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# The Realization Doctrine in Florida Corporate Income Taxation: A History and an Analysis Since *S.R.G.*

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# The Realization Doctrine in Florida Corporate Income Taxation: A History and an Analysis Since *S.R.G.*

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*The authors analyze the present status of the doctrines of realization and recognition as they exist in Florida corporate income taxation. Relevant legislative history and recent cases, focusing on a conflict between these doctrines, are examined. The resulting problems are analyzed and possible solutions suggested.*



## I. INTRODUCTION

Through a combination of statutory drafting and judicial interpretation, the concept of realization has been given an unorthodox meaning and heightened significance for purposes of the Florida Income Tax Code (Florida Code).[1] A conflict between the doctrines of realization and recognition has resulted. The issues created by the conflict have cast a shadow upon Florida's scheme of corporate income taxation.

The purpose of this article is to examine the impact of realization, as now defined for purposes of Florida law, and to analyze the conflict. First, the history of the Florida Code is reviewed to pinpoint the genesis of the conflict between the realization and recognition doctrines as utilized by the Florida Code. After examining the nature of the conflict itself, this article reviews the cases which have dealt with the realization-recognition inconsistency, particularly *S.R.G. Corp. v. Department of Revenue.*[2] The ramifications of the inconsistency and its judicial interpretations are studied, followed by suggested legislative reform or possible judicial solution.

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1. FLA. STAT. §§ 220.01-.69 (1977 & Supp. 1978).

2. 365 So. 2d 687 (Fla. 1978).

## II. HISTORY

On Tuesday, November 4, 1924, the people of Florida voted in a general election to amend the state constitution to prohibit the Florida Legislature from ever levying any "tax . . . upon the income of residents or citizens of this State."[3] The vote followed a statewide campaign to convince Floridians of the state's need to attract outside capital in order to reach its full potential. The people apparently felt that a constitutional assurance that income would never be depleted by an income tax would effectively attract such capital.[4] During the same election, Floridians also amended their constitution to include a prohibition against the taxing of inheritances.[5] Together, the two prohibitions revealed a constitutional scheme creating a "tax haven" in Florida.

Without the constitutional prohibition, the Florida Legislature would have been free to tax incomes at any time. The constitutional prohibition, broad in its terms, effectively stripped the legislature of that power.[6]

By the late 1960's, however, more than eighty percent of the states were taxing the incomes of corporations;[7] only Florida maintained a blanket constitutional prohibition on the taxation of all incomes.[8] State officials registered grave complaints of budgetary demands far exceeding the revenue potential of Florida's then current tax structure.[9] Removal of the constitutional prohibition on the taxation of incomes, at least with respect to corporations, had become a political issue. The question of amending the constitution to permit a tax on corporate incomes drew much debate in the 1970 gubernatorial campaign.[10]

Some felt that the prohibition against taxing the income of "residents or citizens" did not extend to corporations. Amending

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3. FLA. CONST. art. 9, § 11 (1885) (amended 1924).

4. The Florida Times-Union, Nov. 4, 1924, at 6, *reprinted in* Appendix to Brief for Appellees at 33-34, Department of Revenue v. Leadership Housing, Inc., 343 So. 2d 611 (Fla. 1977) (on file *University of Miami Law Review)* [hereinafter cited as Appendix to Brief]; St. Petersburg Times, Nov. 4, 1924, at 1, *reprinted in* Appendix to Brief at 50-51; The Tampa Morning Tribune, Apr. 13, 1923, at 6-A, *reprinted in* Appendix to Brief at 55-56.

5. The Tampa Morning Tribune, Nov. 5, 1924, at 1-A, *reprinted in* Brief of Appellees, *supra* note 4, at 62-63.

6. FLA. CONST. art. 7, § 5(b) (1968) (amended 1971).

7. [1969] STATE & LOC. TAXES (P-H) ¶ 101.

