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to clarify the *Lambert* holding, but rather have limited it to statutes creating *mala prohibita* offenses which are designed for constitutionally dubious purposes and which impose a duty to register wherein the "circumstances which might move one to inquire as to the necessity of registration are completely lacking."[58]

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A NEW APPROACH TO THE TAX BENEFIT RULE

After property has been disposed of in such a way as to allow a taxpayer to deduct the value thereof from his income, he may have the property or the value thereof returned to him in a later year. The general rule in such cases is that the recovery constitutes taxable income in the year of the recovery.[1] A modification of this rule, called the tax benefit rule, has been developed by court decisions, statutes, and revenue rulings.[2] Basically, the tax benefit rule is that the recovery of a prior deduction does not constitute taxable income if the deduction *did not* result in a reduction of taxable income, *i.e.*, a tax benefit, in the year it was taken.

The United States Court of Claims arrived at a novel interpretation of the tax benefit rule in the case of *Perry v. United States*.[3] There the taxpayer, Perry, created a trust fund to be used to construct an addition to the public library. Perry contributed to the trust each year from 1944 through 1948 and was allowed a charitable contribution deduction each time. Each deduction reduced his taxable income to the extent of the contribution. In 1953 the town decided not to build the addition and returned the fund to Perry. The Commissioner of Internal Revenue took the position that the amount returned was income, as the taxpayer had realized a tax benefit from the deduction. Perry paid the tax on the amount recovered and brought a suit for a refund of that tax. In a three-to-two decision the

[58] 355 U.S. at 229.

[1] Kahn v. Commissioner, 108 F.2d 748 (2d Cir. 1940); Union Trust Co. v. Commissioner, 111 F.2d 60 (7th Cir. 1940); Putnam Nat'l Bank v. Commissioner, 50 F.2d 158 (5th Cir. 1931); 1 Mertens, Federal Taxation § 7.34 (rev. ed. 1956); Stanley & Kilcullen, The Federal Income Tax 45 (3d ed. 1955); Atlas, Tax Free Recoveries: The Tax Benefit Rule, N.Y.U. 9th Inst. on Fed. Tax. 847 (1951); Plumb, The Tax Benefit Rule Today, 57 Harv. L. Rev. 129, 130 (1943); Note, 56 Harv. L. Rev. 428, 434 (1942).

[2] Plumb, supra note 1, at 131.

[3] 160 F. Supp. 270 (Ct. Cl. 1958); Rich, The Tax Benefit Rule, N.Y.U. 17th Inst. on Fed. Tax. 257, 264 (1959).

Court of Claims held that the return of the fund was a return of capital, not income, and that Perry could exclude it from income. The court further held that the tax benefit rule required that the taxpayer add to his 1953 income *tax* the amount by which his *taxes* in prior years had been reduced by the charitable contribution deductions he had taken. This is a novel view of the tax benefit rule, although, as will be pointed out, it may be desirable.

It is necessary to view the problem raised by the *Perry* case in the light of the use and development of the rule over the years. Originally, an amount deducted in one year and recovered in a later year was income in the year of the recovery even though no tax benefit had resulted from the deduction.[4] Then the Treasury adopted the view that recoveries of bad debts and taxes, which had been previously deducted, constituted taxable income only if the prior deduction had accomplished a reduction of taxable income.[5] This concept was short-lived, for the Treasury abruptly reversed itself and held that recovery of *any* prior deduction was taxable income when received regardless of whether their had been any tax benefit.[6] Following this, there developed a conflict in case decisions.[7] The Board of Tax Appeals continued to apply the tax benefit rule[8] while the federal courts were strongly against the rule.[9] At this point Congress enacted section 116 of the Revenue Act of 1942 which became section 22 (b) (12) of the Internal Revenue Code of 1939.[10] This statute applies the tax benefit rule to recoveries of previously-deducted bad debts, taxes, and de-

[4]Houbigant, Inc., 31 B.T.A. 954 (1934); Lake View Trust & Sav. Bank, 27 B.T.A. 290 (1932); Plumb, supra note 1, at 131.

