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Determining an Individual's Federal Income Tax Liability When the Tax Benefit Rule Applies: A Fifty-Year Checkup Brings a New Prescription for Calculating Gross, Adjusted Gross, and Taxable Incomes

Matthew J. Barrett*

Fifty years ago, William T. Plumb, Jr.'s preeminent article on the tax benefit rule appeared in the *Harvard Law Review*.¹ Forty years later, the Supreme Court cited Plumb's article and decided two cases directly involving the application of the rule.² Over the last fifty years, but especially in the last ten years, Congress has introduced numerous provisions that have increased the complexity of the Internal Revenue Code.³ These legislative developments have complicated the computation of an individual's⁴ federal income tax liability and increased the

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1. William T. Plumb, Jr., *The Tax Benefit Rule Today*, 57 HARV. L. REV. 129 (1943).

2. *Hillsboro Nat'l Bank v. Commissioner*, 460 U.S. 370, 380 (1983) (consolidating *Hillsboro* and *United States v. Bliss Dairy, Inc.*).

3. See *infra* text accompanying note 142. Unless otherwise stated, all references to the Internal Revenue Code, sometimes referred to as the "Code," are to the Internal Revenue Code of 1986, found at 26 U.S.C., as amended and in effect prior to the Revenue Reconciliation Act of 1993, Pub. L. No. 103-66, 107 Stat. 416. Unless otherwise noted, the Revenue Reconciliation Act of 1993 does not affect this article in any material way.

4. This article focuses on the taxation of individuals. The article, however, ignores the accumulated earnings tax, the personal holding company tax and the special rules that apply to those taxes. I.R.C. § 111(d) (1988).

Most individuals use the cash method and the calendar year to report income. Under the cash method, a taxpayer reports income when actually or constructively received and deducts expenses when paid. Some individuals, however, use the accrual method, under which a taxpayer reports income when earned and deducts expenses when incurred. Some individuals also use a fiscal year, rather than the calendar year, to report income. Unless otherwise stated, this article assumes the

potential unfairness in the application of the tax benefit rule.⁵

use of the cash method and the calendar year.

5. The term "tax benefit rule" dates back to at least 1942. Although courts and commentators recognized the tax principles which became known as the "tax benefit rule" prior to 1942, they did not use the term in their legal writings. Patricia D. White, *An Essay on the Conceptual Foundations of the Tax Benefit Rule*, 82 MICH. L. REV. 486, 488 n.12 (1983).

In 1942, the Board of Tax Appeals, the predecessor of the United States Tax Court, used the terms "tax benefit theory" and "tax benefit rule" for the first time. In *Haughey v. Commissioner*, the Board described the "tax benefit theory" as follows:

Where a taxpayer takes a deduction in one year but because of other deductions has no taxable income for that year without reference to the deduction in question, a later refund of all or a part of the amount deducted will not be treated as income. We have consistently followed this doctrine Where, however, a taxpayer by virtue of a deduction paid less tax than would have been paid if the deduction were not taken, a subsequent refund to the taxpayer of the deducted item is includible in gross income to the extent that taxable income of the prior year was offset by the deduction.

47 B.T.A. 1, 4 (1942) (citations omitted). In that case, the Board concluded that partners could not invoke the tax benefit rule with respect to a partnership. The Board, therefore, held that the Commissioner could require the partners to report their proportionate shares of the partnership's stamp tax refund as income even though the partnership's deduction of the stamp taxes did not reduce their income taxes.

Within two months, a tax periodical published an article entitled "The Tax Benefit Rule and Related Problems," which described the basic idea of the rule as follows:

If a taxpayer has derived a benefit from a deduction by reducing his taxable income in the year of deduction, he must declare as taxable income any recovery or other change of his status which—*ex nunc*—makes the original deduction seem unjustified

It is only a logical conclusion to go one step further and say that no such taxable income is derived from recoveries if the taxpayer at the time of the original deduction did not derive a tax benefit from it by virtue of the fact that the gross income was not sufficient to be offset by such deduction.

Rowland W. Lassen, *The Tax Benefit Rule and Related Problems*, 20 TAXES 473 (1942).

During the summer of 1942, at least two witnesses used the phrase in testimony before the Senate Finance Committee. On August 3, 1942, Lawrence Arnold Tanzer, Chairman of the Committee on Taxation and Public Revenue of the Commerce and Industry Association of New York, Inc., stated the organization's support for a "tax benefit rule." Revenue Act of 1942: Hearings on H.R. 7378 Before the Senate Finance Committee, 77th Cong., 2d Sess. 699, 706 (1942) (statement of Lawrence A. Tanzer, Commerce and Industry Association of New York, Inc.), reprinted in 36 INTERNAL REVENUE ACTS OF THE UNITED STATES 1909-1950 LEGISLATIVE HISTORIES, LAWS, AND ADMINISTRATIVE DOCUMENTS (Bernard D. Reams, Jr. ed., 1979) [hereinafter "INTERNAL REVENUE ACTS"]. The testimony described the tax benefit rule as "the rule heretofore applied by the United States Board of Tax Appeals, that recoveries of bad debts and other deductions of prior years shall be treated as taxable income only to the extent to which the deduction

Historically, the tax benefit rule has required a taxpayer who previously claimed a *deduction*, but who recovers an amount related to that deduction in a subsequent tax year, to report the recovery as gross income in the later year.⁶ The rule, of course, applies only to the extent that the deduction produced a tax benefit.⁷ For example, the tax benefit rule requires an individual who benefitted from deducting an amount paid for state income taxes in one year, but who subsequently receives a refund of that amount in a later year, to include the refund as income in the later year.

This simple explanation, however, does not recognize the full reach of the tax benefit rule. Because exclusions and credits also produce tax benefits, the tax benefit rule applies equally to deductions, exclusions, and credits. This article, therefore, suggests a comprehensive, new description of the tax benefit rule. Under this proposed description, if a taxpayer properly uses an item in the computation of federal income tax in one year, *whether as an exclusion, deduction, or credit*, and events occur in a subsequent taxable year that are inconsistent with the prior treatment, the taxpayer must reflect the item in the computation of federal income tax in the later year to the extent that the prior treatment produced a tax benefit.

With the increasing complexity in the computation of federal income tax and the dependence of various state income tax statutes on the federal system, the mechanics of where to report a recovery under the tax benefit rule have become very

reduced the taxpayer's income tax liability." *Id.*

Later on August 12, Ellsworth C. Alvord, Chairman of the Committee on Federal Finance, Chamber of Commerce of the United States, suggested that the tax benefit rule should take the form of limiting the tax for such year to the amount of tax saved by the prior deduction rather than limiting the amount of income to be reported in the year of recovery and then taxing the limited recovery at the rates applicable to that year. *Id.* at 1762, 1784 (statement of Ellsworth C. Alvord, Chamber of Commerce of the United States), *reprinted in* 37 INTERNAL REVENUE ACTS, *supra*.

In December 1943, Plumb's article on the tax benefit rule appeared in the *Harvard Law Review*. Plumb, *supra* note 1.

6. The rule also applies when events occur in a subsequent taxable year which are inconsistent with the previous deduction. *Hillsboro Nat'l Bank v. Commissioner*, 460 U.S. 370, 381-85 (1983).

7. I.R.C. § 111(a) (1988). The rule requiring a taxpayer to recognize income applies only to the extent that the previous deduction produced a tax benefit. Note that if part of the deduction did not reduce the individual's federal income tax, perhaps because the taxpayer had negative taxable income, the taxpayer would not have to include that part of the recovery in income.

important. Two recent Supreme Court decisions, *Davis v. Michigan Department of Treasury*,⁸ and *Harper v. Virginia Department of Taxation*,⁹ may require various states which taxed federal retirement benefits while exempting state retirement benefits from tax to refund close to \$2 billion in state income taxes.¹⁰ The principles developed in this article could have a dramatic impact on the amount of additional federal income tax due as a result of those refunds.

The Internal Revenue Service and the judges and commentators¹¹ who have considered the tax benefit rule have uniformly assumed that the recovery of an earlier deduction generates *gross income* in the year of recovery. The resulting "artificial gross income" can create significant unfairness to both taxpayers and the government, but especially to taxpayers.

This article argues, in the interest of equity, that the Internal Revenue Service and the courts should permit taxpayers to report recoveries of deductions under the tax benefit rule in the same place that the previous deduction affected the computation of federal income tax. Congress already requires this treatment for recoveries of amounts previously used to claim a tax credit. At the election of the taxpayer, the recovery of an earlier deduction, therefore, should not increase gross income, but depending upon the circumstances surrounding the deduction should increase either adjusted gross income or taxable income. If the taxpayer

8. 489 U.S. 803 (1989).

9. 113 S. Ct. 2510 (1993).

10. *Court Holds 'Davis' Ruling Retroactive But Allows States Flexibility on Relief*, DAILY TAX REPORT (BNA), June 21, 1993, at G-2, G-3.

11. Many commentators have written about the tax benefit rule. See, e.g., Steven J. Willis, *The Tax Benefit Rule: A Different View and a Unified Theory of Error Correction*, 42 FLA. L. REV. 575 (1990); Wm. D. Elliott, *The Tax Benefit Rule: A Common Law of Recapture*, 39 SW. L.J. 845 (1985); Louis A. Del Cotto & Kenneth F. Joyce, *Double Benefits and Transactional Consistency Under the Tax Benefit Rule*, 39 TAX. L. REV. 473 (1984); White, *supra* note 5; Boris I. Bittker & Stephen B. Kanner, *The Tax Benefit Rule*, 26 UCLA L. REV. 265 (1978); James T. 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 (1972); Charles W. Tye, *The Tax Benefit Doctrine Reexamined*, 3 TAX L. REV. 329 (1948); William T. Plumb, Jr., *The Tax Benefit Rule Tomorrow*, 57 HARV. L. REV. 675 (1944); Plumb, *supra* note 1; Lassen, *supra* note 5; see also William R. Lindsay, Comment, *An Asset-Based Approach to the Tax Benefit Rule*, 72 CAL. L. REV. 1257 (1984); John G. Corlew, Note, *The Tax Benefit Rule, Claim of Right Restorations, and Annual Accounting: A Cure for the Inconsistencies*, 21 VAND. L. REV. 995 (1968).

recovers an "above-the-line" deduction, the taxpayer can elect to report the recovery as additional adjusted gross income. If the recovery relates to an itemized deduction, the taxpayer can elect to increase taxable income directly. Thus, this article proposes new principles for determining an individual's federal income tax liability when the tax benefit rule applies.

Part I of this article discusses the development of the tax benefit rule and presents an overview of the rule's application. Because the tax benefit rule applies to exclusions and credits, as well as to deductions, this part proposes a broader description of the rule. Part II illustrates the different ways that the tax benefit rule may apply to exclusions, deductions, and credits and discusses the different tax consequences that flow from these applications. Part III illustrates the unfairness of requiring individuals to report all recoveries or other inconsistent events related to deductions as gross income and proposes that the Internal Revenue Service and the courts permit taxpayers to report such recoveries in the same place that the previous item affected the computation of federal income tax in the earlier year. Part IV explains how that proposal operates within the Internal Revenue Code and the judicial framework that courts have established for the tax benefit rule. Part V analyzes the potential arguments against the proposed principles. Part VI concludes that the Internal Revenue Service and the courts should adopt this new proposal for the tax benefit rule.

I. THE TAX BENEFIT RULE

The tax benefit rule includes two separate concepts, a doctrine of inclusion coupled with a law of exclusion.¹² Events

12. See *Hillsboro Nat'l Bank v. Commissioner*, 460 U.S. 370, 380 n.12 (1983); *id.* at 405 (Stevens, J., concurring in part and dissenting in part); see also *Putoma Corp. v. Commissioner*, 66 T.C. 652, 664 n.10 (1976), *aff'd*, 601 F.2d 734 (5th Cir. 1979).

Interestingly, Plumb used the term "tax benefit rule" to refer only to the exclusionary part of the rule. Plumb recognized, but did not name, the inclusionary component:

The rule requiring taxation of income from the recovery or cancell[ation] of items previously deducted is a remedial expedient, designed to prevent the unjust enrichment of a taxpayer and to offset the benefit derived from a deduction to which, in the light of subsequent events, the taxpayer was not entitled. The tax benefit rule, whereby such recoveries are not taxed if the prior deduction did not reduce the taxpayer's tax, is likewise an expedient, designed to mitigate the effect of

may subsequently occur which are inconsistent with the way a taxpayer treated an amount in computing federal income tax in a previous tax year.¹³ The inclusionary component requires the taxpayer to reflect those inconsistent events in computing federal income tax for the subsequent year.¹⁴ The exclusionary aspect, however, permits the taxpayer to ignore a refund, recoupment, rebate, reimbursement, recovery, reversal, or other inconsistent event, if the taxpayer did not receive a tax benefit from the previous treatment.¹⁵ In other words, the

the foregoing rule where its justification is absent.

Plumb, *supra* note 1, at 176.

13. These events may include a recoupment, reimbursement, recovery, refund, reversal, rebate, or other inconsistent occurrence. *See, e.g.*, *Rosen v. Commissioner*, 611 F.2d 942 (1st Cir. 1980) (recoupment of real estate previously claimed as a charitable contribution); *Montgomery v. Commissioner*, 65 T.C. 511 (1975) (reimbursement for casualty loss); *Estate of Munter v. Commissioner*, 63 T.C. 663 (1975) (recovery of previously expensed items in a liquidation sale); *Nash v. Commissioner*, 34 B.T.A. 675 (1936), *aff'd*, 88 F.2d 477 (7th Cir.), *cert. denied*, 301 U.S. 700 (1937) (refund of state income tax); *Chicago, R.I. & Pac. Ry. v. Commissioner*, 13 B.T.A. 988 (1928), *aff'd in part, rev'd in part on other grounds*, 47 F.2d 990 (7th Cir.), *cert. denied*, 284 U.S. 618 (1931) (reversal of checks and vouchers for wages, overcharges, loss and damage claims, and other disbursements that the taxpayer had previously deducted, but which after two years the payees had not claimed or cashed); *Lee v. Commissioner*, 6 B.T.A. 541 (1927), *aff'd sub nom. Carr v. Commissioner*, 28 F.2d 551 (5th Cir. 1928) (collection of accounts receivable previously treated as worthless); Rev. Rul. 92-91, 1992-2 C.B. 49 (refund of interest overcharge on an adjustable rate mortgage which the taxpayer deducted in an earlier year).

14. *Hillsboro*, 460 U.S. at 372. The decision resolved two consolidated cases. In *Hillsboro National Bank v. Commissioner*, the bank paid state property taxes on shares for its shareholders and deducted those taxes pursuant to section 164(e) of the Internal Revenue Code of 1954. *Id.* at 372-73. The county treasurer later refunded those taxes to the bank's shareholders. *Id.* at 374. The Supreme Court held that the bank did not have to include the previously deducted taxes in income for the year that the county treasurer refunded the taxes, reasoning that section 164(e) focused on the act of payment, rather than on the use of the funds. As long as the county treasurer did not negate the payment by refunding the taxes to the bank, the tax benefit rule did not require the bank to recognize income. *Id.* at 394-95. In *United States v. Bliss Dairy, Inc.*, the cash basis corporation purchased cattle feed for use in its dairy operations and deducted the full cost of the feed in its fiscal year ending June 30, 1973 as a business expense. At the end of the taxable year, the dairy had not used a substantial portion of the cattle feed. Two days into its next taxable year, the corporation adopted a plan of liquidation and proceeded to distribute its assets, including the remaining cattle feed, to its shareholders in the liquidation. *Id.* at 374. The Supreme Court held that the corporation must recognize income because the distribution of the cattle feed was inconsistent with the earlier deduction and the Code's liquidation provisions did not change the result. *Id.* at 396-97, 402.

15. *Id.* at 381 n.12; *id.* at 405 (Stevens, J., concurring in part and dissenting in part).

inclusionary component "operate[s] only to the extent that the prior [treatment] benefited the taxpayer."¹⁶

A. Development

Commentators agree that the tax benefit rule began developing shortly after the Sixteenth Amendment's ratification.¹⁷ The inclusionary component originated first,¹⁸ while the

16. *Id.* at 405 (Stevens, J., concurring in part and dissenting in part). The exclusionary aspect does not apply independently of the inclusionary component. Rather, the exclusionary aspect limits the amount that the inclusionary component requires a taxpayer to include in income.

If part of a previous deduction did not produce a tax benefit, the exclusionary aspect allows a taxpayer to disregard a recovery or inconsistent event attributable to that part in determining tax liability for the year of recovery. For example, a taxpayer will not have to include the entire amount of a state tax refund in income if (1) the refund exceeds the taxpayer's "excess itemized deductions" or (2) the taxpayer reported negative taxable income in the earlier year. The term "excess itemized deductions" refers to the amount by which the taxpayer's itemized deductions exceeded the standard deduction for the taxpayer's filing status in the earlier year. If the refund exceeds the excess itemized deductions, the taxpayer will treat the excess itemized deductions as income, unless the taxpayer reported negative taxable income in the earlier year. If the taxpayer reported negative taxable income, the taxpayer can reduce the excess itemized deductions by the amount of negative taxable income. A taxpayer will not report any part of the state tax refund as income if the taxpayer did not itemize deductions or reported negative taxable income in the year of deduction and the amount of the negative income exceeds the refund. See INTERNAL REVENUE SERVICE, U.S. DEPT OF TREASURY, PUBLICATION 525, TAXABLE AND NONTAXABLE INCOME 19 (1993).

