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AN ESSAY ON THE CONCEPTUAL FOUNDATIONS OF THE TAX BENEFIT RULE

Patricia D. White*

A good deal has been written over the past forty-odd years about the tax benefit rule. Over this period the federal courts have decided many cases in which its application has been at issue,¹ and the law journals have published a small but steady stream of commentary on the rule and its manifestations.² Last term, in *Hillsboro National Bank v. Commissioner*,³ the Supreme Court issued an opinion that focused squarely, and at some length, on the tax benefit rule. Despite this attention, relatively little has been done to examine the conceptual foundations of the tax benefit rule⁴ and to try, in the light of that examination, to give a coherent account of the principle behind the rule. This essay attempts to begin to fill that void.

The phrase "tax benefit rule" has been widely used to refer to the requirement that a taxpayer who *recovers* an amount that he deducted in an earlier year include the recovery in his income for the

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1. Federal courts have regularly ruled on the tax benefit doctrine since its codification as section 116 of the Revenue Act of 1942, Pub. L. No. 77-753, 56 Stat. 798 (1942). Two examples of the rule's early application are *Dobson v. Commissioner*, 320 U.S. 489 (1943), and *Central Hanover Bank & Trust Co. v. United States*, 159 F.2d 865 (2d Cir. 1947). For more recent applications of the principle, see *Mayfair Minerals, Inc. v. Commissioner*, 456 F.2d 622 (5th Cir. 1972); *Alice Phelan Sullivan Corp. v. United States*, 381 F.2d 399 (Ct. Cl. 1967).

2. See, e.g., Bittker & Kanner, *The Tax Benefit Rule*, 26 UCLA L. REV. 265 (1978); Byrne, *The Tax Benefit Rule as Applied to Corporate Liquidations and Contributions to Capital: Recent Developments*, 56 NOTRE DAME LAW. 215 (1980); Feld, *The Tax Benefit of Bliss*, 62 B.U. L. REV. 443 (1982); Plumb, *The Tax Benefit Rule Today*, 57 HARV. L. REV. 129 (1943); Plumb, *The Tax Benefit Rule Tomorrow*, 57 HARV. L. REV. 675 (1944); Tye, *The Tax Benefit Doctrine Reexamined*, 3 TAX L. REV. 329 (1948); Note, *Tax Treatment of Previously Expensed Assets in Corporate Liquidations*, 80 MICH. L. REV. 1636 (1982) [hereinafter cited as Note, *Previously Expensed Assets*]; Note, *The Tax Benefit Rule, Claim of Right Restorations, and Annual Accounting: A Cure for the Inconsistencies*, 21 VAND. L. REV. 995 (1968) [hereinafter cited as Note, *Claim of Right Restorations*]; Comment, *The Tax Benefit Rule and the Loss Carryover Provisions of the 1954 Code*, 67 YALE L.J. 1394 (1958).

3. 103 S. Ct. 1134 (1983).

4. A notable exception is Note, *Previously Expensed Assets*, *supra* note 2. However, this piece mistakenly concludes that inclusion of an amount of a prior deduction in income under the tax benefit rule is tantamount to the realization of income. See note 96 *infra*.

current year unless he received no tax benefit from the deduction.⁵ In *Hillsboro*, the Supreme Court rejected this "recovery" formulation⁶ and described the rule instead as "ordinarily apply[ing] to require the inclusion of income when events occur that are *fundamentally inconsistent* with an earlier deduction."⁷ In a lengthy separate opinion and partial dissent, Justice Stevens sharply criticized the Court's "reformulation" as "an extremely significant enlargement of the tax collector's powers."⁸ Although Justice Stevens' concern is understandable and although the majority opinion is objectionable on a number of grounds,⁹ I shall argue that the majority's

5. See, e.g., M. CHIRELSTEIN, FEDERAL INCOME TAXATION ¶ 10.03, at 204-06 (3d ed. 1982); Bittker & Kanner, *supra* note 2, at 265; see generally articles cited at note 2 *supra*. I.R.C. § 111 (1982) provides:

(a) General Rule.—Gross income does not include 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.

(b) Definitions.—For purposes of subsection (a)—

(1) Bad debt.—The term "bad debt" means a debt on account of the worthlessness or partial worthlessness of which a deduction was allowed for a prior taxable year.

(2) Prior tax.—The term "prior tax" means a tax on account of which a deduction or credit was allowed for a prior taxable year.

(3) 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 tax.

(4) 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 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 subtitle (not including the accumulated earnings tax imposed by section 531 or the tax on personal holding companies imposed by section 541) or corresponding provisions of prior income tax laws (other than subchapter E of chapter 2 of the Internal Revenue Code of 1939, relating to World War II excess profits tax), reduced by the amount excludable in previous taxable years with respect to such debt, tax, or amount under this section.

(c) Special Rules for Accumulated Earnings Tax and for Personal Holding Company Tax.—In applying subsections (a) and (b) for the purpose of determining the accumulated earnings tax under section 531 or the tax under section 541 (relating to personal holding companies)—

(1) a recovery exclusion allowed for purposes of this subtitle (other than section 531 or section 541) shall be allowed whether or not the bad debt, prior tax, or delinquency amount resulted in a reduction of the tax under section 531 or the tax under section 541 for the prior taxable year; and

(2) where a bad debt, prior tax, or delinquency amount did not result in a reduction of the tax under section 531 or the tax under section 541.

(d) Increase in Carryover Treated as Yielding Tax Benefit.—For purposes of paragraph (4) of subsection (b), an increase in a carryover which has not expired shall be treated as a reduction in tax.

6. See 103 S. Ct. at 1142.

7. 103 S. Ct. at 1138 (emphasis added).

8. 103 S. Ct. at 1154 (Stevens, J., concurring in part, dissenting in part).

9. For a good discussion of some of the objectionable features, see Blum, *The Role of the Supreme Court in Federal Income Tax Controversies—Hillsboro National Bank and Bliss Dairy, Inc.*, 61 TAXES 363 (1983).

account of the tax benefit rule is close to being consistent with the only principled justification that can be offered for the rule.

My aim in this essay is to explore the foundations of the tax benefit notion. My strategy is simple, but it is probably best to state it explicitly at the outset. I begin with a straightforward and uncontroversial example of the application of the "inclusionary aspect"¹⁰ of the tax benefit rule. Using it as a paradigm, I try to discern why the law deems it appropriate to increase a taxpayer's taxable income. Next I examine the account of the tax benefit rule given by the Supreme Court in *Hillsboro* to see if it is consistent with the paradigm. I conclude that the results in *Hillsboro* are consistent, but that the rationale offered by the Court does not fully explain the principle. Along the way I suggest an analysis of the tax benefit principle that attempts to capture the notion exemplified by the paradigm. Throughout, my premise is a variant of the supposition that always underlies conceptual analysis: namely, that the features which characterize a principle in its simplest forms will also characterize it in more complex circumstances. My hope is that as extraneous factors are stripped away, we can more instructively begin to come to grips with the core concept underlying the tax benefit rule.