[5]G.C.M. 20854, 1939-1 Cum. Bull. 102; I.T. 3278, 1939-1 Cum. Bull. 76; G.C.M. 18525, 1937-1 Cum. Bull. 80. At this time the courts recognized the tax benefit rule. Central Loan & Inv. Co., 39 B.T.A. 981 (1939); National Bank of Commerce, 40 B.T.A. 72, 75 (1939), aff'd, 115 F.2d 875 (9th Cir. 1940).

[6]I.T. 3390, 1940-2 Cum. Bull. 68; G.C.M. 22163, 1940-2 Cum. Bull. 76.

[7]Plumb, supra note 1, at 133.

[8]Barnhardt-Morrow Consol., 47 B.T.A. 590, 600 (1942); Hoboken Land & Improv. Co., 46 B.T.A. 495, 506 (1942); Motor Prods. Corp., 47 B.T.A. 938 (1942); Amsco-Wire Prods. Corp., 44 B.T.A. 717 (1941); Western Adjustment & Inspection Co., 45 B.T.A. 721, 729 (1941).

[9]Commissioner v. United States & Int'l Sec. Corp., 130 F.2d 894, 897 (3d Cir. 1942); Helvering v. State-Planters Bank & Trust Co., 130 F.2d 44 (4th Cir. 1942); Helvering v. Jane Holding Corp., 109 F.2d 933, 941 (8th Cir. 1940); Stearns Coal & Lumber Co. v. Glenn, 42 F. Supp. 28 (W.D. Ky. 1941).

[10]Int. Rev. Code of 1939, § 22(b)(12), added by ch. 619, § 116, 56 Stat. 798 (1942) (now Int. Rev. Code of 1954, § 111). Perry v. United States was decided under the 1939 Code, 160 F. Supp. at 271; however, it is pointed out that the wording of § 111 of the 1954 Code is identical with that of § 22(b)(12) of the 1939 Code. Therefore, wherever possible, citations will be to the 1954 Code.

linquency amounts.[11] Although the statute seemed to be limited in its application, it has not been so interpreted. The Supreme Court in *Dobson v. Commissioner*[12] stated:

> "We are not adopting any rule of tax benefits. We only hold that no statute or regulation having the force of one and no principle of law compels the Tax Court to find taxable income in a transaction where as a matter of fact it found no economic gain and no use of the transaction to gain tax benefit."[13]

Whether the Supreme Court thought it was adopting the tax benefit rule or not, this decision has not only entrenched that rule into the law, but it has also been interpreted to mean that section 22(b)(12) is applicable to recoveries of items previously deducted other than bad debts, taxes, and delinquency amounts.[14] The Treasury has acquiesced

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[11]Int. Rev. Code of 1954, § 111.

[12]320 U.S. 489 (1943).

[13]Id. at 506. The Dobson case is a prime example of the conflict which had developed at that time between the Board of Tax Appeals (now known as the Tax Court) and the federal courts as to whether the tax benefit rule should be applied at all. Four cases with similar facts originated in the Board of Tax Appeals and were consolidated upon appeal to the Court of Appeals. Hardwick v. Commissioner, 133 F.2d 732 (8th Cir. 1943). In each case a taxpayer had purchased stock and sold it at a loss, deducting the loss from his income. Later it appeared that the stock had not been properly registered, and the taxpayers sued to rescind the original purchase. The suits were settled and part of the purchase price recovered. 320 U.S. at 491. The Commissioner contended that all the recoveries were income. The Board of Tax Appeals held that the recoveries were income except in two cases in which the loss deductions had not resulted in a tax benefit. Estate of James N. Collins, 46 B.T.A. 765 (1942); John V. Dobson, 46 B.T.A. 770 (1942). The other two cases were dismissed without an opinion. 133 F.2d at 734. The Court of Appeals held that the recoveries were income regardless of tax benefit. Id. at 736. The Supreme Court upheld the decision of the Board of Tax Appeals, holding that the Tax Court's determinations in matters of tax accounting should be final and subject to review only as to mistakes of law. 320 U.S. 507. It appears that the Supreme Court was attempting to prevent conflict among the different courts of appeals. However, inconsistencies arose in Tax Court decisions which reached a peak in John Kelly Co. v. Commissioner, 326 U.S. 521 (1946), in which the Supreme Court applied the Dobson rule and affirmed two highly divergent Tax Court decisions. This rule of the Dobson case is now dead. Congress amended the Internal Revenue Code of 1939 so as to allow complete review of Tax Court decisions. Int. Rev. Code of 1939, § 1141(a), as amended, ch. 646, § 36, 62 Stat. 991 (1948) (now Int. Rev. Code of 1954, § 7482(a)).