17. Justice Stevens, concurring in the judgment in *Hillsboro National Bank v. Commissioner* and dissenting in *United States v. Bliss Dairy, Inc.*, traced the development of the tax benefit rule. *Hillsboro*, 460 U.S. at 405-12 (Stevens, J., concurring in part and dissenting in part). Several articles have also discussed the rule's history. See Willis, *supra* note 11, at 580-92; White, *supra* note 5, at 488-90; Tye, *supra* note 11, at 329-30; Plumb, *supra* note 1, at 130-34; Lassen, *supra* note 5, at 473; Ralph A. Hart, *Bad Debt Recoveries*, 20 TAXES 75 (1942); H. Zysman, *Income Derived from the Recovery of Deductions*, 19 TAXES 29 (1941); see also Lindsay, *supra* note 11, at 1258-64; Corlew, *supra* note 11, at 999-1007.

18. As early as 1914, the Bureau of Internal Revenue issued regulations which required companies that collected previously deducted bad debts to include the collections in income. Treas. Reg. 33, art. 125 (1914), reprinted in 132 INTERNAL REVENUE ACTS, *supra* note 5 ("Bad debts, if so charged off the company's books, during the year, are proper deductions. But such debts, if subsequently collected, must be treated as income."); see White, *supra* note 5, at 489. The courts, at the Bureau's urging, not only applied this principle, but expanded the theory to similar situations. See, e.g., *Cooper v. United States*, 9 F.2d 216 (8th Cir. 1925) (receipt of insurance proceeds to reimburse fire loss which corporation previously deducted); *Lee v. Commissioner*, 6 B.T.A. 541 (1927), *aff'd sub nom. Carr v. Commissioner*, 28 F.2d 551 (5th Cir. 1928) (collection of accounts receivable previously treated as worthless); *Chicago, R.I. & Pac. Ry. v. Commissioner*, 13 B.T.A. 988 (1928), *aff'd in part, rev'd in part on other grounds*, 47 F.2d 990 (7th Cir.), *cert. denied*, 284 U.S. 618 (1931) (reversal of checks and vouchers for wages,

exclusionary aspect emerged later.

1. *Inclusionary component*

The inclusionary component developed to reduce the inequities existing in an annual tax accounting system.¹⁹ Under the federal income tax system, taxpayers report income and pay taxes on an annual, rather than a transactional, basis.²⁰ Strict adherence to an annual accounting system, however, would create transactional inequities.²¹ A taxpayer, for exam-

overcharges, loss and damage claims, and other disbursements which after two years the taxpayer had previously deducted, but which the payees had not claimed or cashed); *Excelsior Printing Co. v. Commissioner*, 16 B.T.A. 886 (1929) (payment of debt previously charged off); *Putnam Nat'l Bank v. Commissioner*, 20 B.T.A. 45 (1930), *aff'd*, 50 F.2d 158 (5th Cir. 1931) (collection of bonds partially claimed as a bad debt deduction); *South Dakota Concrete Prods. Co. v. Commissioner*, 26 B.T.A. 1429 (1932) (recovery of amounts embezzled and previously deducted as various and sundry operating expenses); *Houbigant, Inc. v. Commissioner*, 31 B.T.A. 954 (1934), *aff'd*, 80 F.2d 1012 (2d Cir.), *cert. denied*, 298 U.S. 669 (1936) (refund of customs duties previously included in cost of goods sold); *Victoria Paper Mills Co. v. Commissioner*, 32 B.T.A. 666 (1935), *aff'd*, 83 F.2d 1022 (2nd Cir. 1936) (refund of property taxes previously paid under protest and deducted); *Chevy Chase Land Co. v. Commissioner*, 34 B.T.A. 150 (1936) (refund of special assessment taxes previously included in cost of real estate sold); *Nash v. Commissioner*, 34 B.T.A. 675 (1936), *aff'd*, 88 F.2d 477 (7th Cir.), *cert. denied*, 301 U.S. 700 (1937) (refund of state income tax).

19. *Hillsboro Nat'l Bank v. Commissioner*, 460 U.S. 370, 377 (1983). Courts use the tax benefit rule "to adjust income and deduction inconsistencies between tax years." *Schwartz Rojas v. Commissioner*, 901 F.2d 810, 812 (9th Cir. 1990) (footnote omitted). The Supreme Court has described the tax benefit rule's purpose as "to approximate the results produced by a tax system based on transactional rather than annual accounting." *Hillsboro*, 460 U.S. at 381. One Tax Court judge has described the tax benefit rule "as a necessary counterweight to the consequences of the annual accounting principle." *Estate of Munter v. Commissioner*, 63 T.C. 663, 678 (1975) (Tannenwald, J., concurring); *see also* Bittker & Kanner, *supra* note 11, at 269.

20. I.R.C. § 441 (West Supp. 1993). The Supreme Court has explained the rationale underlying our annual tax accounting system as follows:

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 practicable to produce a regular flow of income and apply methods of accounting, assessment, and collection capable of practical operation.

Burnet v. Sanford & Brooks Co., 282 U.S. 359, 365 (1931). Under a transactional accounting system, in contrast, a taxpayer reports the income or loss from a particular undertaking in the year of completion. Because one undertaking could conceivably last a lifetime, individuals might only pay income taxes at death and corporations might only pay taxes upon dissolution. *Id.*

21. *Hillsboro*, 460 U.S. at 377. Under an annual accounting system, large amounts of income might be followed or preceded by losses in different years. *See* Plumb, *supra* note 1, at 180 n.176.

ple, may claim a deduction for a medical expense in one taxable year and receive a reimbursement from an insurance company in a subsequent taxable year. Without the tax benefit rule, the taxpayer would gain a windfall from deducting the medical expense without having to report any income from the reimbursement. The inclusionary aspect of the tax benefit rule emerged as a judicial doctrine to deal with such situations.²² In essence, the tax benefit rule views a single transaction as a whole, even though the transaction may extend over more than one tax period.²³ The Supreme Court has stated that “[t]he basic purpose of the tax benefit rule is to achieve rough transactional parity in tax . . . and to protect the Government and the taxpayer from the adverse effects of reporting a transaction on the basis of assumptions that an event in a subsequent year proves to have been erroneous.”²⁴ By requiring taxpayers that recover previous deductions to include those recoveries in income, rather than amending the return which claimed the previous deduction,²⁵ the tax benefit rule respects the statute

22. *Hillsboro*, 460 U.S. at 377. While the tax benefit rule originally applied to recoveries of deductions that provided a tax benefit, the rule “has refused to be confined by statute or code section.” Bittker & Kanner, *supra* note 11, at 266. In *Hillsboro*, the Supreme Court observed that “[l]ower courts have been able to stretch the definition of ‘recovery’ to include a great variety of events.” 460 U.S. at 382. The Court, however, also stated 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.’” *Id.* at 381.

23. Lassen, *supra* note 5, at 474; see also *Allstate Ins. Co. v. United States*, 20 Cl. Ct. 308, 312 (1990), *rev’d*, 936 F.2d 1271 (Fed. Cir. 1991) (“The tax benefit rule works as a compromise between the ideal of measuring income in transactional parity and the bureaucratic necessity of annual reporting.”).

24. *Hillsboro*, 460 U.S. at 383.

25. Originally, the Bureau of Internal Revenue ruled that taxpayers should file amended returns when they recovered an amount related to an earlier deduction. O.D. 741, 3 C.B. 115 (1920) (ruling that taxpayer should file amended returns to reflect refund of customs duties which taxpayer previously deducted). Later, the Bureau restricted that ruling to cases where the Customs Service illegally or improperly collected the duties or taxes. Mim. 3958, XI-2 C.B. 33, 35 (1932). If the Customs Service legally or properly collected the duties, but later refunded them, perhaps because the importer used the goods to manufacture an article which the importer later exported, the taxpayer should treat the refund as income in the later year. *Id.* Then, the Bureau ruled that if the statute of limitations for assessing additional taxes had expired, the taxpayer should treat the refund of an illegally or improperly collected tax as income in the year of recovery. Mim. 4564, 1937-1 C.B. 93, 94. The courts ultimately required taxpayers to recognize income in the year of recovery. See, e.g., *Central Loan & Inv. Co. v. Commissioner*, 39 B.T.A. 981, 983 (1939); *Estate of Block v. Commissioner*, 39 B.T.A. 338, 341 (1939), *aff’d sub nom.* *Union Trust Co. v. Commissioner*, 111 F.2d 60 (7th Cir.), *cert. denied*, 311 U.S. 658 (1940); *Houbigant, Inc. v. Commissioner*, 31 B.T.A. 954 (1934), *aff’d*,

of limitations by not reopening previous years.²⁶

2. *Exclusionary aspect*

The exclusionary aspect evolved when the Bureau of Internal Revenue and some courts, at the request of taxpayers, determined that the inclusionary principle should apply only to the extent that a previous deduction produced a tax benefit.²⁷

80 F.2d 1012 (2d Cir.), *cert. denied*, 298 U.S. 669 (1936). In *Nash v. United States*, the Court stated that under the tax benefit rule "a recovery of an item that has produced an income tax benefit in a prior year is to be added to income in the year of recovery." 398 U.S. 1, 3 (1970) (footnote omitted).

26. The tax benefit rule may have developed because the statute of limitations precluded adjustment in the earlier year. *Hillsboro*, 460 U.S. at 379 n.10; *id.* at 423 n.* (Blackmun, J., dissenting). Additionally, reopening a tax year to reflect events occurring after the year would "violate the spirit of the annual accounting system." *Id.* at 380 n.10 (quoting *Healy v. Commissioner*, 345 U.S. 278, 284-85 (1953); see also *Hillsboro*, 460 U.S. at 408 n.9 (Stevens, J., concurring in part and dissenting in part); *Estate of Block v. Commissioner*, 39 B.T.A. 338, 341 (1939), *aff'd sub nom.* *Union Trust Co. v. Commissioner*, 111 F.2d 60 (7th Cir.), *cert. denied*, 311 U.S. 658 (1940) ("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.").

27. Both the Bureau of Internal Revenue and the Board of Tax Appeals originally rejected this argument. S.R. 2940, IV-1 C.B. 129 (1925) (treating the recovery of advances to agents allowed as a deduction during an audit as income even though an operating loss precluded the taxpayer from benefiting from the deduction); *Lake View Trust & Sav. Bank v. Commissioner*, 27 B.T.A. 290 (1932) (holding that collection of previously deducted bad debts constitutes income). In Gen. Couns. Mem. 18,525, 1937-1 C.B. 80, a ruling involving "bad debt deductions by banks and other corporations subject to supervision of Federal or State authorities," the Bureau of Internal Revenue announced the principle that "recoveries of debts previously deducted do not constitute taxable income unless the deduction of the debts in prior years resulted in a reduction of tax liability." Gen. Couns. Mem. 20,854, 1939-1 C.B. 102, 104. In the last paragraph of Gen. Couns. Mem. 18,525, the Bureau stated:

The deductions for bad debts contemplated by the clause "allowed as a deduction for income tax purposes" . . . refer to deductions for bad debts which accomplished a reduction in tax liability and do not refer to deductions for bad debts in cases in which the taxpayer, on account of other allowable deductions, had no net income irrespective of the deduction for bad debts.

1937-1 C.B. at 83. Two years later, in Gen. Couns. Mem. 20,854, the Bureau concluded that the principle applied equally to "recoveries of debts voluntarily deducted by banks and other corporations subject to Federal or State supervision and to recoveries of debts deducted by other taxpayers." 1939-1 C.B. 102, 104.

Based at least in part on these authorities, the Board of Tax Appeals applied the same principle to similar recoveries. See, e.g., *Central Loan & Inv. Co. v. Commissioner*, 39 B.T.A. 981, 984 (1939) (refund of county taxes) ("While the question of actual benefit may not heretofore have been made a prerequisite to the inclusion in gross income of the amount recovered, inferentially it has been a controlling factor."); *National Bank of Commerce v. Commissioner*, 40 B.T.A. 72 (1939), *aff'd*,

For example, if the taxpayer in the previous example, who paid the medical expense, would not have paid any federal income tax even without deducting the medical expense, fairness and transactional accounting would suggest that the taxpayer should not pay any tax on the reimbursement from the insurance company. Under the inclusionary component, however, the government could require the taxpayer to report the entire reimbursement in income, even though the previous deduction did not produce a tax benefit.

The Bureau of Internal Revenue and the Board of Tax Appeals, therefore, recognized an exception to the inclusionary rule. The Bureau, however, subsequently switched its position and convinced some courts to reject any limitation to the inclusionary rule.²⁸ In 1942, Congress interceded and partially codified the exclusionary aspect by enacting legislation that authorized an exclusion from gross income for recoveries of bad debts, taxes, and delinquency amounts to the extent that those amounts did not reduce the taxpayer's income tax liability.²⁹

115 F.2d 875 (9th Cir. 1940) (recoveries of debts deducted as worthless); *Marston v. Commissioner*, 41 B.T.A. 847 (1940) (refund of partnership excess profits taxes); *Amsco-Wire Prods. Corp. v. Commissioner*, 44 B.T.A. 717 (1941) (cancellation of accrued salary and interest); *Hurd Millwork Corp. v. Commissioner*, 44 B.T.A. 786 (1941) (settlement of accrued real estate taxes); *State-Planters Bank & Trust Co. v. Commissioner*, 45 B.T.A. 630 (1941), *rev'd*, 130 F.2d 44 (4th Cir. 1942) (recovery of bad debts); *Corn Exch. Nat'l Bank & Trust Co. v. Commissioner*, 46 B.T.A. 1107 (1942), *appeal dismissed in unpublished op.*, (3d Cir. 1944) (recovery of bad debts); *see also Philadelphia Nat'l Bank v. Rothensies*, 43 F. Supp. 923 (E.D. Pa. 1942) (recoveries of bad debts).

28. In Gen. Couns. Mem. 22,163, 1940-2 C.B. 76, the Chief Counsel modified Gen. Couns. Mem. 18,525, revoked Gen. Couns. Mem. 20,854, and recommended that the Bureau withdraw the acquiescences in *Central Loan & Inv. Co. v. Commissioner*, 39 B.T.A. 981, 984 (1939), *acq.*, 1939-2 C.B. 6, and *National Bank of Commerce v. Commissioner*, 40 B.T.A. 72 (1939), *acq.*, 1939-2 C.B. 26, *aff'd*, 115 F.2d 875 (9th Cir. 1940). Gen. Couns. Mem. 22,163 concluded that recoveries of previously deducted bad debts constituted taxable income whether or not the prior deduction resulted in any tax benefit to the taxpayer. 1940-2 C.B. at 80. Several courts adopted the Bureau's revised position. *See, e.g., Commissioner v. United States & Int'l Sec. Corp.*, 130 F.2d 894 (3rd Cir. 1942), *modified*, 138 F.2d 416 (1943); *Helvering v. State-Planters Bank & Trust Co.*, 130 F.2d 44 (4th Cir. 1942), *rev'g* 45 B.T.A. 630 (1941); *see also Stearns Coal & Lumber Co. v. Glenn*, 42 F. Supp. 28 (W.D. Ky. 1941).

29. In section 116 of the Revenue Act of 1942, Pub. L. No. 753, 56 Stat. 798, 812, Congress added section 22(b)(12) to the Internal Revenue Code of 1939. That provision served as the forerunner to I.R.C. § 111. As enacted, section 22(b)(12) provided in pertinent part:

(b) EXCLUSIONS FROM GROSS INCOME.—The following items shall not be included in gross income and shall be exempt from taxation under this chapter:

.....
(12) RECOVERY OF BAD DEBTS, PRIOR TAXES, AND DELINQUENCY AMOUNTS.—Income attributable to the recovery during the taxable year of a bad debt, prior tax, or delinquency amount, to the extent of the amount of the recovery exclusion with respect to such debt, tax, or amount. For the purposes of this paragraph:

(A) Definition of Bad Debt.—The term “bad debt” means a debt on account of worthlessness or partial worthlessness of which a deduction was allowed for a prior taxable year.

(B) Definition of Prior Tax.—The term “prior tax” means a tax on account of which a deduction or credit was allowed for a prior taxable year.

(C) Definition of Delinquency Amount.—The term “delinquency amount” means an amount paid or accrued on account of which a deduction or credit was allowed for a prior taxable year and which is attributable to failure to file return with respect to a tax, or pay a tax, within the time required by the law under which the tax is imposed, or to failure to file return with respect to a tax or pay a tax.

(D) Definition of Recovery Exclusion.—The term “recovery exclusion”, with respect to a bad debt, prior tax, or delinquency amount, means the amount, determined in accordance with regulations prescribed by the Commissioner with the approval of the Secretary, of the deductions or credits allowed, on account of such bad debt, prior tax, or delinquency amount, which did not result in a reduction of the taxpayer’s tax under this chapter (not including the tax under section 102) or corresponding provisions of prior revenue laws, reduced by the amount excludible in previous taxable years with respect to such debt, tax, or amount under this paragraph.

Revenue Act of 1942, Pub. L. No. 753, § 116(a), 56 Stat. at 812-13.

Section 22(b)(12), therefore, excluded from gross income recoveries of previously deducted bad debts, prior taxes, or delinquency amounts to the extent that the prior deduction did not reduce the taxpayer’s income tax liability for any taxable year. The provision, however, limited the exclusion to the “recovery exclusion,” which was defined as the amount of deductions or credits that, under regulations which the Commissioner would prescribe, did not reduce the taxpayer’s income tax liability for any prior taxable year, less any amount which the taxpayer could have excluded from gross income under the provision in previous taxable years. Revenue Act of 1942, Pub. L. No. 753, § 116(a), 56 Stat. at 813. Section 22(b)(12) applied retroactively to all prior revenue acts. *Id.* § 116(c).