I. THE BACKGROUND OF THE TAX BENEFIT RULE

Under any formulation, the tax benefit rule has two aspects. The part of the rule that mandates the inclusion of some previously deducted amount in a taxpayer's income, the "inclusionary component," is the conceptually prior part and the one on which this analysis will focus. The part that conditions the requirement of inclusion on there having been a tax benefit as a result of the earlier deduction is known as the "exclusionary component" and is currently set forth in section 111 of the Internal Revenue Code.¹¹ The name "tax benefit rule" seems originally to have been used to describe the exclusionary component alone, but its use has uniformly spread to embrace both aspects.¹²

10. See text accompanying notes 11-12 *infra*.

11. I.R.C. § 111 (1982) provides for the exclusion of recovery amounts related to deductions for bad debts, prior taxes, and delinquency amounts only. See note 5 *supra*. However, section 111's reach has been generalized by *Dobson v. Commissioner*, 320 U.S. 489 (1943) (Tax Court not required to treat recovery of losses from sale of stock as taxable income when the taxpayer derived no tax benefit from the losses, even though the statute did not specifically exclude such recoveries from income). See *Treas. Reg. § 1.111-1(a)* (1956).

12. Although the operation of what is today called "the tax benefit rule" was a subject for discussion and adjudication long before the enactment of the Revenue Act of 1942, at first the concept was not typically given a name in legal writings. See, e.g., *Excelsior Printing v. Commissioner*, 16 B.T.A. 886 (1929); *G.C.M. 22163, 1940-2 C.B. 76*. By 1942, the Board of Tax

The history of the tax benefit rule has been set forth elsewhere¹³ and need only be recounted briefly here. Although the principle that if a taxpayer recovers¹⁴ an amount that he deducted in an earlier tax year, he should include it in his income for the year of the recovery, was first articulated by the Bureau of Internal Revenue in 1914,¹⁵ it was not accepted by the Board of Tax Appeals until 1927.¹⁶ Since then it has been an acknowledged feature of the federal income tax system.¹⁷ The exclusionary aspect of the rule initially surfaced in 1932 when it was rejected by the Board of Tax Appeals.¹⁸ It received its first official sanction in 1937 in a ruling published by the Bureau¹⁹ and, although the Bureau had changed its position by 1940,²⁰ Con-

Appeals applied the titles "tax benefit rule" and "tax benefit theory" primarily, if not exclusively, to the rule's exclusionary component. See *Haughey v. Commissioner*, 47 B.T.A. 1 (1942). Legal commentators from the same period differed in their use of the phrase. See, e.g., Lassen, *The Tax Benefit Rule and Related Problems*, 20 TAXES 473 (1942) (uses "tax benefit rule" to describe both inclusionary and exclusionary components); Plumb, *The Tax Benefit Rule Today*, *supra* note 2, at 130-31 (refers to inclusionary component as a "general rule" without naming it). Current usage favors Lassen's treatment. See, e.g., Bittker & Kanner, *supra* note 2, at 271-72.

13. See Note, *Claim of Right Restorations*, *supra* note 2, at 999-1010. See generally articles cited at note 2 *supra*.

14. The recovery requirement has not been given a satisfactory definition in the case law applying the tax benefit rule. See, e.g., Reveley & Pratt, *Tax Benefit Rule: What Constitutes a Recovery? Sixth and Ninth Circuits Disagree*, 57 TAXES 416, 417-18 (1979). Nevertheless, judicial application of the tax benefit rule has generally been triggered by an event that yields actual economic benefit to the taxpayer. See, e.g., *Nash v. United States*, 398 U.S. 1 (1970). The Ninth Circuit required an actual recovery in *Commissioner v. South Lake Farms*, 324 F.2d 837, 840 (9th Cir. 1963) (liquidating corporation that transferred expensed items to successor corporation had not met requirement that the taxpayer receive or become entitled to receive money or property equal to the amount previously spent and deducted). The Sixth Circuit, in an essentially equivalent factual situation, rejected that holding in *Tennessee-Carolina Transp., Inc. v. Commissioner*, 582 F.2d 378 (6th Cir. 1978), *cert. denied*, 440 U.S. 909 (1979); see also Reveley & Pratt, *supra*, at 417-18. Although its decision did not depend on this holding, the court in *Tennessee-Carolina* held that a transfer of expensed assets by a liquidating corporation satisfied the recovery requirement. 582 F.2d at 382.

15. Treas. Reg. 33, art. 125 (1914).

16. *Lee v. Commissioner*, 6 B.T.A. 541 (1927) (collections from accounts that in previous year were listed as worthless for income tax purposes held part of gross income for year of collection), *affd. sub nom. Carr v. Commissioner*, 28 F.2d 551 (5th Cir. 1928); see also *Excelsior Printing Co. v. Commissioner*, 16 B.T.A. 886 (1929) (recovery of a debt previously charged off as worthless held to be taxable income for the year of recovery); *Chicago, Rock Island & Pac. Ry. v. Commissioner*, 13 B.T.A. 988 (1928) (sums representing unclaimed checks and vouchers, which were originally charged off to a profit and loss account and properly deducted from income, held to be taxable income when credited to that account in later years), *affd. in part, revd. in part*, 47 F.2d 990 (7th Cir. 1931), *cert. denied*, 284 U.S. 618 (1931).

17. See, e.g., Bittker & Kanner, *supra* note 2, at 266; Plumb, *The Tax Benefit Rule Today*, *supra* note 2, at 130-31.

18. *Lake View Trust & Sav. Bank v. Commissioner*, 27 B.T.A. 290 (1932); Tye, *supra* note 2, at 329.

19. G.C.M. 18525, 1937-1 C.B. 80. This ruling was soon followed by other rulings that applied the same principle. See G.C.M. 20854, 1939-1 C.B. 102; I.T. 3278, 1939-1 C.B. 76.

20. G.C.M. 22163, 1940-2 C.B. 76; I.T. 3390, 1940-2 C.B. 68. For a discussion, see Plumb, *The Tax Benefit Rule Today*, *supra* note 2, at 133 n.19.

gress codified the rule's exclusionary aspect in 1942.²¹

Various rationales have been offered for the tax benefit rule.²² The inclusionary component of the rule demands the addition to taxable income of an amount that might or might not otherwise constitute income were it not for the fact that there had been an earlier deduction of that amount. The question addressed by the exclusionary component of the tax benefit rule, specifically, whether the increase should be limited by the amount of the earlier deduction that generated an actual tax benefit, seems premature without a satisfactory explanation of why taxable income should be increased at all. For this reason I shall concentrate on the justification of the inclusionary aspect of the tax benefit rule. Moreover, as should soon be apparent, the exclusionary aspect of the rule is a corollary of the inclusionary aspect and the same rationale should apply to both.

The rationales that have been given for including in taxable income the recovery of an earlier deduction can best be understood through a straightforward example of the rule's operation. Imagine a taxpayer who deducted the state income tax paid by him in year one. In year two he received a refund of some portion of the state tax that he had paid earlier. The inclusionary aspect of the tax benefit rule requires the taxpayer to include the amount of his tax refund in his gross income for year two.²³ Some early courts explained this result as an instance of implied waiver or estoppel: by deducting the earlier tax, the taxpayer had consented to taxation of the subsequent recovery.²⁴ Other early courts suggested that inclusion is a necessary balancing entry because the taxpayer's income over the entire period would otherwise have been underrepresented.²⁵ Clearly, without

21. Revenue Act of 1942, ch. 619, § 116, 56 Stat. 798, 812-13 (1942) (current version at I.R.C. § 111 (1982)). The Code explicitly excludes from gross income only recoveries of previously deducted bad debts, taxes, or delinquency amounts. I.R.C. § 111 (1982). However, the regulations extend the exclusion to "all other losses, expenditures, and accruals made the basis of deductions from gross income for prior taxable years." Treas. Reg. § 1.111-1(a) (1956). The regulation goes on to exclude "deductions with respect to depreciation, depletion, amortization, or amortizable bond premiums." Treas. Reg. § 1.111-1(a) (1956); *see also* Dobson v. Commissioner, 320 U.S. 489 (1943).