[14]Birmingham Terminal Co., 17 T.C. 1011 (1951) (loss deduction); Lloyd H. Faidley, 8 T.C. 1170 (1947) (loss deduction); Rev. Rul. 58-380, 1958 Int. Rev. Bull. No. 31, at 5 (insurance expense); Rev. Rul. 58-546, 1958 Int. Rev. Bull. No. 45, at 12 (interest). Stanley & Kilcullen, The Federal Income Tax 47 (3d ed. 1955); Plumb, The Tax Benefit Rule Tomorrow, 57 Harv. L. Rev. 675, 680 (1944); Tye, Tax Benefit Ramifications in View of Recent Treasury Ruling, N.Y.U. 4th Inst. on Fed. Tax 683, 684 (1946). The scope of the tax benefit rule is not as

in this view and this much of the *Dobson* case has been incorporated into the Regulations.[15] Therefore, the tax benefit rule is applicable to the principal case.

In *Perry* the majority of the Court of Claims, however, seemed reluctant to apply the tax benefit rule at all, preferring to consider the recovery of the contributions as a nontaxable return of capital rather than income.[16] However, the court gave in to "the weight of judicial precedents" and recognized that any tax benefit received by the taxpayer must be considered.[17]

Applying the tax benefit rule to the facts of the principal case, the court held that the tax benefit derived from a deduction was "the amount by which their *taxes* in prior years had been decreased on

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broad as the text seems to indicate. The Supreme Court refused to apply the tax benefit rule to depreciation, Virginia Hotel Corp. v. Helvering, 319 U.S. 523 (1943), and to depletion deductions, Douglas v. Commissioner, 322 U.S. 275 (1944). Apparently on the strength of these cases, the Treasury stated that the tax benefit rule would not apply to recoveries of deductions "with respect to depreciation, depletion, amortization, or amortizable bond premiums." T.D. 5454, 1945 Cum. Bull. 68. This exception remains current under Treas. Reg. § 1.111 (1956). Note: a taxpayer may now restore an excessive claim of depreciation or depletion from which no tax benefit was realized. Int. Rev. Code of 1954, § 1016(a)(2)(B).

[15]T.D. 5454, 1945 Cum. Bull. 68 stated that "the rule of exclusion so prescribed by statute applies equally with respect to all other losses, expenditures, and accruals made the basis of deductions from gross income for prior taxable years.... (See Dobson v. Commissioner, 64 S. Ct. 239.)" (Italics omitted.) At present, this remains the Treasury's view on the subject. See Treas. Reg. 118, § 39.22(b)(12)-1 (1953), and Treas. Reg. § 1.111 (1956).

[16]160 F. Supp. at 271. Taxpayers have often argued that the recovery of an item previously deducted is a return of capital, especially when a bad debt has been charged off and deducted from gross income and is paid back in a later year. It is submitted that the following analysis is a fair and logical answer to the question of whether the recovery is a return of capital or is taxable income. When a party lends money from capital, the repayment is a return of capital and the interest income. Should the debt become worthless it is a loss of capital, but it may be deducted from income which constitutes a recoupment of the capital from income. Therefore, the debt loses its nature as capital and represents income which was not taxed. Thus, when the loan is paid back it is income replacing that which had been set aside to replace the lost capital. However, to the extent that the deduction of the bad debt did not offset taxable income it cannot be said to have effected a return of capital. To the extent that the taxpayer has not had the equivalent of a full return of capital, there is no valid reason for treating the recovery as income. Thus, under the tax benefit rule, recoveries will be treated as returns of capital until the aggregate received equals that portion of the deduction which did not offset income. But, to the extent the deduction did reduce taxable income, the recoveries will be treated as income. Merchants Nat'l Bank v. Commissioner, 199 F.2d 657, 659 (5th Cir. 1952); Commissioner v. First State Bank, 168 F.2d 1004 (5th Cir. 1948); National Bank of Commerce v. Commissioner, 115 F.2d 875 (9th Cir. 1940); G.C.M. 20854, 1939-1 (Part 1) Cum. Bull. 102; I.T. 3278, 1939-1 (Part 1) Cum. Bull. 76.

