taxpayer's total tax liability for year 2 by computing what the tax liability would have been in year 1 without using the deduction, and adding the difference between this amount and the actual tax liability for year 1 computed with the deduction to the tax liability based on the taxpayer's gross income in year 2 without the recovery. Thus, the taxpayer is taxed in year 2 only to the extent of his actual tax saving in year 1.

17. *See* note 8 *supra* and accompanying text.

18. Healy v. Commissioner, 345 U.S. 278 (1953); Estate of William H. Block, 39 B.T.A. 338 (1939), *aff'd sub nom.* Union Trust Co. v. Commissioner, 111 F.2d 60 (7th Cir.), *cert. denied*, 311 U.S. 658 (1940); Webster, *The Claim of Right Doctrine; 1954 Version*, 10 TAX L. REV. 381 (1955); Surrey & Warren, *supra*, note 8.

19. "And absent specific statutory authority sanctioning a departure from this principle, it may only be said of *Perry* that it achieved a result which was more equitably just than legally correct." Principal case at ¶ 84,847. *See also* the court's footnote 5, appealing to Congress for codification of the *Perry* rule.

face of the arguments that can be mustered in support of the *Perry* rule, Congress has failed to sanction this exception to the single-year concept.

When the tax benefit rule was originally adopted, Congress was aware of the inequities involved in situations like that in the principal case, and, in fact, it rejected a proposed solution identical to that found in Perry.[20] In contrast, Congress did take action with respect to a similar adjustment problem arising in the "claim of right" context. Assume an employer mistakenly overpays his employee by $5,000 in year 1. In year 2, the employer discovers the mistake and requires the taxpayer to return the extra $5,000. This situation is similar to that in the principal case in that some adjustment must be made to reflect the change in the employee's income position. In effect, he has paid taxes on $5,000 of income that he was not permitted to retain. In *United States v. Lewis*,[21] the Supreme Court held that a taxpayer in this situation should deduct from gross income in year 2 the amount which he was forced to return. This result was not wholly satisfactory on the facts of *Lewis*, since the taxpayer was taxed at a lower rate in year 2 and thus realized a tax saving in that year which was less than the additional taxes originally paid when the item was included in gross income in year 1.[22] Congress responded to the *Lewis* case by enacting section 1341 of the Code.[23] Under this provision, if the tax saving produced by

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20. I suggest, however, that the tax benefit rule should take the form, not of limiting the amount of income to be reported in the year of recovery and then taxing it at the rates applicable to such year, but of limiting the tax for such year to the amount of tax saved by the prior deduction. This will more nearly square with the real purpose of taxing such recoveries, which is to neutralize the benefits derived from the prior deduction.

Statement of Ellsworth C. Alvord, Washington, D.C. Chairman, Committee on Federal Finance, Chamber of Commerce of the United States, *Hearings on H.R. 7378 Before the Senate Comm. on Finance*, 77th Cong., 2nd Sess. 1784 (1942). *See also id.* at 1802. The subsequent committee report did not provide a reason for the failure of Congress to adopt the proposed method. S. REP. No. 1631, 77th Cong., 2d Sess. (1942).

21. 340 U.S. 590 (1951).

22. The inequities of this procedure were again brought before the Court in Healy v. Commissioner, 345 U.S. 278 (1953). The Court followed the *Lewis* decision emphasizing that such a result was necessitated by the annual accounting principle.

23. INT. REV. CODE of 1954, § 1341. The pertinent part of this section provides:

(a) General rule—If—

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

(2) a deduction is allowable for the taxable year because it was established after the close of such prior taxable year (or years) that the taxpayer did not have an unrestricted right to such item or to a portion of such item; and

(3) the amount of such deduction exceeds $3,000 then the tax imposed by this chapter for the taxable year shall be the lesser of the following:

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

(5) an amount equal to—

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

(B) the decrease in tax under this chapter (or the corresponding provisions of prior revenue laws) for the prior taxable year (or years) which

the deduction in year 2 is less than the amount the tax liability was increased in year 1 due to the improper inclusion of an item in gross income, the tax for year 2 is computed without a deduction for the item returned and the taxpayer then receives a credit against the amount computed for the additional tax paid in year 1.[24] The similarity between this approach and the *Perry* rule is readily apparent.

Congress has also remedied another inequity very similar to that found in the principal case. If a taxpayer had deducted an amount paid to a third party as a result of an adverse judgment in a patent infringement suit, and subsequently recovers the amount because the judgment is reversed, section 1342 of the Code[25] operates to include the amount recovered in the gross income in the year of recovery unless the increase in taxes due to the inclusion of the recovery in gross income is greater than the prior tax saving realized when the deduction was taken. In that event, the recovery is taxed in much the same manner as under the *Perry* rule.[26]

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would result solely from the exclusion of such item (or portion thereof) from gross income for such prior taxable year (or years).

24. If in the hypothetical, the $5,000 subsequently returned was originally taxed in year 1 at a rate of 30%, the additional tax would have been $1,500. But if the rate in effect in year 2 is 20%, and if the $5,000 must be deducted in year 2, a tax saving of only $1,000 will result. The government will be unjustly enriched by $500. In this event, § 1341(a)(5) requires that $1,500—the additional tax in year 1—be applied as a credit against the tax liability in year 2, computed without the $5,000 deduction.