The legislative history of the Revenue Act of 1942 documents Congress’ attempt to resolve the uncertainty present in previous law:

There is at present considerable confusion as to the state of the law regarding the recovery of bad debts or taxes which have been taken as deductions in previous years. The confusion has arisen as to whether the taxation of the amount of the bad debt or tax recovered in the year of such recovery depends upon the tax benefit which the taxpayer derived from the deduction of these items in a prior year.

The bill settled this question by excluding from the gross income of the taxpayer in the year of the recovery the amounts recovered to the extent that the debt or tax did not in any prior taxable year reduce his income tax liability. Securities which become worthless and which result

The following year, the Supreme Court extended this exclusionary doctrine to include other, similar items.³⁰ Today, the Internal Revenue Code provides that “[g]ross 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.”³¹ Treasury Regulations extend the

in a capital loss are allowed the same treatment as bad debts and taxes.

H.R. REP. NO. 2333, 77th Cong., 2d Sess. 45 (1942), *reprinted in* 108 INTERNAL REVENUE ACTS, *supra* note 5.

By mandating the exclusionary aspect, which operates as an exception to the inclusionary component, Congress implicitly acknowledged the propriety of the inclusionary component. *Hillsboro Nat'l Bank v. Commissioner*, 460 U.S. 370, 406 (1983) (Stevens, J., concurring in part and dissenting in part).

30. In *Dobson v. Commissioner*, 320 U.S. 489 (1943), the Court considered whether taxpayers had to report as income the recoveries of previous losses on the sale of stock. The taxpayers in the consolidated cases bought, then sold the stock at losses, and claimed deductible losses on their tax returns. The government argued that in the absence of a specific statutory exemption, taxpayers must include recoveries in income. The Supreme Court expressly rejected the argument, concluding that while the statute only partially codified the rule, the noncodified portion survived:

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 matter of fact it found no economic gain and no use of the transaction to gain tax benefit.

Id. at 506.

In *Hillsboro*, the Supreme Court stated that section 111 “lists a few applications and represents a general endorsement of the exclusionary aspect of the tax benefit rule to other situations within the inclusionary part of the rule.” 460 U.S. at 388; *see also Putoma Corp. v. Commissioner*, 66 T.C. 652, 664 n.10 (1976), *aff'd*, 601 F.2d 734 (5th Cir. 1979).

31. I.R.C. § 111(a) (1988). In the Internal Revenue Code of 1954, Pub. L. No. 83-591, 68A Stat. 1, Congress reenacted section 22(b)(12) of the Internal Revenue Code of 1939 as section 111 of the Internal Revenue Code of 1954 “without significant change in wording and without any legislative comment.” *Segel v. Commissioner*, 89 T.C. 816, 843 n.36 (1987).

In the Bankruptcy Tax Act of 1980, Pub. L. No. 96-589, 94 Stat. 3389, Congress amended section 111 of the Internal Revenue Code of 1954 to provide that “an increase in a carryover which has not expired shall be treated as a reduction in tax.” *Id.* § 2(c), 94 Stat. at 3396. The legislative history explains that the amendment clarified previous law by providing that in applying the tax benefit rule to determine if a taxpayer must include a recovery in gross income, a deduction produced a reduction in tax if the deduction increased a carryover that had not expired at the end of the taxable year in which the recovery occurred. S. REP. NO. 96-1035, 96th Cong., 2d Sess. 20 (1980), *reprinted in* 1980 U.S.C.C.A.N. 7017, 7035. Carryovers permit a taxpayer to use a deduction or credit from the current tax year in another tax year.

In the Deficit Reduction Act of 1984, Pub. L. No. 98-369, 98 Stat. 494, Congress made two important changes to section 111 of the Internal Revenue Code of

1954. First, Congress repealed the "recovery exclusion" concept. Prior to the amendment, section 111 and the related regulations assumed that a taxpayer first recovered the portion, if any, of the amount that the taxpayer previously deducted in the prior year that did not reduce taxable income. H. REP. NO. 432, 98th Cong., 2d Sess., pt. 2, at 1368-69 (1984). Congress concluded that such an assumption produced a windfall to taxpayers. *Id.* Congress, therefore, amended section 111 to provide that when a taxpayer recovers an amount attributable to a prior year's deduction, the taxpayer may exclude the recovery from gross income only to the extent that the prior deduction did not reduce income subject to tax. *Id.* at 1369. Second, Congress provided that when a taxpayer recovers an amount that relates to a credit that the taxpayer claimed in a prior year, the taxpayer must increase the tax in the year of recovery by the amount of the credit attributable to the recovery to the extent that the credit reduced the amount of tax. *Id.*

The amendments in the Deficit Reduction Act of 1984 applied to amounts that taxpayers recovered after December 31, 1983, in taxable years ending after that date. Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 171(c), 98 Stat. 494, 699. As amended, section 111 of the Internal Revenue Act of 1954 read:

SEC. 111. RECOVERY OF TAX BENEFIT ITEMS.

(a) DEDUCTIONS.—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 income subject to tax.

(b) CREDITS.—

(1) IN GENERAL.—If—

(A) a credit was allowable with respect to any amount for any prior taxable year, and

(B) during the taxable year there is a downward price adjustment or similar adjustment,

the tax imposed by this chapter for the taxable year shall be increased by the amount of the credit attributable to the adjustment.

(2) EXCEPTION WHERE CREDIT DID NOT REDUCE TAX.—Paragraph (1) shall not apply to the extent that the credit allowable for the recovered amount did not reduce the amount of tax imposed by this chapter.

(3) EXCEPTION FOR INVESTMENT TAX CREDIT AND FOREIGN TAX CREDIT.—This subsection shall not apply with respect to the credit determined under section 46 and the foreign tax credit.

(c) TREATMENT OF CARRYOVERS.—For purposes of this section, an increase in a carryover which has not expired before the beginning of the taxable year in which the recovery or adjustment takes place shall be treated as reducing income subject to tax or reducing tax imposed by this chapter, as the case may be.

Id. § 171(a), 98 Stat. at 698.

The Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085, redesignated the Internal Revenue Code of 1954 as the Internal Revenue Code of 1986. *Id.* § 2(a), 100 Stat. at 2095. In addition, the Tax Reform Act of 1986 made two technical corrections to section 111. First, the legislation amended section 111(a) by striking out the phrase "did not reduce income subject to tax" and inserting in its place the phrase "did not reduce the amount of tax imposed by this chapter." *Id.* § 1812(a)(1), 100 Stat. at 2833. The Tax Reform Act of 1986 also amended section 111(c) by replacing the phrase "reducing income subject to tax or reducing tax imposed by this chapter, as the case may be" with the phrase "reducing tax imposed by this chapter." *Id.* § 1812(a)(2). The modifications permit taxpayers to

exclusionary aspect to "all other losses, expenditures, and accruals made the basis of deductions from gross income for prior taxable years."³²

B. Expansion

Recent decisions and articles have failed to appreciate the full reach of the tax benefit rule.³³ These authorities often assume that the tax benefit rule applies only to recoveries and other events that are inconsistent with a previous deduction.³⁴

exclude recoveries of deductions and credits that did not reduce the taxpayer's tax liability. This situation could arise, for example, if the alternative minimum tax applies to the taxpayer. The amendments apply as if included in the Deficit Reduction Act of 1984. Today, I.R.C. section 111 provides, in pertinent part:

SEC. 111. RECOVERY OF TAX BENEFIT ITEMS.

(a) DEDUCTIONS.—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.

(b) CREDITS.—

(1) IN GENERAL.—If—

(A) a credit was allowable with respect to any amount for any prior taxable year, and

(B) during the taxable year there is a downward price adjustment or similar adjustment,

the tax imposed by this chapter for the taxable year shall be increased by the amount of the credit attributable to the adjustment.

(2) EXCEPTION WHERE CREDIT DID NOT REDUCE TAX.—Paragraph (1) shall not apply to the extent that the credit allowable for the recovered amount did not reduce the amount of tax imposed by this chapter.

(3) EXCEPTION FOR INVESTMENT TAX CREDIT AND FOREIGN TAX CREDIT.—This subsection shall not apply with respect to the credit determined under section 46 and the foreign tax credit.

(c) TREATMENT OF CARRYOVERS.—For purposes of this section, an increase in a carryover which has not expired before the beginning of the taxable year in which the recovery or adjustment takes place shall be treated as reducing tax imposed by this chapter.

I.R.C. § 111(a)-(c) (1988).

32. Treas. Reg. § 1.111-1(a) (1956). The rule of exclusion, however, does not apply to "deduction with respect to depreciation, depletion, amortization or amortizable bond premium." *Id.* The Treasury Department adopted the existing regulations on December 28, 1956. T.D. 6220, 1957-1 C.B. 34. Interestingly, although Congress substantively amended section 111 in the Bankruptcy Tax Act of 1980, Pub. L. 96-589, § 2(c), 94 Stat. 3389, 3396, the Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 171(a), 98 Stat. 494, 698, and the Tax Reform Act of 1986, Pub. L. No. 99-514, § 1812(a), 100 Stat. 2085, 2833, the Treasury Department has not amended the regulations to reflect those legislative changes. *See supra* note 31.

33. *But cf.* Bittker & Kanner, *supra* note 11 at 272 n.24.

34. Decisions and articles typically have explained the tax benefit rule as providing that if a taxpayer deducts an item in one year and events occur in a

Not only deductions, however, generate tax benefits. Amounts which taxpayers exclude from gross income or use to claim tax credits also produce tax benefits.³⁵

Several courts and commentators, therefore, have recognized that the tax benefit rule also applies to exclusions.³⁶ As

subsequent taxable year that are inconsistent with the prior deduction, the taxpayer must report the item as income in the later year, but only to the extent that the earlier deduction provided a tax benefit. *See, e.g., Hillsboro Nat'l Bank v. Commissioner*, 460 U.S. 370, 372 (1983) ("[U]nless a nonrecognition provision of the Internal Revenue Code prevents it, the tax benefit rule ordinarily applies to require the inclusion of income when events occur that are fundamentally inconsistent with an earlier deduction."); White, *supra* note 5, at 488 ("The 'inclusionary component' mandates the inclusion of some previously deducted amount in a taxpayer's income . . ."); O'Hare, *supra* note 11, at 215 ("[T]he recovered deduction aspect . . . means that where a deduction from income is recovered the amount of the recovery is includable in income . . . [T]he tax benefit principle . . . permits exclusion from income of the recovered deduction to the extent it produced no tax benefit when taken.") (footnotes omitted); Lindsay, *supra* note 11, at 1259 ("The tax benefit rule requires a taxpayer who recovers a previously deducted item or amount to report that item as income in the year of recovery, unless the previous deduction did not reduce her tax liability."); Corlew, *supra* note 11, at 1007 ("[The judicially created doctrine] taxes recovery of items previously deducted . . .").

Some definitions or descriptions of the rule, however, have recognized the possibilities. *See, e.g., Willis, supra* note 11, at 580 ("Gross income results from events which 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."); Elliott, *supra* note 11, at 849 ("The tax benefit rule applies to credits as well as deductions."); Del Cotto & Joyce, *supra* note 11, at 473 ("A tax benefit may be provided to taxpayers by either an exclusion from gross income or a deduction."); Bittker & Kanner, *supra* note 11, at 272 ("[T]he inclusionary component of the tax benefit rule comes into play when the taxpayer recovers an item that would not be includable in income except for the fact that it was previously deducted or credited in computing his federal income tax liability for a prior year."); *see also* INTERNAL REVENUE SERVICE, U.S. DEPT OF TREASURY, PUBLICATION 525, TAXABLE AND NONTAXABLE INCOME 18 (1993) ("A recovery is a return of an amount you deducted or took a credit for in an earlier year.")

35. The Internal Revenue Code imposes a tax on taxable income. I.R.C. §§ 1, 11 (1988 & Supp. IV 1992). The Code defines taxable income as gross income less allowable deductions. I.R.C. § 63(a) (1988). The determination of federal income tax liability, therefore, begins with the computation of gross income. Gross income generally includes all income from whatever source derived. I.R.C. § 61 (1988). Taxpayers, however, may exclude certain items from gross income. *See, e.g., I.R.C. §§ 101-136* (1988 & West Supp. 1993). These exclusions reduce a taxpayer's income subject to tax.

After subtracting their deductions from their gross income, individuals use the appropriate tax rate schedule or tax table to compute the tax on their taxable income. I.R.C. §§ 1, 3 (1988 & Supp. IV 1992). The Code, however, also provides certain credits that reduce the tax which taxpayers must pay to the federal government. *See, e.g., I.R.C. §§ 21-52* (1988 & West Supp. 1993). These credits directly reduce tax liability. Exclusions, deductions, and credits, therefore, all determine an individual's federal income tax.

36. In *Home Mutual Insurance Co. v. Commissioner*, 639 F.2d 333, 343 n.26

a result of the Deficit Reduction Act of 1984,³⁷ the Internal Revenue Code explicitly includes credits within the reach of the tax benefit rule.³⁸ For example, a taxpayer operating an eligible small business may claim a credit for expenditures on new bathroom fixtures that make a restroom accessible to persons with disabilities³⁹ and receive a manufacturer's rebate in a subsequent taxable year. In that event, the taxpayer must increase the tax paid in the year of the rebate by the amount of the credit attributable to the rebate.⁴⁰

(7th Cir. 1980), *cert. denied*, 451 U.S. 1017 (1981), the court indicated that the principle underlying the tax benefit rule also applies to funds, such as embezzled monies, that the taxpayer never included in gross income. *See also* California & Hawaiian Sugar Ref. Corp. v. United States, 311 F.2d 235, 238 n.1 (Ct. Cl. 1962) ("A tax benefit can be in the form of a deduction for the taxes originally paid, or a credit for those taxes, or an exclusion from gross income of the receipts from which the taxes were paid.") (citations omitted); Keystone Nat'l Bank v. United States, 57-2 U.S. Tax Cas. (CCH) ¶ 9773 (W.D. Pa. 1957); *supra* note 34.

37. Pub. L. No. 98-369, 98 Stat. 494 (1984).

38. Section 111(b) discusses the recovery of amounts related to expenditures which a taxpayer previously used to claim a credit. I.R.C. § 111(b) (1988). *See supra* note 31.

If the Deficit Reduction Act of 1984 serves as any indication of congressional intent, Congress "apparently did not perceive section] 111, as in effect before 1984, as applying any tax benefit rule to the recapture of tax credits." *Segel v. Commissioner*, 89 T.C. 816, 843 n.36 (1987). Under a literal reading of the predecessors of section 111, however, the statutory tax benefit rule has always applied to credits. *See Plumb, supra* note 1, at 140. Section 22(b)(12) of the Internal Revenue Code of 1939 defines "prior tax" as "a tax on account of which a deduction or credit was allowed for a prior taxable year." At the time of the Revenue Act of 1942, however, some "credits" acted like deductions. Section 11 of the Internal Revenue Code of 1939, as amended by the 1942 Act, imposed a normal tax on "the amount of the net income in excess of the credits against net income provided in section 25." 3 WALTER E. BARTON, *BARTON'S FEDERAL TAX LAWS CORRELATED* 4 (reprint ed. 1944). Section 25 of the Internal Revenue Code of 1939 provided "credits of individuals against net income" for interest on United States obligations, interest on obligations of instrumentalities of the United States, earned income, personal exemptions, and dependents. *Id.* at 104, 106, 108. Sections 31 to 33 of the Internal Revenue Code of 1939 provided "credits against tax" for taxes of foreign countries and possessions of the United States, taxes withheld at source, and overpayments. *Id.* at 138.

39. I.R.C. § 44 (Supp. IV 1992).

40. I.R.C. § 111(b)(1) (1988). This rule applies only to the extent that the credit reduced the amount of tax and does not apply to the investment or foreign tax credits. I.R.C. § 111(b)(2), (3) (1988). The Code treats an increase in a carry-over which has not expired before the beginning of the recovery year as reducing the amount of tax. I.R.C. § 111(c) (1988). *See supra* note 31.

Interestingly, Form 1040, U.S. Individual Income Tax Return, does not provide a specific line for increasing tax liability to reflect the recovery of an amount that relates to a credit claimed in a prior taxable year. INTERNAL REVENUE SERVICE, U.S. DEPT OF TREASURY, FORM 1040, U.S. INDIVIDUAL INCOME TAX RETURN (1993). Presumably, a taxpayer could report such amounts on either line 39, "Additional

C. Broader Description

Drawing from the previous, but separate, recognitions that the tax benefit rule applies to deductions, exclusions, and credits, three conditions must exist before the tax benefit rule applies.⁴¹ First, based on the facts and circumstances at the end of a taxable year, a taxpayer must have properly used an item as a deduction, exclusion, or credit in computing federal income tax for that year.⁴² Second, the item must produce some federal tax benefit by lowering the taxpayer's federal income tax or by creating an unexpired carryover.⁴³ Third, events must occur in a subsequent taxable year that are inconsistent with the prior treatment and a nexus must connect the subsequent events with the prior treatment.⁴⁴ These inconsistent events may include a refund, recoupment, rebate, reimbursement, recovery, or reversal of the previous item.⁴⁵ Incorporating the

taxes," or line 49, "Recapture taxes." A taxpayer might also enter the additional tax directly on line 53, "This is your total tax" (emphasis deleted). Neither the relevant publication nor the instructions provide any assistance. INTERNAL REVENUE SERVICE, U.S. DEPT OF TREASURY, PUBLICATION 525, TAXABLE AND NONTAXABLE INCOME 19 (1993); INTERNAL REVENUE SERVICE, U.S. DEPT OF TREASURY, INSTRUCTIONS FOR FORM 1040 AND SCHEDULES A, B, C, D, E, EIC, F, AND SE (1993).

41. See, e.g., *Putoma Corp. v. Commissioner*, 66 T.C. 652, 664 (1976), *aff'd*, 601 F.2d 734 (5th Cir. 1979); *Estate of Munter v. Commissioner*, 63 T.C. 663, 678-79 (1975) (Tannenwald, J., concurring).