[17]160 F. Supp. at 272.

account of the deductions...."[18] Therefore, all the taxpayer was required to do was add to his 1953 income tax the amount of taxes he had saved in the prior years as a result of deducting the charitable contributions.[19] The court based this decision upon the reasoning that "the Government would recoup the taxes escaped in the prior year on account of the deduction. It would be inequitable to require plaintiffs to include in their income for 1953 the aggregate of the deductions claimed in prior years... because the inclusion in one year of all the deductions taken in several years would probably put the taxpayer in a higher bracket."[20] Although this view may be both practical and equitable, it seems to be erroneous in light of the history of the tax benefit rule which led to the action by Congress.

As the dissenting opinion in *Perry* points out, the tax benefit rule is not an original doctrine of taxability, but it is a limitation upon the general rule that all recoveries of items previously deducted are income;[21] that is, section 22(b)(12) of the Internal Revenue Code of 1939 was enacted for the purpose of "limiting the amount of the recovery which could be taxed to the amount which had actually been used as a deduction in the prior years."[22] The statute itself is worded in terms of the amount of recovery that is not to be included in income, *i.e.*, the recovery exclusion.[23] This means that the recovery is excluded from gross income to the extent that the prior deduction did not reduce taxable income.[24] For example, suppose that in 1946 Perry had donated $500 to the trust fund and had had taxable income of only $300 before the deduction. One can see that $200 of the deduction did not serve to reduce taxable income—this is the recovery exclusion. Therefore, when the town returned the fund in 1953, $200 of the recovery would be excluded from Perry's income for 1953.[25] It

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[18]Ibid. (Emphasis added.)

[19]Ibid.

[20]Ibid.

[21]160 F. Supp. at 273.

[22]Ibid.

[23]"The term 'recovery exclusion'... means the amount... of the deductions or credits allowed... which did not result in a reduction of the taxpayer's tax...." Int. Rev. Code of 1954, § 111. Stanley & Kilcullen, The Federal Income Tax 46 (3d ed. 1955).

[24]Estate of Fred T. Murphy, 22 T.C. 242, 256 (1954); 1180 E. 63rd St. Bldg. Corp., 12 T.C. 437 (1949); Lloyd H. Faidley, 8 T.C. 1170, 1174 (1947); Barnhardt-Morrow Consol., 47 B.T.A. 590, 600 (1942); Atlas, Tax Free Recoveries: The Tax Benefit Rule, N.Y.U. 9th Inst. on Fed. Tax. 847, 850 (1951); Plumb, The Tax Benefit Rule Today, 57 Harv. L. Rev. 129, 153-54 (1943).

[25]For excellent examples of the mechanics of the rule see Stanley & Kilcullen, The Federal Income Tax 46 (3d ed. 1955); Treas. Reg. § 1.111(b)(3) (1956).

seems obvious that the tax benefit rule is based upon the effect of deductions and later recovery of those deductions upon taxable *income* and not upon the effect of these factors upon the *tax paid* by the taxpayer. In the principal case Perry received a full tax benefit from each deduction taken (his income was reduced by the full amount of the deduction),[26] and, therefore, the entire recovery should have been included in his gross income.[27]

The major criticism of the present tax benefit rule is that it offers no solution for a glaring inequity in the general rule that all recoveries of items previously deducted are income when received. When a tax benefit did result from a prior deduction, there is no correlation between the tax on the recovery and the tax saved by the deduction.[28] Tax rates are graduated and fluctuate, and incomes of taxpayers fluctuate. As a result, the tax on the recovery may be out of proportion to the tax benefit received either because of a change in tax rates or because the taxpayer is in a higher bracket at the time of the recovery.[29] The inequity which may result from recoveries being taxed as income in the year they are received is especially glaring in a case like *Perry*. Here a taxpayer has taken regular deductions over a course of years and then recovers them all in one year. Suppose Perry had contributed $4,000 a year for five years. When the town returned the fund he would have $20,000 added to his 1953 income under the present rule. The tax rates on the recovery are probably higher than the rates would have been on the $4,000 in the prior years had Perry never taken the deductions, as the recovery more than likely puts him in a higher bracket.[30] The Government can lose in this situation as well as the taxpayer. Rates may be lower in the year of recovery, or the taxpayer may be in a lower bracket. Thus the taxpayer has reduced his income by a deduction in a year of high taxes and then recouped the amount at a saving in a year of low taxes. Also, if the recovery occurs in a year the taxpayer has a net loss, the Government will never recoup the tax saved as a result of the prior deduction.[31]