8. Horwich, *Florida Taxation: A State in Chains,* 21 U. MIAMI L. REV. 36, 38 (1966).

9. In his message to a joint session of the legislature, on April 6, 1971, Governor Reubin Askew advised that the $1.44 billion general revenue budget for the 1971-72 fiscal year would exceed revenue expectations for the same period by $170 million. FLA. S. JOUR., 1971 3d Reg. Sess., at 45.

10. *Id.,* Sp. Sess. of Jan. 27 to Feb. 4, 1971, at 6.

the constitution would therefore be unnecessary. Early in 1971, the Supreme Court of Florida settled the question when it issued an advisory opinion, holding that the constitutional prohibition was intended to extend to the incomes of corporations, as well as to the incomes of natural persons.[11] After intensive study, Arthur J. England, Jr., Special Tax Counsel to the Florida Legislature, began drafting a corporate income tax statute. On November 2, 1971, the people of Florida overwhelmingly amended their state constitution by partially removing the long-standing prohibition on the taxation of corporate income so as to permit the taxation of up to "5% of the net income, as defined by law" of artificial persons.[12]

On November 3, 1971, the day following the constitutional amendment, every Florida legislator was sent a draft income tax statute and explanatory report, known as Staff Draft No. 3, which had been prepared over a period of some eleven months by the Staff of the Florida House of Representatives.[13] The draft provided for a tax of five percent of Net Income, which was computed by making certain additions and subtractions to federal taxable income. Proposed section 220.13(1)(c) of the draft permitted taxpayers the election to compute gain from the sale of capital assets acquired prior to November 2, 1971, so as to prohibit the taxation, as income, of appreciation in value which occurred prior to that date.[14] This result was achieved through a complex formula which provided for computation of gain from the sale of property acquired prior to November 2, 1971, by increasing the basis of such property to its fair market value on November 2, 1971.

On November 17th, the members of the Senate Ways and Means Committee and the House Finance and Taxation Committee convened in joint session to conduct public hearings on corporate income taxation. During the next two days, the house and senate committees met separately to hear testimony, and to consider and vote upon many of the issues which had been raised in connection with Staff Draft No. 3. The committees disagreed on certain points, including proposed section 220.13(1)(c). Although the house committee accepted the basis adjustment in order to exclude appreciation in value which occurred prior to November 2, 1971 from income

11. *In re* Advisory Opinion to the Governor, 243 So. 2d 573 (Fla. 1971).

12. FLA. CONST., art. 7, § 5.

13. England, *Corporate Income Taxation in Florida: Background, Scope, and Analysis*, in AN INTRODUCTION TO FLORIDA CORPORATE INCOME TAXATION 4, 4-5 (1972).

14. A. ENGLAND, REPORT TO THE HOUSE ON PROPOSED CORPORATE INCOME TAX LEGISLATION, STAFF DRAFT NO. 3, at 14 (1971).

taxation, as gain, the senate committee rejected the idea.[15]

The Florida Legislature began a special session on November 29th. The bill was reported favorably by the House Finance and Tax Committee, approved by the full house, and sent to the senate on November 30th and December 1st.[16] That bill, committee substitute for House Bill 16-D, was considered and amended by the Senate Ways and Means Committee on December 1st and by the full senate on December 2nd and 3rd.[17] The house had followed its committee's report, retaining the basis adjustment concept of proposed section 220.13(1)(c) from Staff Draft No. 3, although the date had been changed from November 2, 1971 to December 31, 1971.[18] Senate Amendment No. 28, however, had eliminated proposed section 220.13(1)(c) in the senate version, thereby requiring the computation of Net Income without the basis adjustment.[19] The bill as amended by the senate was taken up by the house on December 6th. All of the senate amendments were rejected for the purpose of sending all matters of difference to a Conference Committee.[20]