42. If the taxpayer originally treated the expenditure erroneously and the statute of limitations had not expired, the Internal Revenue Service could assess a deficiency for the year in which the error occurred. If the facts as then known at the end of the taxable year justified the treatment, the Service could not retroactively correct the treatment and assess a deficiency, even if the statute of limitations had not expired. Bittker & Kanner, *supra* note 11, at 265-66.

43. See *supra* note 40.

44. The tax benefit rule only applies when events occur after the close of the taxable year in which the taxpayer reported the original expenditure. *Hillsboro Nat'l Bank v. Commissioner*, 460 U.S. 370, 379 n.10 (1983). If the inconsistent event had occurred in the same taxable year as the original expenditure, the later event would have foreclosed the use of the original expenditure in computing federal income tax. *Id.* at 383-84. Some direct relationship must also exist between the use of the item in computing tax liability and the subsequent event:

The tax benefit rule will not always apply merely because some later event is fundamentally inconsistent with the earlier deduction. Rather, a nexus must exist between the later and earlier events. The IRS has indicated that a direct relationship must exist between the event that constitutes the loss and the event that constitutes the recovery. For example, receiving money from a debtor on a second debt, after the taxpayer had previously written off the first debt as worthless, would not invoke the tax benefit rule if the money recovered were not part of the first debt.

Elliott, *supra* note 11, at 859 (footnotes omitted).

45. In contrast, amounts which a taxpayer collects for goods and services

three conditions, this article proposes, for the first time, a comprehensive description of the tax benefit rule: If a taxpayer properly uses an item in computing federal income tax in one year, *whether as an exclusion, deduction, or credit*, and events occur in a subsequent taxable year that are inconsistent with the prior treatment, the taxpayer must reflect the item in computing federal income tax in the later year to the extent that the prior treatment produced a tax benefit.

II. ALTERNATIVE APPLICATIONS

Part I reviewed the development of the tax benefit rule's inclusionary and exclusionary aspects, discussed the expansion of the rule to exemptions and credits, and proposed a new, comprehensive description to reflect the rule's application to deductions, credits, and exemptions. The remainder of this article focuses on the inclusionary component. This part expands the previous discussion by further categorizing the various types of items to which the tax benefit rule applies and by illustrating the ways that the tax benefit rule may apply to those different items. This part also analyzes the tax consequences that flow from these different categories in computing taxable income.

A. *Ways an Expenditure Can Affect Federal Income Tax*

Under this article's expanded description of the tax benefit rule, the rule may apply to recoveries of five different types of items that a taxpayer used in computing federal income tax for a prior year.⁴⁶ The taxpayer may have treated the expenditure

constitute gross income regardless of whether the taxpayer previously deducted amounts necessary to produce the income and regardless of whether the deductions produced a tax benefit. See *Burnet v. Sanford & Brooks Co.*, 282 U.S. 359 (1931); *Plumb*, *supra* note 1, at 140; see also *Jones v. Commissioner*, 19 T.C.M. (CCH) 611, 615-16 (1960).

46. An expenditure may also give rise to a deduction or exclusion from gross income in a subsequent year. A taxpayer, for example, can depreciate or amortize capital expenditures that the taxpayer uses in a trade or business or holds for the production of income and that have a limited useful life. I.R.C. § 167(a) (West Supp. 1993); Treas. Reg. § 1.167-3 (as amended in 1979). A taxpayer can recover any undepreciated or unamortized cost when the taxpayer sells or otherwise disposes of the asset. The recovery of any such cost functions as an offset to the amount realized in computing the gross income from the sale or exchange of the property or as a deduction from gross income in arriving at adjusted gross income if the taxpayer can deduct any loss that may arise from the sale or exchange. I.R.C. §§ 61(a)(3), 62(a)(3), 165(c), 1211(b) (1988 and West Supp. 1993). An expenditure

as: (1) an exclusion from gross income by offsetting gross sales in arriving at net sales; (2) an exclusion from gross income by increasing the cost of goods sold; (3) an "above-the-line" deduction from gross income in arriving at adjusted gross income;⁴⁷ (4) an itemized deduction from adjusted gross income in calculating taxable income; or (5) a credit that reduces or eliminates tax liability. The following discussion illustrates these five different ways.

1. *Offset to gross sales*

First, an allowance, rebate or discount may reduce gross sales in arriving at net sales for the purposes of calculating gross income.⁴⁸ For example, James Beam, a sole proprietor using the accrual method and operating a wholesale liquor distributorship, could offer a dealer's incentive to retailers that purchase liquor at certain minimum prices.⁴⁹ If Beam actually uses the minimum prices merely as the starting point in arriving at an agreed net price, case law authorizes him to use the "rebate" to reduce gross sales in arriving at net sales.⁵⁰ By reducing gross sales, he effectively excludes the rebate from gross income at the time of sale.⁵¹ If, however, Beam issues a rebate check to a retailer, but the retailer never cashes the check because one of the retailer's employees misplaces the check, at some point the tax benefit rule would require Beam to reverse the previously recorded expenditure and reflect the uncashed dealer's incentive in the computation of his federal

can also create a carryover. *See, e.g.*, I.R.C. § 172 (West Supp. 1993). In the interest of brevity, this article will not discuss delayed deductions, exclusions, or carryovers.

47. Individuals use a two-step process in claiming the various deductions that the Code allows in computing taxable income. First, individuals subtract certain deductions, sometimes referred to as "above-the-line deductions," from gross income to determine adjusted gross income. I.R.C. § 62(a) (1988). Second, individuals subtract their remaining deductions, often referred to as "itemized deductions," and an amount for personal exemptions, from adjusted gross income to compute taxable income. I.R.C. § 63(a) (1988). Instead of claiming itemized deductions, individuals may use their standard deduction. I.R.C. § 63(b) (1988).

48. *See Dixie Dairies Corp. v. Commissioner*, 74 T.C. 476 (1980), *acq.*, 1982-2 C.B. 1; *Pittsburgh Milk Co. v. Commissioner*, 26 T.C. 707 (1956), *nonacq.*, 1959-1 C.B. 6, *acq.*, 1962-2 C.B. 5, *nonacq.*, 1976-2 C.B. 3, *acq.*, 1982-2 C.B. 2; *see also Max Sobel Wholesale Liquors v. Commissioner*, 69 T.C. 477 (1977), *aff'd*, 630 F.2d 670 (9th Cir. 1980).

49. *See, e.g., Dixie Dairies*, 74 T.C. at 479; *Max Sobel*, 69 T.C. at 478-79.

50. *Pittsburgh Milk*, 26 T.C. at 715-16.

51. *See, e.g., Dixie Dairies*, 74 T.C. at 492; *Pittsburgh Milk*, 26 T.C. at 717.

income tax for the year of the reversal.⁵²

2. *Cost of goods sold*

Second, an expenditure may reduce gross income by increasing the cost of goods sold.⁵³ Assume that James Beam also sells imported beer. If he pays customs duties on imported beer sold during a taxable period, he can exclude the duties from gross income as part of the cost of goods sold.⁵⁴ By increasing the cost of goods sold, Beam effectively excludes the customs duties from gross income at the time of sale. If Beam later obtains a refund of those duties, he must report the refund as income.⁵⁵

3. *"Above-the-line" deductions*

An expenditure may qualify as an "above-the-line" deduction. Individuals subtract "above-the-line" deductions from gross income in arriving at adjusted gross income.⁵⁶ Assume further that James Beam sells to a retailer on credit and the retailer defaults. Because Beam accrued income at the time of sale, he can claim a bad debt deduction and subtract that

52. See, e.g., *Chicago, R.I. & Pac. Ry. v. Commissioner*, 13 B.T.A. 988 (1928), *aff'd in part, rev'd in part on other grounds*, 47 F.2d 990 (7th Cir.), *cert. denied*, 284 U.S. 618 (1931) (holding taxpayer must recognize income upon the reversal of checks and vouchers for wages, overcharges, loss and damage claims, and other disbursements which the taxpayer had previously deducted, and which the payees had not claimed or cashed after two years).

53. Regulations provide that in a manufacturing or merchandising business, gross income means sales less cost of goods sold. Treas. Reg. § 1.61-3(a) (as amended in 1992); see *Max Sobel*, 69 T.C. at 487 (Drennen, J., dissenting); *Sullenger v. Commissioner*, 11 T.C. 1076, 1077 (1948), *acq.*, 1952-2 C.B. 3, *nonacq.*, 1976-1 C.B. 1 ("[T]he Commissioner has always recognized, as indeed he must to stay within the Constitution, that the cost of goods sold must be deducted from gross receipts in order to arrive at gross income.").

54. See, e.g., *Dixie Margarine Co. v. Commissioner*, 38 B.T.A. 471, 475-76 (1938), *rev'd*, 115 F.2d 445 (6th Cir. 1940), *appeal dismissed*, 127 F.2d 292 (6th Cir. 1942) ("[T]he disbursements made by petitioner for stamp taxes in the years prior to the taxable year were not deducted as 'taxes paid or accrued' in computing net income of the respective years, but petitioner received the benefit of the deductions as a part of cost of its product manufactured and sold in such years.").

55. See, e.g., *Houbigant, Inc. v. Commissioner*, 31 B.T.A. 954 (1934), *aff'd*, 80 F.2d 1012 (2d Cir.), *cert. denied*, 298 U.S. 669 (1936) (refund of customs duties previously included in cost of goods sold); cf. *El Dorado Oil Works v. Commissioner*, 46 B.T.A. 994 (1942) (reversal of costs previously included in cost of goods sold).

56. Section 62(a) contains a list of deductions authorized by other sections of the Code which an individual may deduct from gross income in calculating adjusted gross income. I.R.C. § 62(a) (West Supp. 1993).

amount from gross income in arriving at adjusted gross income.⁵⁷ If Beam ultimately collects the debt, he must include the amount of the payment in income.⁵⁸

4. *Itemized deductions*

If an expenditure does not qualify as an "above-the-line" deduction, a taxpayer may deduct the item only if the taxpayer itemizes deductions. Assuming that James Beam itemizes deductions, he may claim an itemized deduction for state income taxes in arriving at taxable income.⁵⁹ If the state refunds those taxes, Beam may have to include the refund, or at least a part, in income under the tax benefit rule.⁶⁰

5. *Credits*

Finally, an expenditure may qualify for a credit which reduces federal income tax liability. Assume that James Beam qualifies as an "eligible small business" and claims, in one taxable year, the disabled access credit⁶¹ for expenditures on new bathroom fixtures which make a restroom accessible to persons with disabilities. If Beam receives a manufacturer's rebate in a subsequent taxable year, he must reflect the rebate in computing his federal income tax in the later year.⁶²

57. I.R.C. §§ 62(a)(1), 166 (1988).

58. *See, e.g.*, *Lee v. Commissioner*, 6 B.T.A. 541 (1927), *aff'd sub nom. Carr v. Commissioner*, 28 F.2d 551 (5th Cir. 1928) (collection of accounts receivable previously treated as worthless); *cf. Hurd Millwork Corp. v. Commissioner*, 44 B.T.A. 786 (1941) (discharge of accrued real estate taxes); *Amsco-Wire Prods. Corp. v. Commissioner*, 44 B.T.A. 717 (1941) (cancellation of accrued salaries); *Victoria Paper Mills Co. v. Commissioner*, 32 B.T.A. 666 (1935), *aff'd*, 83 F.2d 1022 (2d Cir. 1936) (refund of property taxes).

59. I.R.C. §§ 63(a), 164(a)(3) (1988).

60. *See, e.g.*, *Nash v. Commissioner*, 34 B.T.A. 675 (1936), *aff'd*, 88 F.2d 477 (7th Cir.), *cert. denied*, 301 U.S. 700 (1937). The tax benefit rule, however, does not apply to state tax refunds if the taxpayer did not itemize deductions in the earlier year because the state taxes paid in the previous year did not produce a tax benefit. *See supra* note 16. The tax benefit rule also does not apply to a federal income tax refund because a taxpayer cannot deduct federal income taxes in computing federal income tax liability. I.R.C. § 275(a)(1) (1988 & Supp. IV 1992).

61. I.R.C. § 44 (Supp. IV 1992).

62. As a result of the Deficit Reduction Act of 1984, Pub. L. No. 98-369, 98 Stat. 494, when a taxpayer recovers an amount that relates to a credit claimed in a prior taxable year, the taxpayer must increase the tax paid in the year of recovery by the amount of the credit attributable to the recovered amount. I.R.C. § 111(b)(1) (1988); *see supra* note 40.

B. Importance of These Distinctions

Offsets to gross receipts, additional costs of goods sold, and both "above-the-line" and itemized deductions reduce taxable income.⁶³ The resulting reduction in tax depends upon the marginal tax rate.⁶⁴ Credits, in contrast, directly reduce tax liability. Each dollar of tax credit reduces the taxpayer's tax liability by one dollar.⁶⁵ If the percentage of an expenditure that qualifies for a tax credit exceeds the maximum marginal tax rates, a taxpayer will prefer a credit to a corresponding reduction in taxable income. Even assuming, however, that an expenditure will produce the same reduction in net tax as either an exclusion, deduction, or credit,⁶⁶ other differences among the three can produce significant tax consequences.

1. Net sales

Although gross income essentially serves as the starting point in computing taxable income, the term "net sales" can have independent tax significance for two reasons. First, in determining whether the six-year, rather than the three-year, statute of limitations applies because a taxpayer omitted twenty-five percent or more of gross income,⁶⁷ the Code focuses on "net sales."⁶⁸ Second, certain limitations on deductibility do

63. These amounts could also affect computation of self-employment tax. The Code imposes a self-employment tax on individuals who derive "self-employment income" by carrying on a trade or business as a sole proprietor or as a partner. I.R.C. §§ 1401-1403 (1988 & West Supp. 1993).

64. If the Code treats a taxpayer as self-employed and the expenditure relates to that activity, an offset to gross receipts, additional cost of goods sold, or "above-the-line" deduction would also reduce self-employment income. Unless the taxpayer has reached the applicable contribution base, the resulting reduction in self-employment income would reduce the old-age, survivors, and disability insurance and hospital insurance components of the self-employment tax by 12.4 and 2.9 percent, respectively, for years beginning after December 31, 1989. I.R.C. §§ 1401(a), (b) (West Supp. 1993). The Revenue Reconciliation Act of 1993 repeals the hospital insurance contribution base cap for self-employment income earned after December 31, 1993. Pub. L. No. 103-66, § 13207(b), (e), 107 Stat. at 463-69.

65. The Code uses both refundable and nonrefundable credits. Refundable credits entitle a taxpayer whose tax liability is less than the amount of the taxpayer's credits to a refund for the difference.

66. If, for example, a taxpayer has a fifteen percent marginal tax rate, the tax benefit from a fifteen percent tax credit would approximate the benefit from an exclusion or deduction in the same amount.

67. I.R.C. § 6501(e) (West Supp. 1993). Normally, a three-year statute of limitations applies to assessments of additional taxes or claims for refunds of overpayments. I.R.C. §§ 6501(a), 6511(a) (West Supp. 1993).

68. Section 6501(e)(1)(A)(i) defines the term "gross income" as the total of all

not apply to offsets from gross sales.⁶⁹ Consequently, treating an expenditure as an offset from gross sales in arriving at "net sales," rather than as a cost of goods sold, deduction or credit can have important tax consequences.

2. *Gross income*

In addition to the ways which "net sales" can affect gross income, other exclusions from gross income, such as costs of goods sold, can also have independent tax significance. Treating an expenditure as an exclusion from gross income, rather than as a deduction or credit, can affect the amount of federal income tax that an individual owes. First, gross income can affect dependency exemptions.⁷⁰ Second, substantially underreporting gross income may extend the statute of limitations.⁷¹ Third, an individual's gross income may limit or affect various deductions and losses, including the net operating loss deduction,⁷² the deduction for soil and water conservation ex-

amounts from the sale of goods or services that the internal revenue laws require a taxpayer to show on a tax return before diminution for the costs of such sales or services. I.R.C. § 6501(e)(1)(A)(i) (West Supp. 1993).

69. Section 162(c), for example, denies a deduction for illegal bribes, kickbacks, and other illegal payments. I.R.C. § 162(c) (West Supp. 1993). Section 162(c), however, does not apply to allowances, rebates, and discounts that offset gross income. See *supra* note 48 and accompanying text; see also I.R.C. § 280E (1988) (denying a deduction or credit for any amount paid or incurred in connection with the illegal sale of drugs).

70. I.R.C. § 151(c) (West Supp. 1993). As a general rule, a taxpayer can claim an exemption for a dependent only if the dependent's gross income does not equal or exceed the exemption amount. I.R.C. § 151(c)(1)(A) (West Supp. 1993). For calendar year taxpayers, however, this general rule does not apply to a taxpayer's children who have not attained nineteen years of age at the close of the calendar year or who were full-time students during at least five calendar months and have not attained twenty-four years of age at the close of the calendar year. I.R.C. § 151(c)(1)(B), (c)(4) (West Supp. 1993).