22. For a more complete discussion of these rationales, see Bittker & Kanner, *supra* note 2, at 267-72.

23. It should not be crucial that the taxpayer received his reimbursement from the state itself. For example, if the overpayment were the fault of the lawyer who prepared the taxpayer's return and, after the relevant tax year had closed and the possibility of amendment had ceased to exist, the lawyer paid the taxpayer some portion of the deducted overpayment, the taxpayer ought still to be required by the tax benefit rule to include the amount in income. *See, e.g.*, Edward H. Clark v. Commissioner, 40 B.T.A. 333 (1939).

24. *See, e.g.*, Helvering v. State-Planters Bank & Trust Co., 130 F.2d 44 (4th Cir. 1942); Philadelphia Natl. Bank v. Rothensies, 43 F. Supp. 923 (E.D. Pa. 1942).

25. *See, e.g.*, Barnett v. Commissioner, 39 B.T.A. 864 (1939); South Dakota Concrete Prods. Co. v. Commissioner, 26 B.T.A. 1429 (1932).

such an adjustment the taxpayer's income would be understated, but the federal income tax system operates on the principle of annual accounting,²⁶ and the mere fact of underrepresentation is therefore not sufficient to explain or justify the tax benefit rule. Thus, in a 1975 concurring opinion, Judge Tannenwald wrote that the tax benefit rule is "a necessary counterweight to the consequences of the annual accounting principle."²⁷ He elaborated:

The need to assess and collect taxes at fixed and relatively short intervals underpins the principle of taxation that transactions which may possibly be subject to further developments substantially altering their character for tax purposes should nevertheless be treated as final and closed so that their tax consequences can be determined. . . . On the other hand, a taxpayer should not be permitted to take advantage of this governmental exigency to establish a distorted picture of his income for tax purposes. It is this countervailing consideration which spawned the tax benefit rule. . . . The most common, and most nearly accurate, explanation of the rule is that it recognizes the "recovery" in the current year of taxable income earned in an earlier year but offset by the item deducted.²⁸

Judge Tannenwald properly acknowledged the tension between the principle of annual accounting and the tax benefit rule, and he articulated the widely shared feeling that there is something untoward about allowing a taxpayer to deduct permanently from his taxable income an amount that he later gets back. But the judge's comments did not go far enough. They did not spell out *why* getting the amount back (its "recovery") ought to trigger its inclusion. This is a fairly simple task, but one that illuminates the appeal of the tax benefit rule and allows us to see how it ought to be formulated.

When an amount is included in a taxpayer's gross income, it becomes subject to tax unless it is subsequently deducted in accordance

26. The requirement of a 12-month period for purposes of tax accounting predates the passage of the sixteenth amendment. *Burnet v. Sanford & Brooks Co.*, 282 U.S. 359, 365 (1931); 2 J. MERTENS, *LAW OF FEDERAL INCOME TAXATION* § 13.02 (1982). The Revenue Acts of 1913 and 1916, however, alluded only vaguely to the concept. See 2 J. MERTENS, *supra*, at § 13.03. Consequently, following a dispute over the permissible length of taxable periods that did not end on December 31, Congress specifically mandated that income taxes should be assessed on the basis of a 12-month period. *Id.* I.R.C. §§ 441-43 (1982) modify that requirement to allow certain taxpayers to compute their taxes over periods *shorter* than 12 months (or 52 or 53 weeks).

The Supreme Court affirmed the constitutionality of the annual accounting principle in *Burnet*, holding that compensatory damages received by a taxpayer in 1920 were taxable income for that year. The taxpayer had argued that the compensation should have been offset by related expenditures from prior years, but noting the lack of statutory authority for transactional income tax accounting, the Court rejected that approach. 282 U.S. at 362-66.

27. *Estate of Munter v. Commissioner*, 63 T.C. 663, 678 (1975).

28. *Estate of Munter v. Commissioner*, 63 T.C. 663, 678 (1975) (citations omitted). Bittker and Kanner quote this excerpt as well, referring to it as a "perceptive recent comment." Bittker & Kanner, *supra* note 2, at 269-70.

with some provision of the Code.²⁹ A deduction is given because gross income that would otherwise be taxed is used for an expenditure that Congress has deemed appropriately made with untaxed dollars.³⁰ Annual accounting requires all taxpayers to calculate their taxable income on an annual basis in light of the facts known to them at the time of filing. Strictly applied, annual accounting treats each tax year as a discrete unit. If, for example, four years after a deduction was taken in good faith, it turned out that the taxpayer *had not spent* the untaxed income after all, the application of the requirement of annual accounting would result in the permanent exclusion from taxable income of an otherwise taxable amount that the taxpayer has available to consume. The inequity of this result is clear. The crucial point in such a case is not that the taxpayer *recovered* the deducted amount; rather, it is that the taxpayer *has* it (and has not, after all, consumed it).

Our system employs the mechanisms of basis and adjusted basis to alleviate some of the inequities that would result from strict adherence to annual accounting. If the original deduction reduces the basis of some asset, then the tax treatment of the later disposition of the asset will, in the absence of some special rule to the contrary, reflect the deduction.³¹ But some deductions do not affect the basis of any asset and some issues of later inclusion arise outside of the context of the disposition of an asset. Consider once again the taxpayer who paid and deducted his state income tax in year one only to receive a refund in year two. The reimbursement in year two represents income that was not taxed when it became a part of the taxpayer's gross income because it was removed from taxable income by the deduction. In a tax world where annual accounting was strictly applied, where there was no tax benefit rule and no section 111,³² but that was otherwise governed by our Code, the tax treatment of the reimbursement would depend upon whether it came within the scope of the section 61 conception of income.³³ It would

29. See I.R.C. § 63 (1982) (definition of "taxable income").

30. See M. CHIRELSTEIN, *supra* note 5, ¶ 6.00, at 87-88. Different considerations apply where an *exclusion* from income is granted. See, e.g., *id.* ¶ 1.02, at 19 (suggesting that exclusion from income of employment-related meals and lodging may be due to element of personal compulsion involved).

31. See, e.g., I.R.C. §§ 1016(a)(2), 1245(a) (1982) (providing for adjustments to basis upon the sale of certain depreciable property).