The Conference Committee recommended that the house adopt certain senate amendments, including No. 28, which had eliminated the basis adjustment provision.[21] On December 8th, the Conference Committee Report was submitted to, and approved by, both Houses of the Florida Legislature.[22] The Florida Income Tax Code (Florida Code), chapter 220 of the Florida Statutes,[23] became effective on January 1, 1972.[24] The basis adjustment provision included in Staff Draft No. 3 and the house bill, however, never became law. The computation of Net Income from the sale of assets included all appreciation in value, regardless of when it occurred.[25]

Taxation of income was a new concept in Florida government. The legislators who debated the issues under the Florida Code were, to a great extent, naive with regard to the fine points and nuances of state income taxation. Two important policy decisions, both commonly referred to as "piggybacking,"[26] were adopted: (1) the use of

15. FLA. S. JOUR., Sp. Sess. of Nov. 29 to Dec. 9, 1971, at 53-54.
16. FLA. H.R. JOUR., Sp. Sess. of Nov. 29 to Dec. 9, 1971, at 12-18.
17. FLA. S. JOUR., Sp. Sess. of Nov. 29 to Dec. 9, 1971, at 16-19, 21-23.
18. FLA. H.R. JOUR., Sp. Sess. of Nov. 29 to Dec. 9, 1971, at 50-52.
19. FLA. S. JOUR., Sp. Sess. of Nov. 29 to Dec. 9, 1971, at 54.
20. FLA. H.R. JOUR., Sp. Sess. of Nov. 29 to Dec. 9, 1971, at 50-52.
21. FLA. S. JOUR., Sp. Sess. of Nov. 29 to Dec. 9, 1971, at 53-54.
22. FLA. H.R. JOUR., Sp. Sess. of Nov. 29 to Dec. 9, 1971, at 99; FLA. S. JOUR., Sp. Sess. of Nov. 29 to Dec. 9, 1971, at 55.
23. FLA. STAT. §§ 220.01-.69 (1977 & Supp. 1978).
24. 1972 Fla. Laws ch. 71-984, § 8.
25. *See* FLA. STAT. §§ 220.12-.13 (1977 & Supp. 1978).
26. England, *supra* note 13, at 10.

federal taxable income as the starting point for computing Net Income,[27] and; (2) the use of concepts developed in connection with federal income taxation.[28]

## III. ANALYSIS

The Florida Code contains provisions reflecting legislative intent, one of which, in practice, is inconsistent with the use of piggybacking. Somewhat unusually, the Florida Code inserts a reference to timing, a concept normally reserved for recognition under federal tax concepts, into realization in describing the creation of income. In Florida, income is "created . . . at such time as said income is realized for federal income tax purposes."[29] Nevertheless, the Florida Code impliedly adopts "recognition" as the timing device for triggering the taxability of income by piggybacking federal taxable income as a starting point for the computation of Net Income. In the federal system, recognition is the mechanism for triggering tax liability[30] on income which has been identified and quantified through realization.[31] Realization and recognition coexist peacefully in the Internal Revenue Code, because there, realization is not a timing device; recognition serves that function. The unusual use of realization in the Florida Code is, in certain circumstances, incompatible with the recognition concept.

At the point in time at which income is recognized for federal income tax purposes, it increases federal taxable income, the starting point for the computation of Net Income in Florida. Income cannot be recognized until identified as such and quantified through realization. Because under the federal system, realized income does not become gross income until the point in time at which recognition occurs, there is no conflict for federal purposes. But in Florida, because income is "created . . . at such time as . . . realized,"[32] it is arguable that realization alone requires taxation in Florida, regardless of when recognition occurs for federal purposes. Unfortunately, the judiciary has, to date, unwittingly strengthened this argument.