Note that if the rates were reversed, under § 1341 the *Lewis* rule would still be applied and the taxpayer would deduct the item at the higher tax rate in year 2. Thus, the original tax in year 1 would have been $1,000, but the deduction in the year 2 would produce a $1,500 tax saving allowing the taxpayer a $500 windfall. The Code does not take into account this possible inequity to the government and unjust enrichment of the taxpayer, and in this respect the *Perry* rule would appear superior.

25. INT. REV. CODE of 1954, § 1342. The pertinent part of this section provides:

(a) General rule—If—

(1) an item was deducted from gross income for a prior taxable year (or years) because it appeared that another person held an unrestricted right to such item as a result of a court decision in a patent infringement suit (whether or not the taxpayer is a party to such suit); and

(2) gross income is increased for the taxable year because it was established after the close of such prior taxable year (or years) that such other person did not have an unrestricted right to such item or to a portion of such item because of the subsequent reversal of such court decision on the ground that such decision was induced by fraud or undue influence; and

(3) the amount of such increase in gross income exceeds $3,000, then the tax imposed by this chapter for the taxable year shall be the lesser of the following:

(4) the tax for the taxable year computed with the gross income so increased; or

(5) an amount equal to—

(A) the tax for the taxable year computed without such increase in gross income, plus

(B) the increase in tax (including interest) under this chapter (or the corresponding provisions of prior revenue laws) for the prior taxable year (or years) which would result solely from the elimination of such item (or portion thereof) as a deduction from gross income for such prior taxable year (or years).

26. For instance, if the recovery in the principal case was covered by § 1342, the

There is no apparent reason for the failure of Congress to legislate the *Perry* approach.[27] In the past, Congress has enacted provisions to mitigate the harsh results of a strict application of the annual accounting principle in a variety of situations.[28] Enactment of sections 1341 and 1342 shows that Congress does not feel constrained by the annual accounting principle in situations similar to that of the principal case. In fact, the tax benefit rule[29] is itself an exception to the annual accounting principle, designed to provide a more equitable solution to the problem of taxing the recovery of property previously deducted.[30] However, as illustrated by the principal case, inequities may still result. By adopting the *Perry* rule, Congress would not only eliminate these remaining inequities, but also extend the reasoning behind the tax benefit rule to its logical conclusion.[31]

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contention of the taxpayer would have been sustained. However, under § 1342, if the increase in tax due to the inclusion of the recovery in gross income is less than the tax saving realized when the deduction was taken in effect the rule of the principal case is applied. The taxpayer would then still retain a tax saving to which he has no equitable claim. Again, it would seem that the *Perry* rule is superior since it takes into account the equities of both the government and the taxpayer and insures that neither will receive an unintended tax benefit.

27. It could be argued that the additional inconvenience necessitated by the *Perry* rule precludes its adoption. However, as pointed out above, any additional administrative inconvenience does not seem to be prohibitive. *See* note 16 *supra* and accompanying text. In any event, it would seem that the equitable advantages of the *Perry* rule would counterbalance most objections based on convenience. *See* Surrey & Warren, *supra* note 8. If it is felt that such objections present a serious obstacle to the adoption of the *Perry* rule, application of the *Sullivan* rule could be retained in situations where the recovery is small and has a minor impact on the taxpayer's income position while providing for application of the *Perry* rule only in those situations where the recovery produces a significant impact on the taxpayer's income position. This result could be reached by imposing a requirement, similar to that found in § 1342, that the recovery must produce an increase in gross income more than $3,000 before the *Perry* rule would be applied. Perhaps it might also be argued, if one is to assume that the general trend of tax rates is upward, that adoption of the *Perry* rule will result in a decrease in tax revenue to the government. But, this argument loses much of its force when it is recognized that the revenue lost is that to which the government does not hold an equitable claim, and, in effect, its retention under the *Sullivan* rule is a form of unjust enrichment.

28. For a list of other provisions of the Code—aside from §§ 1341 and 1342—which take exception to the principle, *see* Note, 1959 DUKE L.J. 151, 153, n.15.

29. INT. REV. CODE of 1954, § 111.

30. *See* Plumb, *The Tax Benefit Rule Today*, 57 HARV. L. REV. 129, 176 (1943).

31. The American Law Institute (ALI) has also proposed that the present method be discarded. Their alternative would include the full amount of the recovery in gross income for the year of recovery. However, if the item is in excess of either $2,000 or 20% of the current net income, the taxpayer has the option of excluding the recovery and amending the prior return to disallow the deduction. ALI FED. INCOME TAX STAT. §§ X332, X333 (Feb. 1954 Draft). It would appear, however, that in two respects the *Perry* rule is superior to this proposal. First, the *Perry* rule insures that both the taxpayer and the govenment will receive equitable treatment while the ALI proposal still leaves a possibility that the government will receive inequitable treatment. In addition, by requiring all adjustments in the current year, the *Perry* rule escapes the difficulties of reopening and amending the prior return.