32. See note 11 *supra* and accompanying text.

33. I.R.C. § 61 (1982) contains the statutory definition of "gross income." This statutory concept has been further explicated by case law. See, e.g., *Commissioner v. Glenshaw Glass*, 348 U.S. 426 (1955) ("accessions to wealth" constitute income); *Eisner v. Macomber*, 252 U.S. 189 (1920) ("income" defined as gain derived from labor and capital).

either be fully included or fully excluded. There would be no basis for tying its treatment in year two to its earlier treatment in year one. Annual accounting requires taxpayers, in effect, to stop the clock after each tax year to tally their taxable income. The tax benefit rule, if it is to have any role in the system, ought to set forth the conditions under which the clock will be stopped again for the purpose of reconciling earlier reports of taxable income with what has turned out to be the case.

II. THE SUPREME COURT'S OPINION IN *HILLSBORO* AND *BLISS DAIRY*

The Supreme Court recently had occasion to address the parameters of the tax benefit rule in the consolidated cases of *Hillsboro National Bank v. Commissioner*³⁴ and *United States v. Bliss Dairy, Inc.*³⁵ The fact situations in these two cases were rather different from each other, but the issue in each case had been framed as a test of the adequacy of the recovery formulation of the rule.³⁶ In a fairly long opinion, punctuated by contentious footnotes,³⁷ Justice O'Connor rejected the view that the tax benefit rule "requires the inclusion of amounts *recovered* in later years"³⁸ and held instead that it "ordinarily applies to require the inclusion of income when events occur that are *fundamentally inconsistent* with an earlier deduction."³⁹ While the Court, oddly, did not explicitly apply its own analysis to either of the two cases at hand,⁴⁰ it devoted a substantial portion of the opinion to developing the "fundamentally inconsistent" formulation. The discussion is confused at some points and confusing at others, but in a crucial respect it seems to advance the state of the rule because it focuses more on the relationship between the original deduction and the current circumstances than on whether or not the current circumstances can or cannot be classified as a "recovery" having economic benefit to the taxpayer.

The facts of the two cases are easily outlined. In the first case,

34. 73 T.C. 61 (1979), *affd.*, 641 F.2d 529 (7th Cir. 1981), *revd.*, 103 S. Ct. 1134 (1983).

35. No. CIV 77-562 (D. Ariz. Feb. 15, 1979) (order granting plaintiff's motion for summary judgment), *affd. per curiam*, 645 F.2d 19 (9th Cir. 1981), *revd. sub nom.* Hillsboro Natl. Bank v. Commissioner, 103 S. Ct. 1134 (1983).

36. See note 5 *supra*.

37. See *Hillsboro Natl. Bank v. Commissioner*, 103 S. Ct. at 1140-53 nn. 10, 13-17, 21, 24-26, 30, 32 & 37. For a criticism of the use of footnotes in *Hillsboro*, see Blum, *supra* note 9, at 368-69.

38. 103 S. Ct. at 1142 (emphasis in original).

39. 103 S. Ct. at 1138 (emphasis added).

40. See notes 67-79 *infra* and accompanying text.

Hillsboro National Bank paid a state-imposed property tax on behalf of its shareholders in 1972.⁴¹ The validity of the tax in question was uncertain under the state constitution as amended.⁴² Accordingly, the state put the amounts collected in escrow and, when the tax was ultimately declared invalid, paid them directly to the shareholders on whom they had been imposed.⁴³ The Bank deducted its payment of the tax under section 164(e)⁴⁴ in 1972 and neither adjusted its 1972 return when the refunds to the shareholders were made in 1973 nor itself reported any income on account of the refunds.⁴⁵ The Commissioner sought to use the tax benefit rule to include the amount of the refund in the Bank's income.⁴⁶ The Bank resisted on the ground that because it had not recovered the deducted amount, the rule was inapplicable.⁴⁷

In the second case, Bliss Dairy, Inc., purchased cattle feed for use in its operations. It deducted the full cost of the feed in the year of the purchase.⁴⁸ Two days after the close of its taxable year, Bliss liquidated under section 336.⁴⁹ Among the assets distributed on which Bliss reported no gain was unused cattle feed.⁵⁰ The Internal Revenue Service argued that the tax benefit rule required that the value of the unconsumed feed be included in Bliss' income on its final return.⁵¹ Bliss took the position that it had no income because "for the tax benefit rule to apply, there must be an actual recovery of a previous tax benefit derived by the taxpayer."⁵²

The Court's opinion in *Hillsboro* consists of a general analysis of the tax benefit principle followed by particular discussion of the ap-

41. 103 S. Ct. at 1138.

42. 103 S. Ct. at 1138.

43. 103 S. Ct. at 1138.

44. I.R.C. § 164 (1982) deals with the deductibility of taxes paid. Subsection (e) provides: (e) Taxes of Shareholders Paid by Corporation—Where a corporation pays a tax imposed on a shareholder on his interest as a shareholder, and where the shareholder does not reimburse the corporation, then—

(1) the deduction allowed by subsection (a) shall be allowed to the corporation; and

(2) no deduction shall be allowed the shareholder for such tax.

45. 103 S. Ct. at 1138.

46. See 103 S. Ct. at 1140; see also 103 S. Ct. at 1148.

47. 103 S. Ct. at 1142.

48. 103 S. Ct. at 1139.

49. 103 S. Ct. at 1139. I.R.C. § 336(a) (1982) provides in pertinent part that "no gain or loss shall be recognized to a corporation on the distribution of property in partial or complete liquidation."

50. 103 S. Ct. at 1139.

51. See 103 S. Ct. at 1140.

52. Brief for the Respondent Bliss Dairy, Inc. at 5, *Hillsboro Natl. Bank v. Commissioner*, 103 S. Ct. 1134 (1983); see also 103 S. Ct. at 1142.

plicability of the rule to Hillsboro National Bank and Bliss Dairy. Justice O'Connor's characterization of the tax benefit rule as "a judicially developed principle that allays some of the inflexibilities of the annual accounting system"⁵³ underscored her concern with specifying some limit to the "inflexibilities" that the rule may address. The phrasing of her answer — it "ordinarily applies to require the inclusion of income when events occur that are fundamentally inconsistent with an earlier deduction"⁵⁴ — invites the question of how to distinguish a merely inconsistent event from a *fundamentally* inconsistent one,⁵⁵ and is for that reason unfortunately unhelpful. There are places in the opinion, however, where more useful guidance is given, and one senses that Justice O'Connor did have a genuine test in mind. For example, although she wrote generally of the purpose of the tax benefit rule as being "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,"⁵⁶ she focused more specifically on the "concern with *more accurate measurement of income* [that] underlies the tax benefit rule and always has."⁵⁷ She insisted that "[t]he purpose of the rule is not simply to tax 'recoveries.'"⁵⁸ Rather, "*only* if the occurrence of the event in the earlier year would have resulted in the disallowance of the deduction can the Commissioner require a compensating recognition of income when the event occurs in the later year."⁵⁹ "[T]he problem is that the taxpayer has mischaracterized some event. Either he has recognized income that eventually turns out not to be income, or he has taken a deduction that eventually turns out not to be a deduction."⁶⁰

The clear focus of the majority opinion is on the reconciliation of a prior year's report of taxable income with what has "eventually

53. 103 S. Ct. at 1140 (footnote omitted).

54. 103 S. Ct. at 1138.

55. Justice Stevens asked precisely this question in his separate opinion and dissent. 103 S. Ct. at 1161 (Stevens, J., concurring in part, dissenting in part).