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[26]160 F. Supp. at 270.

[27]Merchants Nat'l Bank v. Commissioner, 199 F.2d 657 (5th Cir. 1952); Buck Glass Co. v. Hofferbert, 176 F.2d 250 (4th Cir. 1949); Commissioner v. First State Bank, 168 F.2d 1004 (5th Cir. 1948); St. Louis Refrigerating & Cold Storage Co. v. United States, 66 F. Supp. 62 (E.D. Mo. 1946).

[28]Plumb, supra note 24, at 151-52; Tye, Tax Benefit Ramifications in View of Recent Treasury Ruling, N.Y.U. 4th Inst. on Fed. Tax. 683, 700 (1946).

[29]Plumb, supra note 24, at 176-77; Tye, supra note 28, at 700.

[30]160 F. Supp. at 272.

[31]See note 29 supra.

Several solutions to this problem have been proposed. The most obvious is to do away with the tax benefit rule and adjust the taxpayer's return for the year in which the item he has recovered was deducted, recomputing the tax for that year as though the deduction or part thereof which was recovered had never been taken.[32] Under this method, adjustment of those years not closed by the statute of limitations would be required.[33] As to those years closed by the statute, Congress could either allow the return to be reopened, or the tax on the recovery could be computed at the rate applied in the year of the deduction.[34] Another proposed solution is that adopted by the Court of Claims in the *Perry* case: the tax on the recovery should be no more and no less than the amount of tax saved by the prior deduction.[35]

In the *Perry* case, the court did not err in its reasoning, but rather in its concept of what the tax benefit rule as adopted by Congress in the Internal Revenue Code empowered the courts to do. In the light of the history of the rule and the fact that the statute was enacted in terms of exclusion from gross income, not tax saved, it seems that Congress has adopted a view of "tax benefit" quite different from that taken in *Perry*. The Supreme Court has previously stated that equitable considerations have no place in applying the tax law of deductions or tax benefits[36] and that it is up to Congress to remedy any harshness arising from the operation of a Revenue act.[37] Therefore, it is submitted that only Congress should remedy the weakness existing in the present tax benefit rule. Though the rule adopted in the *Perry* case cannot be supported, it certainly should not be ignored. If we are going to have a doctrine of tax benefit, we should have one that affords complete relief.

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[32]At present it does not seem that the return for the year in which the deduction was taken can be reopened. Lexmont Corp., 20 T.C. 185 (1953); Rich, The Tax Benefit Rule, N.Y.U. 17th Inst. on Fed. Tax. 257, 260 (1959). Contra, E. B. Elliott Co., 45 B.T.A. 82, 91 (1941).

[33]Tye, supra note 28, at 701.

[34]Ibid.

[35]160 F. Supp. at 272; Plumb, supra note 24, at 151-52.

[36]Lewyt Corp. v. Commissioner, 349 U.S. 237, 240 (1955). In this case, a taxpayer on the accrual basis, in computing net operating loss for 1946, was not allowed to deduct excess profits tax paid in 1946 as the taxes had accrued in 1944. The Supreme Court refused to apply "equitable considerations" in requiring the taxpayer to stick to the accrual method of accounting. Ibid. In Perry, the court quoted the Lewyt case for the proposition that the tax benefit rule should not be applied at all as it "is based upon equitable considerations." 160 F. Supp. at 271.

[37]Boehm v. Commissioner, 326 U.S. 287, 295 (1945). This view was also taken by the Court of Appeals in Moir v. United States, 149 F.2d 455, 460 (1st Cir. 1945).