71. I.R.C. § 6501(e)(1); see *supra* note 67 and accompanying text.

72. Section 172(a) allows taxpayers to claim a "net operating loss deduction," which the Code defines as "an amount equal to the aggregate of (1) the net operating loss carryovers to such year, plus (2) the net operating loss carrybacks to such year." I.R.C. § 172(a) (1988). In general, taxpayers may carry a "net operating loss" back for three years prior to the year that the taxpayer incurred the loss and forward for fifteen years after the year of the loss. I.R.C. § 172(b)(1)(A) (Supp. IV 1992). The Code defines "net operating loss" as the amount that the deductions which the Code allows exceed gross income, but requires taxpayers to compute the excess with certain modifications. I.R.C. § 172(c) (1988). One such modification provides that an individual can only use nonbusiness deductions to reduce nonbusiness gross income. I.R.C. § 172(d)(4) (1988). Gross income which a taxpayer did not derive from a trade or business, therefore, may limit an individual's "net operating loss" and "net operating loss deduction."

penditures,⁷³ the "hobby loss" rules,⁷⁴ and the home office and vacation home rules.⁷⁵ Certain limitations on deductibility do not apply to exclusions from gross income.⁷⁶ Finally, gross income affects "adjusted gross income."

3. *Adjusted gross income*

The concept of adjusted gross income has become increas-

73. I.R.C. § 175(a) (1988). This section authorizes taxpayers engaged in farming to deduct expenditures paid or incurred for soil or water conservation or erosion prevention on farm land. *Id.* The Code, however, limits such deductions to twenty-five percent of the gross income which a taxpayer derived from farming during the taxable year. I.R.C. § 175(b) (1988). Taxpayers may carry any excess expenditures to succeeding taxable years. *Id.*

74. I.R.C. § 183 (1988). Section 183(d) creates a presumption that if the gross income from an activity for three or more of the five consecutive years ending with the taxable year exceeds the deductions attributable to the activity, the taxpayer engaged in the activity for profit. I.R.C. § 183(d) (1988). If the taxpayer engaged in the activity for profit, the taxpayer may deduct expenses attributable to the activity either under section 162 as trade or business expenses or under section 212 as expenses for the production of income. I.R.C. §§ 162(a), 212(1) or (2) (1988 & West Supp. 1993). Thus, gross income from a recovery could qualify an activity for the presumption, thereby authorizing deductions which the taxpayer would not have been able to claim without the recovery. *See Willis, supra*, note 11, at 594 n.102.

75. I.R.C. § 280A (1988). Section 280A(c)(5) limits the deduction for home office and vacation home expenses to gross income from the business use or rental activity, reduced by (1) expenses that the taxpayer may deduct without regard to business or rental use, such as qualified residence interest and real estate taxes, and (2) other deductions allocable to the business or rental activity, but not allocable to the use of the property. I.R.C. § 280A(c)(5) (1988). The Code, therefore, denies a deduction to the extent that the deduction creates or increases a net loss from the business or rental activity to which the deduction relates. A taxpayer may carryover any disallowed deduction to a subsequent taxable year, subject to the same limitations in the later year. *Id.* Nevertheless, a recovery could generate gross income which would permit the taxpayer to deduct expenses related to the home office or vacation home which the taxpayer would not have been able to claim without the recovery.

76. Section 280E, for example, denies a deduction or credit for any amount that a taxpayer pays or incurs during a taxable year in carrying on any trade or business if the trade or business consists of trafficking in controlled substances that Federal law or the law of any State in which the taxpayer conducts such trade or business prohibits. I.R.C. § 280E (1988). The legislative history states that the provision does not affect the adjustment for cost of goods sold that taxpayers may subtract from gross receipts to determine gross income. S. Rep. No. 494, 97th Cong., 2d Sess. 309 (1982), *reprinted in* 1982 U.S.C.C.A.N. 781, 1050. In addition, the limitations in section 162(c)(2) do not apply to credits, discounts, or rebates payable in merchandise even though such transactions violate Federal or state law. *See, e.g., Max Sobel Wholesale Liquors v. Commissioner*, 69 T.C. 477 (1977), *aff'd*, 630 F.2d 670 (9th Cir. 1980). The courts have treated such costs as part of the cost of goods sold which taxpayers may exclude from gross income. *See supra* notes 48 and 69.

ingly important in recent years, both for federal and state tax purposes. For federal tax purposes, adjusted gross income affects or limits various inclusions, exclusions, deductions, exemptions, credits, and tax computations. Adjusted gross income also affects state income taxes because twenty-nine states and the District of Columbia use federal adjusted gross income as the starting point for computing state income taxes.⁷⁷

Initially, adjusted gross income or a related term can influence how much gross income an individual must report. If a taxpayer's "modified adjusted gross income" and one-half of the social security benefits received during a taxable year exceed a base amount, the taxpayer will have to include a portion of the social security benefits in gross income.⁷⁸ Individuals who pay qualified higher education expenses during a year may not exclude income from redeeming certain United States savings bonds if their "modified adjusted gross income" exceeds certain amounts.⁷⁹ The Code also uses adjusted gross income to determine whether a minister or lay employee of a church may exclude the value of an annuity which the church purchases for the minister or lay person from gross income under an alternative exclusion allowance.⁸⁰

77. ALL STATES TAX GUIDE (RIA) ¶ 3112, at 3057 (Dec. 14, 1993).

78. I.R.C. § 86 (West Supp. 1993). Section 86(b)(2) defines "modified adjusted gross income" as adjusted gross income plus any tax-exempt interest and amounts earned in a foreign country, certain U.S. possessions or Puerto Rico which the taxpayer could exclude from gross income. I.R.C. § 86(b)(2) (West Supp. 1993). The Code establishes the base amount as zero for married individuals who file a separate return and who lived with their spouse at any time during the year, \$32,000 for married individuals filing a joint return, \$25,000 for all other individuals. I.R.C. § 86(c) (West Supp. 1993). As a result of the Revenue Reconciliation Act of 1993, some taxpayers will have to include eighty-five percent of their social security benefits in gross income for tax years beginning after December 31, 1993. Pub. L. No. 103-66, § 13215(a), 107 Stat. at 475 (1993).

79. I.R.C. § 135 (1988 & Supp. IV 1992). Section 135(c)(4) defines "modified adjusted gross income" as adjusted gross income after considering the partial inclusion of social security benefits in section 86, the deduction for contributions to individual retirement arrangements in section 219, and adjustments for limitations on passive activity losses in section 469, but before the exclusion for interest income on qualified United States savings bonds, and the exclusions for amounts earned in a foreign country, certain U.S. possessions, or Puerto Rico. I.R.C. § 135(c)(4) (1988). For 1993, the exclusion does not apply to married individuals filing a joint return with modified adjusted gross incomes of \$98,250 and above and all other individuals with modified adjusted gross incomes of \$60,500 or more. The exclusion begins phasing out at modified adjusted gross income of \$68,250 for married individuals filing a joint return and \$45,500 for all other individuals. Rev. Proc. 92-102, 1992-2 C.B. 579, 581; see I.R.C. § 135(b) (1988 & Supp. IV 1992).

80. I.R.C. § 403(b)(2)(D)(ii) (1988). The alternative exclusion allowance autho-

In addition, adjusted gross income affects or limits several deductions. Individual taxpayers may only deduct medical and dental expenses to the extent that those expenses exceed seven and one-half percent of adjusted gross income.⁸¹ The Code also imposes various percentage limitations on charitable contributions, based upon a taxpayer's contribution base.⁸² In general, the term "contribution base" means adjusted gross income.⁸³ Individuals may deduct personal casualty losses only to the extent that those losses exceed ten percent of adjusted gross income in any year.⁸⁴ Similarly, taxpayers may deduct miscellaneous itemized deductions to the extent that those deductions exceed two percent of adjusted gross income.⁸⁵ If adjusted gross income exceeds certain levels, individuals may not deduct all or a part of their contributions to individual retirement accounts. This limitation, however, applies only if the taxpayer or the taxpayer's spouse could participate in a qualified retirement plan.⁸⁶ Adjusted gross income also affects

rizes a minister or lay person to exclude the lesser of \$3,000 or the employee's includible compensation. I.R.C. § 403(b)(2)(D)(i) (1988). The alternative exclusion allowance, however, does not apply to any individual whose adjusted gross income for the taxable year exceeds \$17,000. I.R.C. § 403(b)(2)(D)(ii) (1988).

81. I.R.C. § 213(a) (1988). Again, an increase in adjusted gross income could handicap a taxpayer in reaching or exceeding the floor. See Willis, *supra* note 11, at 594 n.100.

82. I.R.C. § 170(b) (1988). For example, the Code limits an individual's total annual deduction for charitable contributions to fifty percent of the taxpayer's "contribution base." I.R.C. § 170(b)(1)(A) (1988). The Code imposes other limits depending upon the type of organization to which the taxpayer contributes and the type of property that the taxpayer donates. I.R.C. § 170(b)(1) (1988). Taxpayers may carry over contributions which exceed the annual limits for five years. I.R.C. § 170(d) (1988).

83. I.R.C. § 170(b)(1)(F) (1988). A taxpayer, however, must compute adjusted gross income without regard to any net operating loss carryback to the taxable year. *Id.*

84. I.R.C. § 165(h)(2) (1988).

85. I.R.C. § 67(a) (1988). The Code defines "miscellaneous itemized deductions" as itemized deductions other than the thirteen types listed in section 67(b). I.R.C. § 67(b) (1988). Examples of miscellaneous itemized deductions include unreimbursed employee business expenses, union dues and expenses, qualified safe deposit box rent, and tax preparation fees. INTERNAL REVENUE SERVICE, U.S. DEPT OF TREASURY, PUBLICATION 529, MISCELLANEOUS DEDUCTIONS 2-6 (1993).

86. I.R.C. § 219(g) (West Supp. 1993). If adjusted gross income exceeds \$25,000 for unmarried individuals, \$40,000 for married individuals filing a joint return, or zero for a married individual filing a separate return, the Code phases out the deduction for contributions to an individual retirement account if the taxpayer or the taxpayer's spouse could participate in a qualified retirement plan. *Id.* The Code completes the phase out when adjusted gross income reaches \$35,000 for unmarried individuals, \$50,000 for married individuals filing a joint return, and \$10,000 for married individuals filing a separate return. I.R.C. § 219(g)(2) (West

the application of the exception to the passive loss rules for rental real estate activities.⁸⁷

Additionally, adjusted gross income determines, in whole or in part, the credit for dependent care expenses,⁸⁸ the credit for the elderly and the permanently and totally disabled,⁸⁹

Supp. 1993).

87. I.R.C. § 469(i) (1988 & Supp. IV 1992). In general, section 469 disallows a deduction for an individual's "passive activity loss." I.R.C. § 469(a) (1988). The Code defines "passive activity loss" as the amount by which the taxpayer's aggregate losses from all passive activities for the year exceed the taxpayer's aggregate income from such activities for the year. I.R.C. § 469(d) (1988). The term "passive activity" means any activity which involves the conduct of a trade or business and in which the taxpayer does not materially participate. I.R.C. § 469(c)(1) (1988). Section 469(i), however, provides an exception to the passive loss rules for rental real estate activities. I.R.C. § 469(i) (1988 & Supp. IV 1992). Under that provision, an individual can deduct up to \$25,000 in passive activity losses attributable to rental real estate activities in which the individual actively participated during the taxable year. *Id.* If the taxpayer's adjusted gross income exceeds \$100,000, the Code reduces the amount allowable under the exception by fifty percent of excess. I.R.C. § 469(i)(3)(A) (1988). The Code, therefore, completely phases out the exception when adjusted gross income reaches \$150,000. For purposes of section 469(i)(3), the Code states that the taxpayer should determine adjusted gross income without regard to (1) any social security benefits that the taxpayer must include in income under section 86, (2) any interest on United States savings bonds which the taxpayer may exclude from gross income under section 135, (3) any amount which the taxpayer may deduct for a contribution to any individual retirement account under section 219, and (4) any passive activity loss. I.R.C. § 469(i)(3)(E) (Supp. IV 1992). For taxable years beginning after December 31, 1993, the Revenue Reconciliation Act of 1993 requires a taxpayer to determine adjusted gross income without regard to the new exception to the passive loss rules in subsection 469(c)(7) for taxpayers in real property trades or businesses. Pub. L. No. 103-66, § 13,143(b)(2), 107 Stat. at 441 (1993).

88. I.R.C. § 21 (1988). Section 21 allows a credit for expenses which a taxpayer pays for qualified household and dependent care services to enable the taxpayer to hold gainful employment. *Id.* The credit equals thirty percent of qualified expenses, which may not exceed \$2,400 for one qualifying individual or \$4,800 for two or more qualifying individuals, for taxpayers whose adjusted gross incomes do not exceed \$10,000. I.R.C. § 21(a)(2), (c) (1988). The Code reduces the credit by one percentage point for each \$2,000, or fraction thereof, that the taxpayer's adjusted gross income exceeds \$10,000, until the credit reaches twenty percent for taxpayers whose adjusted gross incomes equal or exceed \$28,000. I.R.C. § 21(a)(2) (1988).

89. I.R.C. § 22 (1988). The Code also provides a credit for the elderly and the permanently and totally disabled in an amount equal to fifteen percent of the individual's "section 22 amount." I.R.C. § 22(a) (1988). To determine the section 22 amount, section 22(c) requires an individual to reduce the applicable "initial amount" by certain pension, annuity or disability benefits that the taxpayer may exclude from gross income and a phase-out if the individual's adjusted gross income exceeds certain levels. I.R.C. § 22(c) (1988). For individuals who have reached age 65 before the end of the taxable year, the initial amount depends upon filing status as follows: \$5,000 for single individuals and married individuals filing a joint return where only one spouse has reached 65, \$7,500 for married individuals filing a joint return where both spouses have attained age 65, and \$3,750 for a

and the earned income credit.⁹⁰ As a result of the Omnibus Budget Reconciliation Act of 1990,⁹¹ the Code phases out itemized deductions⁹² and personal exemptions⁹³ when adjusted gross income reaches certain levels. For children subject to the "kiddie tax,"⁹⁴ adjusted gross income determines "net un-

married individual filing a separate return. I.R.C. § 22(c)(2)(A) (1988). For permanently and totally disabled individuals under age 65, the initial amount may not exceed the disability income for the year. I.R.C. § 22(c)(2)(B) (1988). If a taxpayer's adjusted gross income exceeds \$7,500 for a single individual, \$10,000 for married individuals filing a joint return or \$5,000 for a married individual filing a separate return, the taxpayer must reduce the section 22 amount by one-half of the excess. I.R.C. § 22(d) (1988).

90. I.R.C. § 32 (1988 & Supp. IV 1992). The Code provides an earned income credit for low-income individuals who have earned income, have a dependent child, maintain a household, and meet adjusted gross income requirements. *Id.* The credit includes three components: the basic earned income credit, a supplemental young child credit, and the health insurance credit. I.R.C. § 32(b) (Supp. IV 1992). For 1993, these credits phase out when adjusted gross income or earned income, if greater, exceeds \$12,200. Rev. Proc. 92-102, 1992-2 C.B. 579, 581. The credits phase out completely when either adjusted gross income or earned income reaches \$23,050 for 1993. *Id.* For tax years beginning after December 31, 1993, the Revenue Reconciliation Act of 1993 expands eligibility for the credit to individuals without children, repeals the supplemental young child and health insurance credits, and increases the maximum credit and phaseout amounts. Pub. L. No. 103-66, § 13,131(a), (b), 107 Stat. at 433-35 (1993).

91. Pub. L. No. 101-508, §§ 11,103(a) & 11,104(a), 104 Stat. 1388, 1388-406 to 1388-408 (1990).

92. I.R.C. § 68 (Supp. IV 1992). If an individual's adjusted gross income exceeds the applicable amount, section 68(a) requires the individual to reduce certain itemized deductions otherwise allowable by the lesser of (1) three percent of the excess over the applicable amount or (2) eighty percent of those itemized deductions. I.R.C. § 68(a) (Supp. IV 1992). The Code requires the Internal Revenue Service to adjust the applicable amounts for inflation. I.R.C. § 68(b)(2) (Supp. IV 1992). For 1993, the applicable amount is \$108,450, unless a married individual files a separate return, in which case a \$54,225 applicable amount applies. Rev. Proc. 92-102, 1992-2 C.B. 579, 581.

93. I.R.C. § 151(d)(3) (West Supp. 1993). Generally, taxpayers may claim a personal exemption for themselves and for their dependents. I.R.C. §§ 151(b), (c), 152 (1988). Section 151(c), however, phases out the benefit of personal exemptions if a taxpayer's adjusted gross income exceeds certain "threshold amounts," which the Code adjusts for inflation. Rev. Proc. 92-102, 1992-2 C.B. 579, sets the threshold amounts for 1993 at \$162,700 for married individuals filing a joint return, \$135,600 for heads of households, \$108,450 for single individuals, and \$81,350 for married individuals filing a separate return. The phaseout eliminates the deduction for personal exemptions for 1993 when adjusted gross income reaches \$285,200 for married individuals filing a joint return, \$258,100 for heads of households, \$230,950 for single individuals, and \$142,600 for married individuals filing a separate return. *Id.* at 580-81.

94. Section 1(g) imposes a tax on unearned income of certain minor children. I.R.C. § 1(g) (Supp. IV 1992). The "kiddie tax" applies to any child who has not attained age 14 before the end of the year if either parent is alive at the end of the year. I.R.C. § 1(g)(2) (Supp. IV 1992). In essence, section 1(g) taxes a child's

earned income."⁹⁵ Finally, "modified adjusted gross income" may affect the amount by which a taxpayer must increase tax liability to reflect the recapture of federally subsidized mortgage interest from the use of qualified mortgage bonds or mortgage credit certificates upon the disposition of a residence within nine years of purchase.⁹⁶

III. APPLICATION

If the inclusionary component of the tax benefit rule requires a taxpayer to report a recovery or other inconsistent event, where should the taxpayer include the item in computing tax liability? The Code requires taxpayers who subsequently recover amounts used to qualify for a credit in a previous year to increase their federal income tax in the year of recovery if the credit produced a tax benefit.⁹⁷ Currently, the Internal Revenue Service treats recoveries or other inconsistent events related to earlier deductions as gross income.⁹⁸ Whether im-

"net unearned income" at the highest marginal tax rate of the child's parents.