56. 103 S. Ct. at 1143. Justice O'Connor also noted that the tax benefit rule is designed "to approximate the results produced by a tax system based on transactional rather than annual accounting." 103 S. Ct. at 1142.

57. 103 S. Ct. at 1142 n.11 (emphasis added).

58. 103 S. Ct. at 1142.

59. 103 S. Ct. at 1146 (footnote omitted) (emphasis in original).

60. 103 S. Ct. at 1146-47 n.24. Justice O'Connor's opinion is explicitly limited in scope to the inclusionary aspect of the tax benefit rule, *see* 103 S. Ct. at 1142 n.12, but its general thrust and its theme that the rule is concerned with the "more accurate measurement of income" ought to apply with equal force to the exclusionary aspect.

turned out” to be its accurate measure. It is not on, and (putting aside questions of precedent and of the appropriate role of the Court)⁶¹ as a matter of good sense should not be on, whether or not the taxpayer has recovered some previously deducted amount. The point, further, seems to be that the reconciliation is of some *particular* earlier characterization and *its* eventual accuracy.

The majority was less successful, however, at spelling out exactly *when*, under the tax benefit rule, it is appropriate to reconcile earlier claims with current circumstances. On the one hand, it stressed that the rule must be applied on a case-by-case basis because it often conflicts with some rule of non-recognition.⁶² To this extent, therefore, the Court rejected the invitation to prescribe generally when the rule is to be used. On the other hand, as has been seen, the Court did indicate that except in cases of such conflict, the tax benefit rule should apply whenever there has been an event that is fundamentally inconsistent with an earlier deduction. An event is fundamentally inconsistent in the required sense when, if it “had occurred within the same taxable year [as the original deduction], it would have foreclosed the deduction.”⁶³ Even taking account of the modifications of this statement that are implied by the language quoted and discussed above,⁶⁴ this test is overbroad. It merely describes the inaccuracy that the rule is supposed to alleviate and does not, by itself, provide a sufficiently precise way of distinguishing circumstances where its use is appropriate from those where it is not. And it should be clear that it would never be appropriate to invoke the tax benefit rule if the earlier deduction would have been allowed even if all the events had happened within the same taxable year. There would have been no inaccuracy to rectify.

More important, inconsistency of this sort is present any time later events show that a taxpayer earlier misrepresented (albeit in good faith and in accordance with all the facts as then known) the nature of a deducted expenditure. For example, suppose that in year one a taxpayer who was the sole proprietor of a game shop paid \$1,000 for promotional T-shirts. The shirts featured a picture of a Rubik’s Cube underneath the store’s name. The taxpayer deducted the full cost of the shirts as a business expense in year one. When the

61. The Court’s account of earlier tax benefit rule cases seems to have been disingenuous. See 103 S. Ct. at 1145-46. Justice Stevens gives a far more reliable history in his separate opinion and dissent. 103 S. Ct. at 1155-57 (Stevens, J., concurring in part, dissenting in part).

62. 103 S. Ct. at 1144-45 & n.20.

63. 103 S. Ct. at 1143-44.

64. See text accompanying notes 56-60 *supra*.

Rubik's Cube became *passé* the taxpayer stopped distributing the shirts. In year four he used the remaining shirts as undershirts for his family.

This example is instructive in several respects. There is no doubt that the deduction of the cost of the T-shirts in year one would not have been allowed had the shirts been used then as family undershirts.⁶⁵ On the other hand, if at the end of year one the taxpayer fully intended to distribute the shirts over the next several months as a promotion of his business he would have been allowed to deduct the cost of the shirts in the year it was incurred. If we suppose that the taxpayer came gradually to decide that it was not, after all, in his business interest to distribute the shirts, then we might naturally ask at what point in the evolution of the change in his intentions the tax benefit rule would apply to include in the taxpayer's income the amount of the deduction for the undistributed shirts? To ask the question in the Court's terms, what is the "fundamentally inconsistent event"? To ask the question in the terms suggested at the end of part I above, at what point should the clock be stopped in order to reconcile the taxpayer's earlier report of his taxable income for year one with what it has turned out to be?

It is simply not helpful to try (as the Court's account of fundamental inconsistency suggests that we do) to answer the question, however put, by looking to see exactly when the minimum degree of certainty and belief required to justify the taxpayer's deduction of the shirts' cost in year one has no longer been met. Clearly, there may be some point before the actual conversion of the shirts to personal use where the taxpayer will no longer be sufficiently certain that he will use the shirts in his business to have justified the original deduction, but where their ultimate use is sufficiently uncertain as to make inclusion of their cost in the taxpayer's income problematical at best. It would be a strange and unadministrable result to require

65. The *Hillsboro* Court's discussion of *Zaninovich v. Commissioner*, 616 F.2d 429 (9th Cir. 1980), suggests that it would regard any loss of this taxpayer's ability to use the T-shirts as attributable to its business and thus not as fundamentally inconsistent with the earlier deduction. See 103 S. Ct. at 1144. But if, as the hypothetical intends, the fair market value of the T-shirts when used by the taxpayer for personal purposes is at least equivalent to the amount deducted in connection with their purchase, the Court wrote that the conversion "would be an event fundamentally inconsistent with the business use on which the deduction was based." 103 S. Ct. at 1144. "In general, if the taxpayer converts the expensed asset to some other, non-business use, that action is inconsistent with his earlier deduction, and the tax benefit rule would require inclusion in income of the amount of the unwarranted deduction." 103 S. Ct. at 1150. The implication seems to be that the portion of the original deduction that was converted ought therefore to be included in the taxpayer's income unless there is some countervailing provision of non-recognition in the Code. Other than the general principle of annual accounting, I can think of no rule of non-recognition that is responsible for the apparent non-inclusion of this amount in income.

the inclusion in income of the amount of a prior year's deduction whenever the taxpayer wavered from unswerving mental allegiance to the plan upon which the deduction was based. Quite likely, as shall be discussed shortly, there should be tax consequences for not adhering to the plan under which the deduction was allowed, but I doubt that the Court or any of us would want those consequences to be triggered merely by the taxpayer's thought in a later year that he may well decide not to abide by his earlier intention. For one thing, what if, after all, the taxpayer resolved his qualms in favor of distributing the shirts to customers?

Perhaps we ought to take seriously the Court's use of the word "event" and require that the fundamental inconsistency be marked by some outwardly observable event (the words "outwardly observable" might rule out the "event" of the taxpayer having thought heretical thoughts). Thus, the Court could say, the event of the actual conversion of the shirts to personal use would trigger the tax benefit principle. But it might not be altogether clear when the actual conversion took place. Was it when the taxpayer took the shirts from his store and put them in his car (where, in his indecision, he left them for some weeks before unloading them)? Was it when he finally did take them from his car and put them in his linen closet at home? Was it when he actually distributed them to his various family members? Or was it when they actually began to wear the shirts? I would expect the answer to turn on the facts of the case and not on the characterization of one of these outwardly observable occurrences as an "event."⁶⁶ Indeed, in any standard sense, all of these things are events and all may well be "fundamentally inconsistent" with the earlier expensing of the shirts. But, once again, what if the taxpayer had resolved his dilemma in favor of distributing the shirts to customers and, having so decided, had unloaded the shirts from his car and put them back into his store?