The phraseology of section 220.02(4)(a) was a part of Staff Draft No. 3, along with the provision permitting taxpayers to elect to have appreciation which occurred prior to November 2, 1971 not be taxed

27. FLA. STAT. §§ 220.12-.13 (1977 & Supp. 1978).
28. *Id.* § 220.02(2) (1977).
29. *Id.* § 220.02(4)(a).
30. *See* I.R.C. § 1001(c).
31. *Id.* § 1001(a)-(b).
32. FLA. STAT. § 220.02(4)(a) (1977).

as gain on a later sale. When that latter provision was stricken, however, the language concerning realization was left intact. In *Department of Revenue v. Leadership Housing, Inc.*,[33] a case which challenged the constitutionality of taxing as gain appreciation which occurred prior to November 2, 1971, the Supreme Court of Florida adopted, for Florida income tax purposes, the definition of realization found in *Eisner v. Macomber*.[34] This is particularly surprising since most authorities cast *Eisner* aside years ago.[35]

Arthur J. England, Jr., the chief draftsman of the Florida Code, apparently thought that the adoption of piggybacking carried realization into the Florida Code.[36] Although it clearly does this, the primary duty of piggybacking in this area is the adoption of the federal concept of timing, *i.e.*, recognition. Section 220.02(4)(a) had already introduced the realization concept, although incorrectly linking it with timing. The Florida Code, as a result, exhibits a confusion between the functions of realization and recognition, particularly with respect to timing.[37]

Section 1001(c) of the Internal Revenue Code (IRC) sets forth the general rule that recognition (the time at which realized income is taxed) occurs simultaneously with realization (the quantitative measure of the income). Nevertheless, numerous other provisions of the IRC permit recognition of realized income to be postponed until some later occurrence.[38] In cases in which realization and recognition occur simultaneously, the overlapping definitions of the Florida Code are of no consequence. When they do not occur simultaneously, however, because recognition is postponed by a federal realization-nonrecognition provision, hazy treatment by the Florida

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33. 343 So. 2d 611 (Fla. 1977).

34. 252 U.S. 189 (1920). The Supreme Court of Florida quoted with approval the *Eisner* definition as follows:

> ". . . 'Income may be defined as the gain derived from capital, from labor, or from both combined,' provided it be understood to include profit gained through a sale or conversion of capital assets . . . .
>
> ". . . [It is] *not* a gain *accruing* to capital, not a *growth* or increment of value *in* the investment; but a gain, a profit, something of exchangeable value *proceeding from* the property, *severed from* the capital however invested or employed, and *coming in*, being *'derived,'* that is *received* or *drawn by* the recipient (the taxpayer) for his *separate* use, benefit and disposal;—*that* is income derived from property. Nothing else answers the description." 252 U.S. at 207, 40 S. Ct. at 193.

*Leadership Housing*, 343 So. 2d at 614 (emphasis in original).

35. *See, e.g.*, B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS 7-61 (1971).

36. England, *supra* note 13, at 10.

37. *Id.* at 10, 17-18.

38. *E.g.*, I.R.C. § 1031.

Code of realization and recognition causes problems. These problems may be divided into two categories.

First, when realization occurs prior to November 2, 1971, with recognition occurring after January 1, 1972, the question arises as to whether the full gain recognized for federal income tax purposes may be taxed in Florida. The Supreme Court of Florida has said no; only that portion of the full amount recognized which was realized after January 1, 1972 may be taxed.[39] The portion realized before then may not be taxed. This problem was prophesied by the draftsman of the Florida Code.[40]

Second, when realization occurs on or after January 1, 1972, with recognition postponed for federal income tax purposes, may Florida nevertheless impose its tax at the moment of realization? Although for computational purposes the piggybacking concept would negate this possibility, the legislature stated its intent that income is created at the point in time at which realization occurs.[41] May Florida impose its tax at that time? The opinion denying the motion for rehearing in *S.R.G.*[42] appears to say no, but the rationale is, at best, obscure.