95. The Code defines "net unearned income" as the excess of the portion of the child's adjusted gross income attributable to unearned income over the sum of (1) an inflation-adjusted amount and (2) the greater of the child's standard deduction or the itemized deductions directly connected with the production of the unearned income. I.R.C. § 1(g)(4)(A) (Supp. IV 1992). "Net unearned income," however, may not exceed the child's taxable income. I.R.C. § 1(g)(4)(B) (Supp. IV 1992).

96. I.R.C. § 143(m) (Supp. IV 1992). Qualified governmental units issue qualified mortgage bonds and loan the proceeds to eligible individuals for use in purchasing, rehabilitating or improving single family, owner-occupied homes. These individuals must meet purchase price, income, and other restrictions. Certain governmental units may also issue mortgage credit certificates, which give homebuyers a tax credit for a specified portion of the interest which they pay on mortgage loans for their principal residence. Eligibility requirements similar to those governing qualified mortgage bonds apply to mortgage credit certificates. In the Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, § 4005(g)(1), 102 Stat. 3342, 3647-50, Congress added a provision which required taxpayers who sell a home which they financed under one of these programs to recapture the subsidy which the assisted loan provided. This recapture, however, only applied to borrowers whose income increased substantially after the loan. H.R. Conf. Rep. No. 964, 101st Cong., 2d Sess. 1117 (1988), *reprinted in* 1988 U.S.C.C.A.N. 2822. As a result of the Omnibus Budget Reconciliation Act of 1990, Congress amended section 143(m) so that the recapture amount depends upon the excess of the taxpayer's "modified adjusted gross income" in the year in which the sale or other disposition occurs over the adjusted qualifying income for that year. Pub. L. No. 101-508, § 11408(c)(2)(B), 104 Stat. at 1388-477 to 1388-478 (1990). For purposes of this provision, "modified adjusted gross income" means adjusted gross income increased by tax-exempt interest which the taxpayer received for the year and decreased by the amount of gain which the taxpayer included in gross income from the sale or other disposition. I.R.C. § 143(m)(5)(B) (Supp. IV 1992).

97. I.R.C. § 111(b) (1988); *see supra* note 40 and accompanying text.

98. *See* Rev. Rul. 93-75, 1993-35 I.R.B. 4 ("If . . . the taxpayer subsequently

licitly or explicitly, the courts and commentators that have considered the tax benefit rule have assumed that a recovery of an earlier deduction increases gross income in the year of recovery.⁹⁹

recovers all or a portion of the previously deducted amounts (for example, state income taxes), the recovery or refund is, in general, fully includible in gross income under the tax benefit rule.”); Rev. Rul. 92-91, 1992-2 C.B. 49 (requiring taxpayer who recovers an interest overcharge on an adjustable rate mortgage from a prior year to include the overcharge in gross income in the year of recovery to the extent that the deduction of the overcharge reduced the taxpayer’s federal income tax in the prior year). In addition, the Internal Revenue Service instructs taxpayers to report recoveries or other inconsistent events related to previous deductions on page one of Form 1040, U.S. Individual Income Tax Return, on either line 10, “Taxable refunds, credits, or offsets of state and local income taxes . . .” or line 22, “Other income.” If a taxpayer reports the recovery as “Other income,” the instructions direct the taxpayer to “[l]ist the type and amount of income.” INTERNAL REVENUE SERVICE, U.S. DEPT OF TREASURY, FORM 1040, U.S. INDIVIDUAL INCOME TAX RETURN (1993); INTERNAL REVENUE SERVICE, U.S. DEPT OF TREASURY, INSTRUCTIONS FOR FORM 1040 AND SCHEDULES A, B, C, D, E, EIC, F, AND SE 20 (1993); see also INTERNAL REVENUE SERVICE, U.S. DEPT OF TREASURY, PUBLICATION 525, TAXABLE AND NONTAXABLE INCOME 19 (1993). Although the term “gross income” does not appear on Form 1040, a taxpayer must add both lines 10 and 22 to compute “Adjusted Gross Income” on line 31. INTERNAL REVENUE SERVICE, U.S. DEPT OF TREASURY, FORM 1040, U.S. INDIVIDUAL INCOME TAX RETURN (1993). Prior to 1971, individuals included recoveries of previous deductions in “Adjusted Gross Income” as “Miscellaneous income.” INTERNAL REVENUE SERVICE, U.S. DEPT OF TREASURY, FORM 1040, U.S. INDIVIDUAL INCOME TAX RETURN 2, line 39 (1970), reprinted in INDIVIDUALS’ FILLED-IN TAX RETURN FORMS 13 (CCH 1971 ed.). In 1971, the Internal Revenue Service added a separate line for “State income tax refunds.” INTERNAL REVENUE SERVICE, U.S. DEPT OF TREASURY, FORM 1040, U.S. INDIVIDUAL INCOME TAX RETURN 2, line 39(c) (1971), reprinted in INDIVIDUALS’ FILLED-IN TAX RETURN FORMS 11 (CCH 1972 ed.).

The Internal Revenue Service has not provided any guidance for reporting recoveries of exclusions.

99. *Hillsboro Nat’l Bank v. Commissioner*, 460 U.S. 370, 380 n.10 (1983) (“[Section 111] 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.”) (second emphasis added); *id.* at 405 (Stevens, J., concurring in part and dissenting in part) (“The ‘inclusionary’ component requires that the recovery within a taxable year of an item previously deducted be included in *gross income*.”) (emphasis added); *Frederick v. Commissioner*, 101 T.C. 35 (1993) (“[T]o summarize the tax benefit rule, an amount must be included in *gross income* in the current year if, and to the extent that: (1) The amount was deducted in a year prior to the current year, (2) the deduction resulted in a tax benefit, (3) an event occurs in the current year that is fundamentally inconsistent with the premises on which the deduction was originally based, and (4) a nonrecognition provision of the Internal Revenue Code does not prevent the inclusion in *gross income*.”) (emphasis added); *Eboli v. Commissioner*, 93 T.C. 123, 135 (1989) (“The tax benefit rule includes an item in *gross income* where that item has been deducted in an earlier year and a later unforeseen event occurs which is ‘fundamentally inconsistent with the premise on which the deduction was initially based.’”) (emphasis added and citation omitted); *Nadler v. Com-*

A. Illustrations

The following illustrations, however, demonstrate the potential unfairness of treating recoveries of earlier deductions as gross income in the year of recovery.

1. Illustration one

During 1993, Mary provides more than half the support for her mother, Susan, whose medical expenses from a serious illness have consumed almost all of Susan's savings. For 1992, when the illness started, Susan claimed \$30,000 in itemized deductions, primarily from medical expenses, to offset the capital gains which Susan realized from selling assets to pay the medical expenses. During 1993, Susan had \$2,300 in interest income, and received a \$100 reimbursement from an insurance company for a medical expense which Susan paid and deducted in 1992, after the insurance company initially rejected the claim. As traditionally interpreted, the tax benefit rule required Susan to include the \$100 reimbursement in gross income, giving her \$2,400 in total gross income for 1993. Because Susan's gross income exceeded \$2,350, the inflation adjusted exemption amount for 1993,¹⁰⁰ Mary cannot claim a dependency exemption for Susan for 1993, even though Mary provided more than one half of Susan's support during that year. If the medical expense reimbursement had not affected gross income, Mary could have claimed a dependency exemption for

missioner, 55 T.C.M. (CCH) 949, 951 (1988) ("Under the tax benefit rule, if a loss is deducted and a recovery subsequently made, the amount recovered is includable in *gross income* to the extent that a tax benefit was received when it was deducted.") (emphasis added and citation omitted); Willis, *supra* note 11, at 580 ("Gross income results from events which 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.") (footnote omitted) (emphasis added).

Other commentators make this assumption implicitly by not referring to any type of income. See, e.g., Elliott, *supra* note 11, at 846 n.7 ("recovery of an item previously deducted must be included in income") (quoting Putoma Corp. v. Commissioner, 66 T.C. 652, 664 n.10 (1976), *aff'd*, 601 F.2d 734 (5th Cir. 1979)) (emphasis deleted); Bittker & Kanner, *supra* note 11, at 271 (same); O'Hare, *supra* note 11, at 215 ("where a deduction from income is recovered the amount of the recovery is includable in income"). At least one other commentator simply refers to taxable income. White, *supra* note 5, at 488.

100. Rev. Proc. 92-102, 1992-2 C.B. 579; see also *supra* note 70 and accompanying text.

Susan because Susan's interest income did not equal or exceed \$2,350.

2. *Illustration two*

Thomas, who develops real estate, had gross income from real estate activities of \$1,249,000 during 1989. Due to a large, but innocent mistake, however, Thomas reported only \$999,000 in gross income from the real estate activities on his 1989 federal income tax return. During 1989, Thomas also received a \$5,000 state tax refund. As historically interpreted, the tax benefit rule required Thomas to include the \$5,000 refund in gross income, and he reported \$1,004,000 in total gross income for 1989. Early in 1994, the Internal Revenue Service discovers Thomas's mistake during an audit of his 1990 return. Because the \$250,000 omission of gross income did not exceed twenty-five percent of \$1,004,000, the gross income which Thomas reported in his return, the special six-year statute of limitations does not apply and the Internal Revenue Service cannot assess any additional taxes against Thomas because the three-year statute of limitations has expired.¹⁰¹ If, however, the state tax refund had not affected gross income, the six-year statute of limitations would have applied because the \$250,000 omission would exceed twenty-five percent of \$999,000, the gross income which Thomas would have reported without the current interpretation of the tax benefit rule.

3. *Illustration three*

During 1993, Kate, a federal retiree received \$21,000 from her investments and federal pension and \$8,000 in social security benefits which she earned while working in the private sector. During the year, Kate also received a \$10,000 state tax refund for taxes collected between 1985 and 1988.¹⁰² Kate

101. I.R.C. § 6501(a), (e)(1)(A) (West Supp. 1993); see also *supra* note 67 and accompanying text.

102. In *Davis v. Michigan Department of Treasury*, 489 U.S. 803 (1989), the Supreme Court held that state laws which impose taxes on federal retirement benefits while exempting state retirement benefits violate the Public Salary Tax Act of 1939, 4 U.S.C. § 111 (1988), and the intergovernmental tax immunity doctrine. In *Harper v. Virginia Department of Taxation*, 113 S. Ct. 2510 (1993), the Supreme Court recently held that the *Davis* decision applied retroactively, but the Court did not order a refund of taxes paid before the earlier decision. Instead, the Court remanded the case so that the state courts could determine the appropriate remedy. The Bureau of National Affairs reports that "Virginia now faces the possi-

itemized deductions for each of the years between 1985 and 1988 and the state income taxes fully reduced her federal taxable income during each of those years. Under the tax benefit rule as currently interpreted, Kate had to include one-half of her social security benefits, or \$4,000, in gross income because her modified adjusted gross income exceeded \$25,000.¹⁰³ If, however, the state tax refund had not affected gross income, she would not have had to include any portion of her social security benefits in gross income because her modified adjusted gross income, without the state tax refund, and one-half of her social security benefits did not exceed \$25,000.¹⁰⁴

4. *Illustration four*

During 1990, I.M. Generous gave land to a city on the condition that the city use the land to establish a park and deducted the \$50,000 fair market value of the land. Because the city did not have the funds to build the park, the city returned the land to Generous in 1993. During 1993, Generous had income from other sources totaling \$100,000 and made charitable contributions totaling \$60,000 to various public charities. Under the current interpretation of the tax benefit rule, Generous must include the \$50,000 in gross income, which gives him \$150,000 in adjusted gross income and a "contribution base" of the same amount. With a \$150,000 contribution base, the Code would disallow any deductions for contributions in excess of \$75,000, but would allow Generous to carry over those contributions for up to five years.¹⁰⁵ If the returned charitable contributions had not affected gross income, Generous

bility of having to refund nearly \$500 million to 200,000 retired federal workers for taxes collected between 1985 and 1989 For all states facing litigation with taxpayers in the wake of *Davis*, the estimated potential refund liability is close to \$2 billion." *Court Holds Davis Ruling Retroactive but Allows States Flexibility on Relief*, DAILY TAX REPORT (BNA), June 21, 1993, at G-2, G-3.

103. Because Kate's "modified adjusted gross income" and one-half of her social security benefits exceeded \$25,000, Kate had to include one-half of the benefits in her gross income. I.R.C. § 86 (West Supp. 1993); see also *supra* note 78 and accompanying text. The Revenue Reconciliation Act of 1993 increases the maximum amount of social security benefits that a retiree may have to include in gross income to eighty-five percent of the benefits for tax years beginning after December 31, 1993. *Id.*

104. If Kate itemized deductions and claimed a deduction for medical and dental expenses, the \$10,000 state tax refund would also reduce her allowable deduction for those expenses by \$750. I.R.C. § 213(a) (1988).

105. I.R.C. § 170(b)(1) (1988); see, e.g., Willis, *supra* note 11, at 593-94; see also *supra* notes 82-83.

ous could have deducted only \$50,000 in charitable contributions for the year and would have had to carry over the remaining \$10,000 to the following year.

5. *Illustration five*

Rocky and Shelly Beach live in a state which imposes a state income tax based on federal adjusted gross income. In 1992, a hurricane severely damaged their residence, causing \$30,000 in damage. The Beaches' home insurance policy covered wind damage, but specifically excluded losses from water, floods, and tidal waves. Asserting that water forces caused the damage, the insurance company denied the claim that the Beaches filed for the damage.¹⁰⁶ The Beaches claimed a \$30,000 casualty loss on their 1992 federal income tax return.

In 1993, after almost a year of litigation, the Beaches recovered \$30,000 from their insurance company in a settlement. Pursuant to applicable regulations,¹⁰⁷ the Beaches reported the \$30,000 recovery on their 1993 federal income tax return. Even though the Beaches did not, and could not, receive any state tax benefit from the casualty loss because itemized deductions do not affect state taxable income, the Beaches had to include the reimbursement in their state taxable income for 1993. By including the reimbursement in gross income, the reimbursement increased adjusted gross income which, in turn, increased state taxable income. At a five percent marginal state tax rate, the additional state taxable income from the \$30,000 reimbursement increased the Beaches' state tax liability by \$1,500. If the reimbursement had not affected gross income, the Beaches could have avoided the harsh results from the existing application of the tax benefit rule.

B. *Prescription to Remedy Unfairness*

The examples in the previous section illustrate the various

106. See, e.g., *Montgomery v. Commissioner*, 65 T.C. 511 (1975). Taxpayers may experience similar denials in the wake of 1993's record flooding in the Midwest or 1992's Hurricane Andrew.

107. Treas. Reg. § 1.165-1(d)(2)(iii) provides that if a taxpayer deducts a casualty loss and receives reimbursement for the loss in a subsequent taxable year, the taxpayer may not recompute the tax for the taxable year in which the taxpayer deducted the loss. Instead, the taxpayer must include the amount of the reimbursement in gross income for the taxable year in which the taxpayer receives the reimbursement, subject to the provisions of the tax benefit rule in section 111. Treas. Reg. § 1.165-1(d)(2)(iii) (as amended in 1977).

inequities that the current interpretation of the tax benefit rule creates both for taxpayers and the government, but especially for taxpayers.¹⁰⁸ To avoid the unfairness toward taxpayers, this article argues that the Internal Revenue Service and the courts should permit taxpayers to report recoveries or other inconsistent events under the tax benefit rule in the same place that the previous item affected the computation of federal income tax in the earlier year.¹⁰⁹ Congress has already required taxpayers to treat recoveries of amounts used to qualify for credits differently than recoveries of deductions. As a result of

108. As the second and fourth illustrations demonstrate, the unfairness can work against the government. Other situations where the current application works against the government include the deduction for soil and water conservation expenses and the "hobby loss" rules. *See supra* notes 73-74 and accompanying text. In the overwhelming majority of cases, the additional gross income which results from the current application of the tax benefit rule works against the taxpayer. In addition to the other three illustrations, these situations include the inclusion of social security benefits, the exclusion for interest income on qualified United States savings bonds used for qualified higher education expenses, the deductibility of medical and dental expenses, personal casualty losses, miscellaneous itemized deductions, contributions to individual retirement accounts, passive losses attributable to rental real estate activities, the credit for dependent care expenses, the credit for the elderly and permanently and totally disabled, the earned income credit, the phase outs for itemized deductions and personal exemptions. *See supra* notes 78-79 and 81-93 and accompanying text.

109. This article argues that the Internal Revenue Service and the courts should *permit*, rather than require, taxpayers to report recoveries or other inconsistent events in the same place that the previous item affected the computation of federal income tax.

The proposed principles do not eliminate the inequities which can operate against the government. *See supra* notes 101, 105, and 108 and accompanying text. Even today, however, the government cannot argue the converse of the tax benefit rule's exclusionary component. Assume, for example, that an accrual method taxpayer included an account receivable in income, but a net loss excused the taxpayer from paying any income taxes for that year. If the account receivable becomes worthless in a subsequent year, the Internal Revenue Service cannot deny the taxpayer a bad debt deduction for the later year on the grounds that the government did not collect any tax from the income accrual. *See Plumb, supra* note 1, at 150. Accordingly, this article proposes that the new principles should apply only at the election of the taxpayer.