It is neither because of the fundamental inconsistency *per se* nor because that inconsistency is marked by some event that inclusion at some point seems appropriate. Rather, inclusion in these circumstances can be justified wholly apart from any conception of the tax benefit principle. The conversion of an expensed asset, like the T-shirts, into a personal asset can be explained as the theoretical

66. There is rich discussion in recent philosophical literature about the nature of events and how to distinguish individual events. See, e.g., Kim, *Events and Their Descriptions: Some Considerations*, in *ESSAYS IN HONOR OF CARL G. HEMPEL* (N. Rescher ed. 1969); Kim, *Events as Property Exemplifications*, in *ACTION THEORY* (M. Brand & D. Walton 1976); D. Davidson, *ESSAYS ON ACTIONS & EVENTS* (1980).

equivalent of its purchase for fair market value by the taxpayer (wearing his personal hat) from himself (wearing his business hat). The basis of the expensed asset would, of course, be zero. In theory, therefore, the taxpayer should include the fair market value of the converted asset in his income. That we currently do not appear to require inclusion is probably partly a consequence of annual accounting, and partly a function of the relative difficulty of administering and enforcing such a requirement. In any case, the analysis of the tax benefit principle offered by the Court in *Hillsboro* does not satisfactorily account for examples of this sort.

Curiously, once the Court left its general discussion and moved on to decide whether the tax benefit rule applied to Hillsboro National Bank or Bliss Dairy, Inc., it did not frame its consideration in terms of its test of fundamental inconsistency. It described its decision that the rule did not apply to Hillsboro National Bank as following from the legislative history of the predecessor of current section 164(e).⁶⁷ Apparently, the Court found a comment made in 1921 by Senator Smoot during a congressional hearing⁶⁸ to support its view that section 164(e) is really a provision whose aim is to "provide relief for corporations making these payments"⁶⁹ and not a provision where the nature of "these payments" as payments for *bona fide* taxes makes any difference. Given this interpretation of section 164(e), which seems wholly unpersuasive,⁷⁰ it would follow that the Court's single-year test of fundamental inconsistency would not be satisfied by the facts in the Hillsboro controversy. The Court's holding that the tax benefit rule does not apply to the bank is therefore not surprising. However, except for a single footnote in the middle of its general analysis of the rule, the majority opinion made no explicit reference to the single-year test (or to fundamental inconsistency) in connection with the Hillsboro facts.⁷¹

The Court's discussion of Bliss Dairy's situation made no explicit

67. See 103 S. Ct. at 1148-49.

68. I have been a director of a bank . . . for over 20 years. They have paid that tax ever since I have owned a share of stock in the bank. . . . I know nothing about it. I do not take one cent of credit for deductions, and the banks are entitled to it. *They pay it out.* 103 S. Ct. at 1149 (quoting *Hearings on H.R. 8245 Before the Senate Comm. on Finance*, 67th Cong., 1st Sess. 251 (1921) (statement of Sen. Smoot) (emphasis added by the Court)).

69. 103 S. Ct. at 1149.

70. For a forceful criticism of the way in which the Court used legislative history in connection with its interpretation of § 164(e), see Blum, *supra* note 9, at 364-65; see also note 97 *infra*.

71. In that footnote Justice O'Connor wrote: "Justice S[tevens] apparently disagrees with this rule, for, although he concurs in the result in *Hillsboro*, he asserts that the events there would have resulted in denial of the deduction had they all occurred in one year." 103 S. Ct. at 1144 n.16 (citation omitted).

reference to the single-year test of fundamental inconsistency, either. Instead, the Court proceeded to observe that because section 262 denies the deduction of personal expenses from a taxpayer's income, "[i]n general, if [a] taxpayer converts [an] expensed asset to some other, non-business use, that action is inconsistent with his earlier deduction, and the tax benefit rule would require inclusion in income of the amount of the unwarranted deduction."⁷² From this rather large claim, which is unsupported either by specific statutory requirements or by the reporting mechanisms of our current system,⁷³ the Court moved on to the conclusion that "if a corporation turns expensed assets to the analog of personal consumption, as Bliss did here — distribution to shareholders — it would seem that it should take into income the amount of the earlier deduction."⁷⁴

Having thus established the applicability of the tax benefit rule, the rest of the opinion focused on whether that rule or the counter-vailing non-recognition provision, section 336,⁷⁵ governed the case. In deciding this issue, the Court examined the background of section 336, and concluded that it does not shield corporate taxpayers from the recognition of all income upon an in-kind liquidation such as that undertaken by Bliss Dairy.⁷⁶ Next, the Court looked at section 337⁷⁷ (which grants non-recognition to corporations on the sale of assets within twelve months of liquidation), and concluded that since section 337 does not operate to prevent the tax benefit rule from applying, neither does section 336 "permit a liquidating corporation to avoid the tax benefit rule."⁷⁸ The Court therefore required Bliss Dairy to include its excess deduction in its income.⁷⁹

72. 103 S. Ct. at 1150.

73. See note 65 *supra* and text accompanying notes 51 & 52.

74. 103 S. Ct. at 1150.

75. I.R.C. § 336 (1982); see note 49 *supra*.

76. 103 S. Ct. at 1150-52.

77. I.R.C. § 337(a) (1982) provides:

(a) General Rule—If, within the 12-month period beginning on the date on which a corporation adopts a plan of complete liquidation all of the assets of the corporation are distributed in complete liquidation, less assets retained to meet claims, then no gain or loss shall be recognized to such corporation from the sale or exchange by it of property within such 12-month period.

78. 103 S. Ct. at 1153.

79. The Court remanded the case for a determination of the proper increase in Bliss Dairy's taxable income, which it defined as "the portion of the cost of the grain attributable to the amount on hand at the time of liquidation." 103 S. Ct. at 1154. Explaining that Bliss Dairy had not raised the issue, the majority specifically declined to address the question whether or not the amount attributable to the operation of the tax benefit rule should be measured by the lesser of the amount previously deducted or the basis that the shareholders took in the asset. 103 S. Ct. at 1153 n.37; cf. Feld, *supra* note 2, at 463 (arguing that includible income should be determined in this manner).

III. A SUGGESTED CONCEPTUAL FRAMEWORK

It is important to distinguish between two different questions raised by the tax benefit rule. To apply the inclusionary aspect of the rule, we must know, first, *how much* income to include and, second, *when* to include it. It is surprisingly easy in this context to confuse these two questions. The answer to the first question is surely a function of the amount of the deduction that was originally taken (often, therefore, a function of the adjusted basis of some asset) and of the amount with which it is later compared. The latter amount, however, cannot be determined without answering the second question concerning when it is appropriate to make the comparison.

The tax benefit rule requires a taxpayer to reconcile an earlier report of his taxable income with what has actually turned out to be the case. It seems quite natural therefore to focus on when the rule is triggered. In fact, the controversy over the recovery formulation reflects this focus to some fair extent. On the one hand, the rule is said to operate when the taxpayer recovers some earlier deducted amount. On the other hand, it is said to operate when some later event occurs that is "fundamentally inconsistent" with an earlier deduction. However, as Justice O'Connor did see, "[t]he purpose of the rule is not simply to tax 'recoveries'"⁸⁰ and, as Justice O'Connor did not see, fundamental inconsistency is too broad a test.⁸¹ In what follows I shall try to articulate a formulation of the principle that provides a clearer standard for telling when, as a theoretical matter, its use is appropriate.