## IV. CASE LAW

In *Department of Revenue v. Leadership Housing,*[43] the Supreme Court of Florida was asked whether the state could constitutionally tax, as income, that portion of the gain from the sale of property occurring after January 1, 1972, which is attributable to appreciation in value of the property which occurred prior to November 2, 1971. The taxpayer corporation had purchased real property during the period in which income taxation was constitutionally prohibited in Florida. The property was sold after the prohibition was removed and the Florida Code had become effective. The case did not involve a situation in which recognition was postponed. Realization and recognition occurred simultaneously. The implications of postponed recognition were not before the court.

The court relied upon the realization concept as set forth in section 220.02(4)(a)[44] to uphold the constitutionality of the tax. In so doing, it also engrafted the rule of *Eisner v. Macomber*[45] onto the

39. S.R.G. Corp. v. Department of Revenue, 365 So. 2d 687 (Fla. 1978).
40. England, *supra* note 13, at 17-18.
41. FLA. STAT. § 220.02(4)(a) (1977).
42. 365 So. 2d 687, 694-95 (Fla. 1978).
43. 343 So. 2d 611 (Fla. 1977).
44. FLA. STAT. § 220.02(4)(a) (1975).
45. 252 U.S. 189 (1920); *see* note 34 and accompanying text *supra.*

realization doctrine in Florida. As so concocted, the realization doctrine permitted the court to hold that all gain was taxable when realized, that is, at the time of disposition, regardless of when the appreciation in value giving rise to the gain occurred.[46] The court's unfortunate treatment of the realization doctrine became precedent for the holdings in later cases in which realization and recognition did not occur simultaneously.

In *Clearwater Federal Savings & Loan Association v. Department of Revenue*,[47] the District Court of Appeal, Second District, treated the facts as squarely presenting the question of the proper tax treatment, for Florida purposes, when realization occurred prior to November 2, 1971, with federal recognition being postponed until after December 31, 1971. The taxpayer had changed its method of accounting from the cash basis to the accrual basis commencing with the calendar year 1971. To accomplish the change, all net accrued income was included in the taxpayer's financial statement for the calendar year 1970. The taxpayer was permitted to spread the reporting of this income over a ten year period beginning with 1971.[48] The question before the court involved whether the income reported (recognized) in 1972 and later years was taxable for Florida purposes. The court framed the issue by characterizing the 1970 inclusion as realization and the postponed reporting in 1972 and later years as recognition. The court resolved the question by relying on the realization doctrine of section 220.02(4)(a), as interpreted by *Leadership*.[49]

The use of the realization doctrine in *Clearwater Federal* is one logical step beyond its use in *Leadership*. In fact, the District Court of Appeal, Second District, believed its decision to have been mandated by *Leadership*.[50] Income was realized within the *Eisner* definition of that term during the period of constitutional prohibition. Based upon section 220.02(4)(a), the court reasoned that income must be realized during the year in issue to be taxable for Florida purposes. The fact that it was recognized, for federal purposes, during that year was not controlling. Recognition does not make the income taxable for Florida purposes; realization does.[51]

The court rejected the assertion by the Department of Revenue that the federal recognition doctrine was controlling. Nevertheless,

46. 343 So. 2d at 615.
47. 350 So. 2d 1134 (2d DCA 1977), *aff'd per curiam*, 366 So. 2d 1164 (Fla. 1979).
48. 350 So. 2d at 1135. *See also* Rev. Proc. 70-27, 1970-2 C.B. 509.
49. 350 So. 2d at 1137.
50. *Id.*
51. *Id.*

it failed to address the rather obvious conflict created by the two statutory provisions, the first dealing with the creation of income through realization,[52] and the second governing computation of Net Income.[53] Federal recognition required inclusion in federal taxable income. Piggybacking carried the recognized income into Net Income. The court thus permitted a deduction, not set forth in the Florida Code,[54] from federal taxable income in reaching Net Income. The deduction was the amount recognized for federal tax purposes where realization had occurred prior to November 2, 1971.