This article adopts this flexible approach because in many circumstances the tax savings to the taxpayer will not justify the additional complexity in the computation of federal income tax in the year of recovery. For example, assume a taxpayer whose miscellaneous itemized deductions exceed the two-percent floor. Under the current interpretation of the tax benefit rule, if the taxpayer gets a \$100 state tax refund which the taxpayer must include in income under the tax benefit rule, the taxpayer loses two dollars in miscellaneous itemized deductions. Even assuming the taxpayer falls in the highest marginal tax bracket of 39.6 percent after the Revenue Reconciliation Act of 1993, the lost deduction costs the taxpayer less than one dollar in tax. In such circumstances, the taxpayer may choose to follow the current interpretation of the tax benefit rule.

the Deficit Reduction Act of 1984,¹¹⁰ when a taxpayer recovers an amount that relates to a credit which produced a tax benefit in a prior taxable year, the taxpayer must increase tax liability for the year of recovery.¹¹¹ Because credits *directly* reduce tax liability, having the recovery of amounts used to claim credits *directly* increase tax liability makes sense.

In contrast, exclusions and deductions reduce taxable income, and they do so in different places. Offsets to gross receipts in arriving at net sales and additions to the cost of goods sold operate as exclusions. Such exclusions, which prevent an amount from being included in gross income, also reduce adjusted gross income and taxable income. Under the proposed principles, if a taxpayer previously excluded an amount attributable to a recovery from gross income, the taxpayer should include the recovery in gross income. The additional gross income would correspondingly increase adjusted gross income and taxable income for the year of recovery.

The Internal Revenue Service and the courts should permit taxpayers to apply this same approach to recoveries of both "above-the-line" and itemized deductions. Because taxpayers subtract "above-the-line" deductions from gross income in arriving at adjusted gross income, the Internal Revenue Service and the courts should permit taxpayers to report recoveries attributable to "above-the-line" deductions in the same place, as additional adjusted gross income, rather than as gross income.¹¹² The additional adjusted gross income would not affect a taxpayer's gross income, but would increase taxable income.¹¹³ Under these same principles, the Internal Revenue Service and the courts should permit a taxpayer who recovers an amount attributable to an itemized deduction that the taxpayer subtracted from adjusted gross income in computing taxable income to include the recovery directly in taxable income, rather than requiring the taxpayer to report additional gross income.¹¹⁴ The additional taxable income would not af-

110. Pub. L. No. 98-369, 98 Stat. 494, 698 (1984).

111. The increase equals the amount of the credit attributable to the recovered amount. I.R.C. § 111(b) (1988); *see supra* note 40.

112. If the taxpayer previously excluded or deducted an expenditure in computing income from self-employment, the taxpayer should include the recovery in self-employment income. *See, e.g.*, Rev. Rul. 73-408, 1973-2 C.B. 15, *as amplified by* Rev. Rul. 76-500, 1976-2 C.B. 254.

113. This situation could create an anomaly where a taxpayer's adjusted gross income would exceed gross income.

114. At least one state has adopted this approach in an administrative decision

fect gross income or adjusted gross income.¹¹⁵

IV. JUSTIFICATIONS

Although the tax benefit rule developed and exists as a judicial doctrine, the Internal Revenue Service has an obligation to follow case law in applying the Code. Consistent with separation of powers, courts must construe the inclusionary rule within the confines of the Internal Revenue Code. This part examines the reasons why the new principles operate within both the Code and the judicial framework already established for the tax benefit rule. If the Internal Revenue Service or the courts do not adopt the new principles, Congress should address this topic.

As currently interpreted, the application of the tax benefit rule to recoveries of deductions requires a double inclusion in gross income, generating "artificial gross income," which may create unnecessary unfairness, usually in favor of the government. The courts developed the inclusionary component and the exclusionary aspect to address certain inequities which can arise in an annual accounting system.¹¹⁶ Because tax rates change,¹¹⁷ however, the tax benefit rule tolerates some potential unfairness.¹¹⁸ With one exception,¹¹⁹ courts have not required the recovery of an item previously deducted to increase a taxpayer's tax liability in the year of recovery by the exact amount of tax that the taxpayer saved by deducting the item.¹²⁰ The proposed principles would reduce, if not elimi-

involving the determination of state taxable income. *See, e.g.*, Docket No. INC-86-136, 1987 Ala. Tax LEXIS 51 (Ala. Dep't of Revenue May 6, 1987); *see also* Docket No. INC-86-219, 1988 Ala. Tax LEXIS 63 (Ala. Dep't of Revenue Aug. 31, 1988) (involving corporate income tax).

115. Again, this situation could create an unusual scenario in that the taxpayer's taxable income could exceed both gross income and adjusted gross income.

116. *See supra* notes 19-27 and accompanying text.

117. Tax rates may change as taxpayers enter different tax brackets or as Congress adjusts the tax rate schedules.

118. *Hillsboro Nat'l Bank v. Commissioner*, 460 U.S. 370, 378 n.10 (1983) ("[T]he tax benefit rule is not a precise way of dealing with the transactional inequities that occur as a result of the annual accounting system . . .") (citations omitted); *id.* at 381 n.12 ("[T]he 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.")

119. *Perry v. United States*, 160 F. Supp. 270 (Ct. Cl. 1958), *overruled by Alice Phelan Sullivan Corp. v. United States*, 381 F.2d 399 (Ct. Cl. 1967).

120. *See, e.g.*, *Alice Phelan Sullivan Corp. v. United States*, 381 F.2d 399 (Ct.

nate, the unfairness from double inclusions and "artificial gross income" by giving taxpayers the option of reporting recoveries and other inconsistent events in the same place that the prior item affected the computation of federal income tax.

Because courts created the tax benefit rule as an equitable doctrine, equity suggests that the Internal Revenue Service and the courts should adopt the proposed principles.¹²¹ In *Hillsboro National Bank v. Commissioner*,¹²² the most recent Supreme Court opinion directly involving the tax benefit rule, the Court stated that courts must apply the rule on a case-by-case basis, "consider[ing] the facts and circumstances of each case in the light of the purpose and function of the provisions granting the deductions."¹²³ In another case¹²⁴ involving

Cl. 1967); *cf.* *United States v. Skelly Oil Co.*, 394 U.S. 678, 684 (1969). As a result, Plumb observes that: "[B]enefit, when viewed in terms of gross income rather than in terms of dollars of tax saved, is an artificial concept . . ." Plumb, *supra* note 1, at 151. Plumb also notes that witnesses at the hearings before the Senate Finance Committee on the Revenue Act of 1942 "unsuccessfully urged the adoption of a criterion measuring tax benefit in dollars of tax saved." *Id.* at 152 n.95 (citing Revenue Act of 1942: Hearings on H.R. 7378 Before the Senate Finance Committee, 77th Cong., 2d Sess. 1419, 1422-23 (1942) (statement of William A. Sutherland, Sutherland, Tuttle & Brennan), *reprinted in* 37 INTERNAL REVENUE ACTS, *supra* note 5; *id.* at 1762, 1784 (statement of Ellsworth C. Alvord, Chamber of Commerce of the United States); *id.* at 1795, 1802 (supplement to statement of Ellsworth C. Alvord). In a similar case arising under section 1341, the Supreme Court stated that "[t]here is no requirement that the deduction save the taxpayer the exact amount of taxes he paid because of the inclusion of the item in income for a prior year." *United States v. Skelly Oil Co.*, 394 U.S. 678, 684 (1969) (citing *Healy v. Commissioner*, 345 U.S. 278, 284-85 (1953)).

As a result of the Deficit Reduction Act of 1984, today section 111(b) requires taxpayers that recover amounts related to credits that they claimed in a prior taxable year to increase their tax liability in the year of recovery under certain circumstances. I.R.C. § 111(b) (1988); *see supra* notes 31 and 40 and accompanying text. The amendments in the Deficit Reduction Act, however, apply only to tax credits.

121. *See, e.g., Tennessee-Carolina Transp., Inc. v. Commissioner*, 582 F.2d 378, 382 (6th Cir. 1978), *cert. denied*, 440 U.S. 909 (1979) ("The tax benefit rule should be applied flexibly in order to counteract the inflexibility of the annual accounting concept which is necessary for administration of the tax laws.").

122. 460 U.S. 370 (1983).

123. *Id.* at 385.

124. *United States v. Skelly Oil Co.*, 394 U.S. 678 (1969). In that case, the taxpayer refunded amounts to customers for overcharges on natural gas. Because the taxpayer claimed an unrestricted right to its sales receipts, the taxpayer had included the overcharges in gross income and had claimed percentage depletion on those amounts. When the taxpayer refunded the overcharges, the taxpayer claimed a deduction for the full amount of the overcharges, without adjustment for the percentage depletion which the taxpayer had previously deducted. The Supreme Court, however, held that the taxpayer must reduce the deduction for the refunds by the amount of percentage depletion that the taxpayer had claimed on the over-

section 1341,¹²⁵ the analogue of the tax benefit rule, the Supreme Court stated that "the annual accounting concept does not require us to close our eyes to what happened in prior years."¹²⁶

Based upon these statements, the Internal Revenue Service and the courts should permit taxpayers to use a facts and circumstances test in applying the tax benefit rule. Such an approach would allow taxpayers to use the facts from the year of the previous tax benefit to determine where to report the recovery or other inconsistent event. After all, the courts have always used such a test in determining whether the tax benefit rule applies.¹²⁷ In other contexts, events in the earlier year have determined the character of income resulting from a recovery.¹²⁸ The proposed principles implement the Supreme Court's instruction that a court must apply the tax benefit rule

charges. The Court reasoned that the Code did not give taxpayers a deduction for refunding money that the taxpayers did not originally pay tax on when received. In essence, the Supreme Court "assume[d] a broad equitable authority to weed out tax benefits which it calls 'double deductions' . . ." *Id.* at 695 (Stewart, J., dissenting).

125. I.R.C. § 1341 (1988). Under the "claim of right" doctrine, a taxpayer must report amounts which the taxpayer receives without restriction as gross income, even though the taxpayer may have to return the income, in whole or in part, in a later year. If the taxpayer repays an amount in a subsequent year because the taxpayer did not have a right to the payment in the earlier year, the taxpayer may deduct the repayment in the later year. If, however, the repayment exceeds the taxpayer's income in the year of repayment or the taxpayer falls in a lower tax bracket in the year of repayment, the deduction may not compensate the taxpayer for the tax which the taxpayer paid in the earlier year. If the repayment exceeds \$3,000, section 1341 offers relief by giving the taxpayer the option to reduce the tax for the year of repayment by the amount of tax in the previous year attributable to reporting the income under the "claim of right" doctrine. If deducting the repaid amount produces a greater tax savings in the year of the repayment, however, the taxpayer may claim the deduction instead. *Id.*

Interestingly, the regulations implementing section 1341 provide:

[I]f the amounts of other items in the return are dependent upon the amount of adjusted gross income, taxable income, or net income (such as charitable contributions, foreign tax credit, deductions for depletion, and net operating loss), appropriate adjustment shall be made as part of the computation of the decrease in tax.

Treas. Reg. § 1.1341-1(d)(4)(ii) (as amended in 1978); see also Joel Rabinovitz, *Effect of Prior Year's Transactions on Federal Income Tax Consequences of Current Receipts or Payments*, 28 TAX L. REV. 85 (1972).

126. *Skelly Oil Co.*, 394 U.S. at 684.

127. Plumb, *supra* note 1, at 179; *Dobson v. Commissioner*, 320 U.S. 489, 493 (1943) ("[The Tax Court] went to prior years only to determine the nature of the recovery . . ."); see also *supra* note 123 and accompanying text.

128. See, e.g., *Arrowsmith v. Commissioner*, 344 U.S. 6 (1952); see Rabinovitz, *supra* note 125, at 116-27.

on a case-by-case basis, "consider[ing] the facts and circumstances of each case in the light of the purpose *and function* of the [previous] deductions."¹²⁹ Additionally, the suggested prescription "does no violence to the annual accounting system,"¹³⁰ nor does it reopen earlier returns. The proposed principles, moreover, do not require the additional tax from the inclusion to equal the tax savings from the deduction in the prior year.¹³¹

Fifty years ago, Plumb recognized that when formulating the tax benefit rule, courts faced the challenge of framing an equitable solution that did not conflict with existing statutes.¹³² The proposed principles fit within the Internal Revenue Code. Indeed, Congress itself has recognized that items subject to the tax benefit rule affect federal tax computations differently. By requiring taxpayers to treat recoveries of amounts previously claimed as credits differently from other recoveries,¹³³ Congress ratified the concept that gross income does not automatically increase when the tax benefit rule obliges a taxpayer to reflect a recovery in the computation of federal income tax. The Code, however, does not explicitly specify any treatment for recoveries of amounts that taxpayers previously excluded or deducted from gross income.

Fundamental fairness and common sense suggest that because an exclusion never entered into gross income in the first place, taxpayers should report recoveries of exclusions as gross income. Deductions, on the other hand, offset gross income in the computation of taxable income and may have affected the computation of adjusted gross income.¹³⁴ Within the framework of an annual accounting system, the legislative history underlying the Deficit Reduction Act of 1984 acknowledges a congressional recognition that the tax benefit rule at-

129. *Hillsboro Nat'l Bank v. Commissioner*, 460 U.S. 370, 385 (1983) (emphasis added).

130. *Skelly Oil Co.*, 394 U.S. at 685.

131. See *supra* note 120 and accompanying text; see also *Skelly Oil Co.*, 394 U.S. at 685-86.

132. Plumb, *supra* note 1, at 177.

133. When a taxpayer recovers an amount that relates to a credit claimed in a prior taxable year, the taxpayer must increase tax liability for the year of recovery if the credit reduced the taxpayer's tax in the earlier year. See *supra* notes 31 and 39 and accompanying text.

134. "Above-the-line" deductions affect the computation of adjusted gross income and taxable income. Itemized deductions, in comparison, only affect the computation of taxable income. See *supra* note 47.

tempts to put taxpayers in roughly the same position as if the previous item had not affected the computation of their tax liability.¹³⁵ Because the proposed principles permit taxpayers to include a recovery in the place that the previous item entered into the computation of federal income tax, the suggested prescription advances those attempts.¹³⁶

Finally, the statutory framework that existed at the time Congress partially codified the tax benefit rule in 1942 supports these principles. In 1942, the term "adjusted gross income" did not exist¹³⁷ and the Internal Revenue Code treated most "credits" like other deductions.¹³⁸ Courts, furthermore, apparently did not apply the tax benefit rule to exclusions until 1957.¹³⁹ These circumstances may explain why the partial

135. H.R. REP. NO. 432, 98th Cong., 2d Sess., pt. 2, at 1368 (1984), *reprinted in* 1984 U.S.C.C.A.N. 697, 1015 ("The rationale of the tax benefit rule is that the taxpayer should be put in more or less the same after-tax position as if only the proper amount had been deducted.").

136. These situations do not present scenarios where taxpayers are asking courts to substitute a judicial rule for one that Congress has prescribed. Congress simply has not acted in this regard.

137. The Individual Income Tax Act of 1944, effective for taxable years beginning after December 31, 1943, added the term "adjusted gross income" to the Internal Revenue Code of 1939. Pub. L. No. 78-315, §§ 2, 8(a), 58 Stat. 231, 235-36 (1944). Congress used "adjusted gross income" as the basis for determining (1) the tax under Supplement T relating to individuals with adjusted gross incomes below \$5,000, (2) the amount of the optional standard deduction available to taxpayers with adjusted gross incomes greater than or equal to \$5,000, (3) the amount of the deduction for charitable contributions, (4) the amount of the deduction for medical and dental expenses, and (5) the amount of the normal-tax exemption in the case of a married couple filing a joint return. H.R. REP. NO. 1365, 78th Cong., 2d Sess. 22-25 (1944), *reprinted in* 111 INTERNAL REVENUE ACTS, *supra* note 5.

138. *See supra* note 38. Most credits acted like deductions and did not reduce tax on a dollar for dollar basis. These "credits of individuals against net income" provided reductions "against net income provided in section 25" for interest on United States obligations, interest on obligations of instrumentalities of the United States, earned income, personal exemptions, and dependents. BARTON, *supra* note 38, at 104, 106, 108. Several credits, however, reduced tax on a dollar for dollar basis. These "credits against tax" included credits for taxes of foreign countries and possessions of the United States, taxes withheld at source, and overpayments. *Id.* at 138.

139. *See supra* note 36. In *Keystone National Bank v. United States*, 57-2 U.S. Tax Cas. (CCH) ¶ 9773 (W.D. Pa. 1957), the court held that the tax benefit rule applied to reimbursements of items that a taxpayer did not include in gross income as well as to recoveries of amounts that a taxpayer deducted. The court upheld the Commissioner's refusal to grant a refund, concluding that the bank must include a reimbursement from a bonding company for sums that an employee embezzled in earlier years in taxable income under the tax benefit rule. The bank did not report the embezzlements as income or claim the amounts as deductible losses.

codification of the tax benefit rule in 1942 implied that taxpayers should include recoveries in gross income, rather than adjusted gross income or taxable income. Perhaps for these same reasons, Congress did not distinguish between recoveries of deductions, credits, and exclusions.¹⁴⁰ Because Congress partially codified the *exclusionary* aspect of the tax benefit rule at a time when the term "adjusted gross income" did not exist in the Internal Revenue Code,¹⁴¹ the Internal Revenue Service and the courts should not limit the judicial doctrine's *inclusionary* component to its scope in 1942, especially when the computation of federal income tax liability today differs significantly from the computation of tax in 1942.¹⁴² One can

140. This historical perspective also explains why the language in the original codified tax benefit rule that "[i]ncome attributable to the recovery during the taxable year of a bad debt, prior tax, or delinquency amount, to the extent of the amount of the recovery exclusion with respect to such debt, tax, or amount" would "not be included in gross income" could not have drawn a distinction between "gross income" and "adjusted gross income." See *supra* note 29.

141. Section 111 and its predecessors codify the *exclusionary* aspect of the rule. With the exception of certain language in section 111(b)(1), Congress has not codified the *inclusionary* component of the rule.