Once again, the simple example of the taxpayer who paid and deducted his state income tax in one year and received a refund in the next year is helpful. After he receives his refund, the taxpayer has at his disposal taxable income on which he has never been taxed and on which, were it not for the tax benefit rule, he would never be taxed. Not only has he not spent his income in the deductible manner that he reported on his federal income tax return for the first year, but it has turned out in a later year that he has not spent it at all. It is this latter fact that the tax benefit rule properly addresses. From the taxpayer's perspective, the refund marks the end of the matter.⁸² In fact, there is no other way in which the end of this mat-

80. 103 S. Ct. at 1142; *see also* text accompanying notes 53-61 *supra*.

81. *See* text accompanying notes 62-66 *supra*. I suspect that Justice O'Connor was confused in her formulation of the rule partly because she *did* see that the purpose of the rule is to reconcile certain inaccuracies in past reporting. Whereas the recovery formulation tends to focus on when to apply the principle and to lose sight of its purpose, the Court's formulation was more a description of the rule's purpose than a guide to its application.

82. The receipt of a tax refund does not, of course, close the tax year to which the refund

ter could be marked in a later year⁸³ for a cash-basis taxpayer. If the taxpayer were on the accrual method, an analogous description could be given. He would deduct in year one any state income tax accrued in that year but not paid until the second year. If he received notification in the second year that the state had retroactively repealed the accrued tax and that it therefore would not be collected, he would nonetheless be required by the tax benefit rule to include in his income for year two the amount that he had deducted in year one. The retroactive repeal of the accrued tax would mark the end of the matter.

I have used two rather vague phrases to describe what has happened when the taxpayer in the example receives his state income tax refund: "it turns out"⁸⁴ (that the taxpayer has not spent the deducted amount) and (the refund) "marks the end of the matter." Neither of these phrases is entirely satisfactory but together they begin to capture what is characteristic about the tax benefit principle. In theory, the rule calls for the reconciliation of the current situation with an earlier claim. The key is to specify *when* such a reconciliation is called for — to identify what constitutes a "reconciliation event," if you will. The requirement that the two phrases seek to articulate is a kind of finality requirement with respect to a particular deduction. Something happens that puts a taxpayer once and for all (finally) in the position of not having spent gross income that he deducted in an earlier year from his taxable income.⁸⁵

It should be emphasized that this test is *not* met just because a taxpayer consumes deducted gross income differently from the way indicated on his return. If the deduction was not justified when it was taken, the federal income tax system includes a variety of mechanisms that in various combinations deal with the situation. The original return may be adjusted — either by the taxpayer himself by

pertains. The taxpayer may well be audited and assessed additional state income tax. But normally the refund is based on information supplied by the taxpayer to the state on his tax return and, at least in the absence of notification of an audit, he therefore regards the matter as having ended.

83. It must be remembered that the tax benefit rule could only apply to this taxpayer at all in a year after the deduction was taken.

84. Justice O'Connor used "eventually turns out" in her characterization of the tax benefit rule. 103 S. Ct. at 1146 n.24; *see* note 60 *supra* and accompanying text.

85. This description is directed specifically at the inclusionary aspect of the tax benefit rule. However, the exclusionary aspect is also triggered only in connection with the reconciliation of a past reporting position with the current situation. The difference is that it operates to exclude from current income any amount that the reconciliation shows does *not* represent previously untaxed income. The application of both aspects of the tax benefit rule to circumstances where the earlier return involved a tax credit is somewhat more difficult to articulate, but should, in principle, be the same.

amending it, by the Internal Revenue Service through its audit procedure, or eventually by the courts — or the statute of limitations may operate to keep it from being corrected. If the deduction was justified, the only way that a cash-basis taxpayer could have spent the income differently from the way that he indicated on the return⁸⁶ was to have used it originally to acquire something that was not fully consumed or used in the year of deduction and then to have put the purchase to some different use.⁸⁷ In each of these circumstances, the taxpayer has consumed the gross income that he earlier deducted. He is not in the position of having (either still or again) that untaxed income available to him.

Although I have characterized the tax benefit rule in somewhat imprecise terms, they are sufficient, I think, to yield a fairly clear sense of when, in theory, it would be appropriate to apply the rule. Just as the other formulations of the rule do, this account invokes the principle whenever a taxpayer recovers an amount that he had deducted in an earlier year. This is hardly a surprising result since I have proceeded by taking the example of the later refund of a previously deducted state income tax payment as the paradigm case whose examination generated my analysis of the tax benefit concept. The notion of a “recovery” has received substantial attention in the course of the development of the tax benefit rule,⁸⁸ and although I suspect that it would be interesting and perhaps useful to try to examine that requirement further, I am content for present purposes to accept a broad use of “recovery.”

The more significant consequence of the analysis I suggest is that a recovery is not the only sort of circumstance that should trigger the tax benefit rule. When a taxpayer properly deducts the cost of tangible property, it is on the assumption that the expensed property will be consumed by the taxpayer in the sanctioned way over a short period of time.⁸⁹ If the taxpayer holds the property indefinitely, then he has failed — up to that point — to meet one of the conditions on which the original deduction was premised. However, on the assumption that the deduction was properly taken,⁹⁰ nothing has hap-

86. An accrual basis taxpayer would have to purchase something that was not used as specified by the deduction and that was actually acquired after the year its cost accrued.

87. The example of the promotional T-shirts discussed earlier provides an analysis of this sort of case. See text accompanying notes 65-66 *supra*.

88. See note 14 *supra*.

89. Usually one year. See, e.g., I.R.C. § 162 (1982). But see Treas. Reg. § 1.162-12, T.D. 7198, 1972-2 C.B. 166, 167-68.

90. If the later failure to use the property as required by the deduction makes the deduction unjustified, then the audit process provides a mechanism for the government to recoup its loss.

pened that precludes the possibility of the taxpayer's eventually consuming the property in the appropriate way. If, however, the taxpayer goes out of existence (*i.e.*, either dies or liquidates) holding unconsumed but previously expensed property, something *has* happened to ensure that the taxpayer will *never* use the property as required by the deduction. It has turned out that the taxpayer has not spent income that he removed from his tax base on the assumption that he would. At the end, the taxpayer still had that untaxed income available to him. The tax benefit rule should apply.⁹¹

Perhaps this point can better be made by contrasting two different sorts of cases. If the proprietor of the game shop in my earlier example⁹² had been somehow required by the tax system to reconcile his earlier deduction of the cost of the promotional T-shirts with his circumstances the next year when he still held the undistributed shirts in his store (and when there was no question of his having converted them to personal use), or if Bliss Dairy, Inc. had been required to reconcile its earlier deduction of the cost of feed with the presence in a later year of unused cattle feed in its storage bins, each would have included the unconsumed but previously deducted amount in income. The measure of the amount included would have been the amount by which taxable income was reduced in year one netted against the amount of year one's untaxed income held by the taxpayer at the time of the reconciliation. Neither taxpayer would be said to have realized income at the moment of the reconciliation. The income was realized in year one. Its recognition would have been deferred until the time of the reconciliation. The theory of these cases would differ significantly from the theory of the case where the expensed asset is converted to personal use. There, as discussed above,⁹³ the taxpayer should recognize gain that he had realized at the time of the conversion. The gain would be measured by the difference between the fair market value of the previously ex-

91. So far as I can tell the tax benefit rule has not been applied to include the cost of a deceased taxpayer's previously expensed assets that survive him in the final income tax return of the decedent. My analysis holds that as a theoretical matter the tax benefit principle should apply, but it does not address any of the countervailing policy considerations that might be deemed to make inclusion under the tax benefit rule inappropriate. *See, e.g.*, I.R.C. §§ 1245(b)(2), 1250(d)(2) (1982) (special rules precluding recapture of depreciation deductions upon transfer of decedent's property).

I.R.C. § 381(c)(12) (1982) specifies that the tax benefit rule as embodied in I.R.C. § 111 (1982) applies to increase the income of the acquiring corporation in a liquidation where the amount would otherwise have been includible in the acquired corporation's income.

92. *See* text accompanying notes 65-66 *supra*.

93. *See* text accompanying notes 65-66 *supra*.

presumed asset at the time of its conversion and the taxpayer's basis (presumably zero) in the asset at the same time.

There is no principle in our system that requires taxpayers to engage generally in the first sort of reconciliation just described. Annual accounting forbids it. The tax benefit principle provides the exception. It can be conceived as setting forth the conditions which mark a "reconciliation event" — as distinct from a realization event.

Throughout its opinion in *Hillsboro*, the Supreme Court emphasized that the tax benefit rule often conflicts with some principle of non-recognition. It (along with the lower courts and various commentators) characterized the *Bliss Dairy* dispute as one in which the issue was whether the tax benefit rule or the "conflicting" rule of non-recognition set forth in section 336 would apply.⁹⁴ If my analysis of the principle underlying the tax benefit rule is correct, this view of the issue is confused. Section 336 is indeed a non-recognition provision, but like other such provisions it directs the non-recognition of gain (or loss) that would otherwise be triggered by the transaction or event that occasions the non-recognition. At the very least, gain requires that the taxpayer have realized income.⁹⁵ A taxpayer, like *Bliss Dairy, Inc.*, that triggers the tax benefit rule because it is liquidating and still has untaxed income on hand has not, *by virtue of its still having the income available in one form or another at the time of liquidation*, realized income at all. The taxpayer has no gain as a result of the liquidation and therefore it has no gain not to recognize.⁹⁶ It is merely recognizing income that it realized in year one — income that has nothing to do with its subsequent liquidation.

94. See, e.g., Feld, *supra* note 2, at 445, 451; Note, *Previously Expensed Assets*, *supra* note 2. A series of decisions since 1969 have addressed a perceived conflict between the tax benefit rule and the non-recognition provisions of I.R.C. § 337 (1982), holding that the tax benefit rule should apply. See, e.g., *Commissioner v. Anders*, 414 F.2d 1283 (10th Cir. 1969), *rev. g.* 48 T.C. 815 (1967), *cert. denied*, 396 U.S. 958 (1969).

95. Although the Code provides no general definition of "gain," I.R.C. § 1001(a) (1982) provides that "[t]he gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis"

96. In an exceedingly thoughtful student Note, one commentator argues that a taxpayer is enriched by the survival of unused expensed assets because its earlier deduction assumed their consumption. Note, *Previously Expensed Assets*, *supra* note 2, at 1641-43. When a corporation liquidates it can be construed as having realized this income. *Id.* at 1643-46. This commentator goes on to examine the rationales behind the non-recognition treatment of realized income and concludes that none of them "would deny that liquidation is an appropriate time" to recognize the gain. *Id.* at 1643, 1646-51. The mistake that this analysis makes is to construe the corporate taxpayer as having realized income because of the non-consumption of the expensed assets. The income was realized before the expensed assets were acquired. It was reported as a part of the taxpayer's gross income but was deducted from its taxable income on the assumption that it was being spent on assets that would be consumed in some deductible fashion. The effect of the inclusion required by the tax benefit rule is to adjust the earlier deduction (albeit not in the earlier year). It is not to mark the realization of income.

Clearly, this analysis is fully consistent with the Court's actual resolutions of the disputes involving Hillsboro National Bank and Bliss Dairy. Hillsboro National Bank would not be subject to the tax benefit rule because *it* does not have — either again or still — the earlier deducted income.⁹⁷ Bliss Dairy, for the reasons discussed above, would be subject to the rule. Just as clearly, my analysis is not fully consistent with the rationale for the rule offered by the Court nor with all of the various lower court decisions that have been decided along the way.⁹⁸ My aim, however, has not been to synthesize existing precedents and discussions, nor has it been to prescribe when the rule ought, as a matter of tax policy, to override conflicting social goals. Rather, it has been to provide a sensible conceptual framework within which the rule can be understood and developed. Some such framework is surely needed.

97. I wish to emphasize, however, that it is far from clear that Hillsboro National Bank ought to have been entitled to deduct the disputed tax under I.R.C. § 164(e) (1982). The fact that the validity of the tax was genuinely in question at the time payment was made might indicate that the applicability of section 164(e) ought to have remained an open question until that issue was resolved. Certainly, what is discomfiting about the result in this case is that the bank was allowed to deduct as a tax an amount that turned out not to be a tax.

Section 164(e) has the effect of allowing a corporation to deduct the equivalent of a dividend to its shareholders. In *Hillsboro*, the payment of the tax refund directly to the shareholders extends that exception well beyond the intent of § 164(e). Nonetheless, it remains true that upon paying the perceived tax the Bank lost all control of the money and itself retained no right to recover it. This may well be a case that falls uncomfortably between the cracks in the system.

98. My analysis appears to be consistent with the result in, though not the rationale of, *Nash v. United States*, 398 U.S. 1 (1970), the only case other than *Hillsboro* in which the Supreme Court has explicitly dealt with the inclusionary aspect of the tax benefit rule. In *Nash*, the taxpayer transferred partnership assets, including the net worth of its accounts receivable, to corporations in an I.R.C. § 351 (1982) exchange. The Service sought to use the tax benefit rule to include the amount of the partnership's unused bad debt reserve in the partners' incomes. The Court held that the tax benefit rule was not applicable because the partners received securities equal to the net value of the accounts receivable (their face value less the remaining bad debt reserve) and nothing more. They had no gain to recognize as income.

Under my analysis, the fact of the termination of the partnership would trigger the tax benefit principle. (Although the hybrid nature of partnerships as reporting entities whose tax attributes are passed through to their partners makes this result itself interesting, my instinct is that for purposes of the finality requirement that I have tried to articulate it is the termination of the reporting entity that is the relevant event.) Once it is determined that a reconciliation event has occurred, the next step is to see what earlier deducted amounts are now on hand. Where the deduction was from the face value of accounts receivable, it would seem appropriate to value the accounts receivable that are present at the time of the reconciliation at their fair market value. In *Nash*, the fair market value of the accounts receivable at the time of the section 351 transfer was equal to their net value. *For this reason*, Nash and his partners should not have been subject to the inclusion of income under the tax benefit rule. This result should not depend upon what they actually received in exchange for the accounts receivable (except, of course, in so far as what was actually received serves as a measure of the asset's fair market value).