142. Over the past fifty years, but particularly during the last ten years, Congress has added numerous provisions which make the distinctions between gross income, adjusted gross income, and taxable income important. As previously mentioned, the term "adjusted gross income" did not exist until the Individual Income Tax Act of 1944; see *supra* note 137. In addition to reenacting the tax benefit rule, the Internal Revenue Code of 1954 added the deduction for soil and water conservation expenditures. Pub. L. No. 83-591, § 175, 68A Stat. 1, 67-68 (1954); see *supra* note 73 and accompanying text. In the Tax Reform Act of 1969, Congress added the "hobby loss" rules for taxable years beginning after December 31, 1969. Pub. L. No. 91-172, § 213(a), (d), 83 Stat. 487, 571-72 (1969); see *supra* note 74 and accompanying text. The Tax Reduction Act of 1975 applied adjusted gross income to the earned income credit for the first time for taxable years beginning after December 31, 1974 and before January 1, 1976. Pub. L. No. 94-12, §§ 204(a), 209(b), 89 Stat. 26, 30-31, 35 (1975); see *supra* note 90 and accompanying text. Then, the Tax Reform Act of 1976 created the credit for the elderly, the credit for child and dependent care expenses necessary for gainful employment, and the home office and vacation home rules for taxable years beginning after December 31, 1975. Pub. L. No. 94-455, §§ 503(a), 504(a)(1), 601(a), 90 Stat. 1520, 1559-62, 1563, 1569-72 (1976); see *supra* notes 75, 88 and 89. During the last ten years, the Social Security Amendments of 1983 added the provision requiring taxpayers to include a portion of their social security benefits in gross income when their "modified adjusted gross income" and one-half of the social security benefits during a taxable year exceed certain base amounts and expanded the credit for the elderly to also apply to the permanently and totally disabled. The legislation applied to benefits received after December 31, 1983 in taxable years beginning after that date. Pub. L. No. 98-21, §§ 121(a), 121(g), 122(a), 97 Stat. 65, 80-81, 84-87 (1983); see *supra* notes 78 and 89. In the Tax Reform Act of 1986, Congress enacted the two percent floor on miscellaneous itemized deductions, the passive loss rules and the exception for rental real estate activities in which the taxpayer actively participated and limited

conclude, therefore, that the prescription addresses certain inequities which arise in our annual accounting system without conflicting with the Internal Revenue Code.

V. RESERVATIONS

The preceding part presented arguments urging the Internal Revenue Service and the courts to permit taxpayers to report recoveries of previous *deductions*¹⁴³ that reduced the amount of federal income tax paid as adjusted gross income or taxable income, rather than gross income. Arguments exist, however, against such an extension of the tax benefit rule. This part examines, and rejects, several reasons why the proposed principles may not operate within the Internal Revenue Code and the judicial framework that the courts have established for the rule. Additionally, this part points to the increased complexity which would result in an already complicated area as another argument against adopting the proposed prescription. The proposed principles, however, minimize additional complexity because they give taxpayers the option of reporting the recovery or other inconsistent event in the same place that the previous item affected the computation of federal income tax liability. A taxpayer could always elect to report a recovery under the current application of the tax benefit rule if the tax

the ability of certain active participants in pension plans to deduct contributions to their individual retirement accounts for tax years beginning after December 31, 1986. Pub. L. No. 99-514, §§ 132(a), 151(a), 501(a), 501(c)(1), 1411(a), 1411(c), 100 Stat. 2085, 2113, 2121, 2241, 2411-13, 2714-16 (1986); *see supra* notes 85-87. The Technical and Miscellaneous Revenue Act of 1988 authorized the exclusion from gross income for interest on certain United States savings bonds used to pay higher education tuition and fees for taxable years beginning after December 31, 1989. Pub. L. No. 100-647, § 6009(a), (c), 102 Stat. 3342, 3688-90 (1988); *see supra* note 79. The Omnibus Budget Reconciliation Act of 1990 added the phaseouts for personal exemptions and itemized deductions when adjusted gross income reaches certain levels for taxable years beginning after December 31, 1990. Pub. L. No. 101-508, §§ 11,103(a), (e), 11,104(a), (c), 104 Stat. 1388, 1388-406 to 1388-408 (1990); *see supra* notes 92-93. That same legislation also amended the provision governing the recapture of federally subsidized mortgage interest upon the disposition of a residence within nine years of purchase so that the recapture amount depends upon the excess of the taxpayer's modified adjusted gross income in the year in which the sale or other disposition occurs over the adjusted qualifying income for that year. Pub. L. No. 101-508, § 11408(c)(2)(B), 104 Stat. 1388, 1388-477 (1990); *see supra* note 96.

143. The extension would not apply to exclusions or credits. Exclusions never entered into gross income in the first place. Congress has required special treatment for credits. *See supra* notes 31 and 40 and accompanying text.

savings do not justify the additional complexity.¹⁴⁴

As a preliminary matter, opponents of the proposed principles could argue that the prescription does not offer precision in dealing with the transactional inequities that occur as a result of the annual accounting system. For example, a sole proprietor who excluded customs duties from gross income as part of the cost of goods sold may have reduced adjusted gross income to a level which did not subject the taxpayer to the phaseouts of itemized deductions and personal exemptions. If the sole proprietor later obtains a refund of those duties, the sole proprietor must include the refund in income, but need not recalculate tax liability for the earlier year based on the phaseouts of itemized deductions and personal exemptions.¹⁴⁵ In response, one could argue that the tax benefit rule, as currently interpreted, would not remedy such inequities either because the rule does not reopen the previous year. With the one exception previously cited, the courts have been satisfied with the imprecise adjustments that the tax benefit rule produces.¹⁴⁶

As a judicial doctrine, the tax benefit rule must operate within the confines of the Internal Revenue Code. In theory, opponents of the proposed principles can argue that the plain language of section 111 precludes the proposed principles. Section 111(a) specifically provides that: "*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 that such amount did not reduce the amount of tax imposed by this chapter."¹⁴⁷ That language implies that a taxpayer must include the remainder of a recovery in *gross income* for the year of recovery.¹⁴⁸

This criticism, however, fails to recognize that the proposed principles involve the *inclusionary* component of the tax benefit rule. The Revenue Act of 1942 partially codified the *exclusionary* aspect.¹⁴⁹ With the exception of the language in

144. See *supra* note 109.

145. As previously noted, the proposed principles do not eliminate the unfairness which can operate against the government. See *supra* note 109.

146. See *supra* note 120 and accompanying text. *Contra* Perry v. United States, 160 F. Supp. 270 (Ct. Cl. 1958), *overruled by* Alice Phelan Sullivan Corp. v. United States, 381 F.2d 399 (1967) (refusing to penalize the taxpayers for increase in tax rates between year of deduction and year of recovery).

147. I.R.C. § 111(a) (1988) (emphasis added); see *supra* note 31.

148. Hillsboro Nat'l Bank v. Commissioner, 460 U.S. 370, 380 n.10 (1983).

149. See *supra* note 29 and accompanying text.

section 111(b)(1) relating to tax credits, Congress has not codified the inclusionary component of the rule. For this reason, one should not place undue emphasis on the *exclusionary* language in section 111(a).¹⁵⁰

Opponents of the proposed principles could also argue that Congress should initiate any change to remedy unfairness which Congress may perceive involving the application of the tax benefit rule. Based on existing case law, these critics could assert that Congress must have known of the coexistence of the tax benefit rule and the term "adjusted gross income" during the fifty years that have elapsed since Congress added "adjusted gross income" to the Code.¹⁵¹ These critics also might argue that the Deficit Reduction Act of 1984 shows that Congress knows how to distinguish between recoveries of deductions and credits.¹⁵² Presumably, if Congress also wanted to draw a distinction between the way recoveries of deductions and exclusions affect the computation of federal income tax, Congress could have done so. But Congress has not done so. Such opponents can argue that because Congress has not acted,

150. See *supra* notes 141-42 and accompanying text.

151. In *Weiser v. United States*, 746 F. Supp. 958, 963 (N.D. Cal. 1990), *aff'd*, 959 F.2d 146 (9th Cir. 1992), the government argued that the since Congress added the tax benefit rule under the alternative minimum tax provisions of the Internal Revenue Code at a time when only the add-on minimum tax existed and the use of the alternative minimum tax differs structurally from the add-on minimum tax which existed at the time, it would be inappropriate to apply the tax benefit rule to the alternative minimum tax. Although the court did not accept this argument, the court nevertheless granted the government's motion for summary judgment. *Id.* at 963-64. Based on a statement in the legislative history that "relief from the minimum tax under the tax benefit rule is not appropriate solely by reason of the fact that a taxpayer has received no benefit under the regular tax with respect to a particular item," the court concluded that Congress intended to limit application of the tax benefit rule to the alternative minimum tax. *Id.* at 963 (emphasis omitted) (quoting H.R. CONF. REP. NO. 841, 99th Cong. 2d Sess., 4350-51 (1986), reprinted in 1986 U.S.C.C.A.N. 4075, 4350-51). Similarly, one could argue that Congress has known of the co-existence of the tax benefit rule and adjusted gross income in the Internal Revenue Code during the fifty years that have elapsed since the addition of adjusted gross income to the Code.

152. At the time that Congress partially codified the rule in 1942, Congress arguably appreciated the difference between deductions and credits. Congress, for example, defined the term "prior tax" as "a tax on account of which a *deduction or credit* was allowed for a prior taxable year." See Revenue Act of 1942, *supra* note 29 (emphasis added). Congress also defined "delinquency amount" as "an amount paid or accrued on account of which a *deduction or credit* was allowed for a prior taxable year and which is attributable to failure to file return with respect to a tax, or pay a tax, within the time required by the law under which the tax is imposed, or to failure to file return with respect to a tax or pay a tax." *Id.* (emphasis added).

regardless of whether or not Congress has even considered the problem, the courts should not engage in judicial legislation.¹⁵³

In response, these critics ignore the fact that the *inclusionary* component of the tax benefit rule developed as a *judicial doctrine*. To reiterate, with the exception of the language in section 111(b)(1) relating to credits, Congress has not codified the *inclusionary* component of the rule. In addition, at the time Congress added section 111(b)(1) to the Code, the legislative history specifically stated that “[n]o change is made to the present law rules relating to what constitutes the recovery of an item previously deducted and no inference is intended as to the scope of those rules under present law.”¹⁵⁴ Congress has been aware of the inclusionary component for more than fifty years. During that time, Congress has retained the tax benefit rule in essentially its original form and has explicitly declined to limit the courts’ authority in this area. The courts, moreover, should reject any argument that only Congress can initiate any change involving the tax benefit rule. In principle, such an argument would prevent any court from improving any judicial doctrine in any area of the law, presumably on the grounds that the legislature knows everything. Ironically, if courts had accepted this argument in the 1930s and 1940s, the tax benefit rule never would have come into existence because Congress must have known that annual accounting causes transactional inequities.

Finally, opponents of the prescription could argue that even if the proposed principles improve fairness, the improvement does not justify the additional complexity¹⁵⁵ that such

153. See, e.g., *Commissioner v. South Lake Farms, Inc.*, 324 F.2d 837, 840 (9th Cir. 1963).

154. H.R. CONF. REP. NO. 861, 98th Cong., 2d Session 1011 (1984), reprinted in 1984 U.S.C.C.A.N. 1445, 1699.

155. If the Internal Revenue Service accepts the suggested prescription, at a minimum it should revise the instructions to Form 1040, U.S. Individual Income Tax Return. Presumably, a taxpayer could report recoveries of “above-the-line” deductions directly on Line 31, “Adjusted Gross Income,” by adding the amount of the recovery and attaching an explanation. See INTERNAL REVENUE SERVICE, U.S. DEPT OF TREASURY, FORM 1040, U.S. INDIVIDUAL INCOME TAX RETURN (1993). A taxpayer could similarly report recoveries of itemized deductions directly on Line 37, “Taxable income.” *Id.* As previously noted, Form 1040, U.S. Individual Income Tax Return, does not provide a specific line for increasing tax liability to reflect the recovery of an amount that relates to a credit claimed in a prior taxable year. See *supra* note 40.

In the alternative, the Internal Revenue Service could delete Line 10, “Taxable refunds, credits, or offsets of state and local income taxes from worksheet on page

an interpretation would incorporate into the computation of taxable income.¹⁵⁶ Although the tax benefit rule seems very simple on its face, the application of the rule already creates significant complexity under many circumstances.¹⁵⁷ Fifty years ago, Plumb warned that "the tax benefit rule introduces infinite difficulties of administration and computation for both the Government and the taxpayer."¹⁵⁸ Ultimately, however, the tax benefit rule exists as an equitable doctrine to reduce unfairness. As between fairness and complexity, fairness should control.¹⁵⁹

The proposed principles, moreover, minimize additional complexity because they give taxpayers the option of reporting a recovery or other inconsistent event relating to an earlier deduction as either gross income or in the same place that the previous item affected the computation of federal income tax liability.¹⁶⁰ If the tax savings from reporting the recovery in

16" and add two additional lines. After subtracting "Adjustments to Income" on page one, the Service could add a new line "Recoveries of deductions previously used to determine adjusted gross income." Similarly, after subtracting the amount for personal exemptions on page two, the Service could add a new line "Recoveries of items previously claimed as itemized deductions."

In addition, the Internal Revenue Service and the Treasury Department should consider amending the existing regulations which the Treasury Department adopted in 1956 and which do not reflect significant legislative changes enacted in the Bankruptcy Tax Act of 1980, the Deficit Reduction Act of 1984, and the Tax Reform Act of 1986. *See supra* note 32; *see also* William L. Ruby, *State Tax Refunds and the Tax Benefit Rule: An IRS Dance on the Head of a Pin*, 61 TAX NOTES 980, 982 (1993).

156. These opponents could perhaps argue that the courts should remember the caution in *Dobson v. Commissioner*, 320 U.S. 489, 494-95 (1943), when Justice Jackson wrote: "No other branch of the law touches human activities at so many points. [Tax law] can never be made simple, but we can try to avoid making it needlessly complex."

157. These circumstances include when the taxpayer receives any refund other than an income tax refund or a refund for a tax year other than the previous tax year; when the taxpayer's adjusted gross income exceeded the base amount for the phase-out of itemized deductions; when the taxpayer's taxable income fell below zero; when the taxpayer owed alternative minimum tax in the previous year; when the taxpayer had unused credits from a previous year; or when another taxpayer could claim the taxpayer as a dependent in the earlier year. INTERNAL REVENUE SERVICE, U.S. DEPT OF TREASURY, INSTRUCTIONS FOR FORM 1040 AND SCHEDULES A, B, C, D, E, EIC, F, AND SE 17 (1993).

158. Plumb, *supra* note 1, at 177.

159. If the Internal Revenue Service and the courts fail to allow the tax benefit rule to equitably address unfairness, Congress may need to amend section 111. Unfortunately, such amendments would probably only create more complexity for the tax benefit rule. *Putoma Corp. v. Commissioner*, 66 T.C. 652, 680 (1976) (Simpson, J., dissenting in part), *aff'd*, 601 F.2d 734 (5th Cir. 1979).

160. *See supra* note 109.

the same place that the previous item affected the computation of federal income tax liability do not justify the additional complexity, the taxpayer can always elect to report the recovery as gross income under the current interpretation of the tax benefit rule.

VI. CONCLUSION

As the Internal Revenue Code has grown in complexity, the different ways that an item can affect the computation of taxable income, as either an exclusion, "above-the-line" deduction or itemized deduction, have become increasingly important. Each step in the computation of taxable income, beginning with gross income, proceeding to adjusted gross income, and ending with taxable income itself, has independent significance. When a taxpayer recovers an item that previously affected the computation of taxable income, the type of income that the taxpayer must report can be almost as important as whether the taxpayer must recognize income.

Because exclusions and deductions affect the computation of taxable income differently, requiring individuals to report all recoveries and other inconsistent events as gross income can produce inequitable results, especially for taxpayers. In the interest of equity, the Internal Revenue Service and the courts should construe the tax benefit rule to permit taxpayers to report recoveries in the same place that the previous exclusion or deduction affected the computation of taxable income in the earlier year. Congress already requires this treatment for recoveries of amounts previously used to qualify for a tax credit.

Applying these principles, taxpayers should report recoveries of exclusions as gross income because exclusions never entered into gross income in the previous year. "Above-the-line" deductions, in contrast, offset gross income in determining adjusted gross income. The Internal Revenue Service and the courts, therefore, should permit taxpayers to report recoveries of "above-the-line" deductions which produced a tax benefit as additional adjusted gross income, rather than as gross income. Because itemized deductions only affect the computation of taxable income, the Internal Revenue Service and the courts should allow taxpayers to report recoveries of itemized deductions which produced a tax benefit as taxable income, rather than as gross income or adjusted gross income.

In the absence of congressional adoption of the proposed principles, the Internal Revenue Service and the courts must

ultimately decide whether the proposed principles fit within the confines of the Internal Revenue Code. Strong arguments exist on both sides of this issue. The proposed principles, however, modify a long-standing judicial doctrine involving the *inclusionary* component of the tax benefit rule. With the exception of language in section 111(b)(1) relating to tax credits, Congress has not codified this inclusionary component. More than fifty years ago, Congress partially codified the *exclusionary* aspect of the tax benefit rule at a time when the term "adjusted gross income" did not exist in the Internal Revenue Code. The Internal Revenue Service and the courts, therefore, should not limit the judicial doctrine's *inclusionary* component to its operation at the time of the Revenue Act of 1942, especially when the computation of taxable income today differs significantly from the computation of taxable income in 1942. For these reasons, the Internal Revenue Service and the courts should adopt the proposed prescription for the tax benefit rule.