The decision was based upon a combination of two factors: the legislative blending of timing with realization; and the supreme court's focus in *Leadership* on realization as the key to Florida income taxation. Although the result in *Clearwater Federal* may be correct, the court failed to consider the ramifications of lifting the realization doctrine from *Leadership,* a case in which realization and recognition occurred simultaneously, and applying it to a case in which realization occurred in one year, but recognition occurred later.

The decision in *S.R.G.*[55] is a natural consequence of extending Florida's unusual use of realization, as interpreted by *Leadership* and *Clearwater Federal,* to a federal realization-nonrecognition transaction. In 1963, the federal government condemned the taxpayer's real property. The taxpayer thereafter received a condemnation award, and in 1965 purchased similar replacement property. Pursuant to the realization-nonrecognition provisions of IRC section 1033(a)(2),[56] the taxpayer elected to postpone recognition of the gain which was realized upon receipt of the condemnation award. Therefore, the federal income tax liability was postponed until the ulti-

52. FLA. STAT. § 220.02(4)(a) (1977).

53. *Id.* §§ 220.12-.15 (current versions at *id.* (1977 & Supp. 1978)).

54. *Id.* §§ 220.13-.14.

55. 365 So. 2d 687 (Fla. 1978).

56. I.R.C. § 1033(a)(2) provides in relevant part:

> (2) (A) NONRECOGNITION OF GAIN.—If the taxpayer during the period specified in subparagraph (B), for the purpose of replacing the property so converted, purchases other property similar or related in service or use to the property so converted . . . , at the election of the taxpayer the gain shall be recognized only to the extent that the amount realized upon such conversion . . . exceeds the cost of such other property . . . .
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> (B) PERIOD WITHIN WHICH PROPERTY MUST BE REPLACED.—The period referred to in subparagraph (A) shall be the period beginning with the date of the disposition of the converted property, or the earliest date of the threat or imminence of requisition or condemnation of the converted property, whichever is the earlier, and ending—
>
> (i) 2 years after the close of the first taxable year in which any part of the gain upon the conversion is realized . . . .

mate taxable disposition of the replacement property.

In 1975, the taxpayer sold the replacement property. For federal income tax purposes, the taxpayer properly recognized the gain which was realized in 1963 upon receipt of the condemnation award, plus the gain realized on the sale of the replacement property. For Florida purposes, however, the taxpayer admitted liability only on the gain realized in 1975, not on that portion of the total recognized gain allocable to the 1963 realization. The Department of Revenue sought to tax the full amount recognized in 1975 for federal purposes, which included the amounts realized in both 1963 and 1975.

The taxpayer urged that since section 220.02(4)(a) dictates that income is created when realized,[57] as stressed by *Leadership* and *Clearwater Federal*,[58] gain realized in 1963 could not be realized again in 1975 and therefore could not be taxed at that time. The Department of Revenue, relying on the piggyback doctrine, asserted that recognition of income for federal tax purposes required imposition of the Florida tax.[59]

The court turned first to the timing concept, misplaced at section 220.02(4)(a).[60] It then refused to adopt the Department of Revenue's argument that recognition, not realization, "is the event which brings the Florida tax into operation."[61] The court concluded that the Florida Code authorized only taxation of income realized after January 1, 1972, and refused to allow taxation of the portion of gain which was realized prior to that date.[62]

Upon analysis, *S.R.G.* is a significant case because it confirms the elevation of realization over recognition as the triggering mechanism for determining the point in time at which income becomes taxable in Florida. The ramifications are frightening. The argument that federal realization-nonrecognition transactions should not be so treated for Florida purposes finds new support in the broad language used by the court.[63]

The reasoning of *S.R.G.* is deceptively simple. Corporate income becomes subject to taxation in Florida upon realization; S.R.G. Corporation realized income in 1963 but did not recognize that income until 1975. Because realization of the income occurred

57. 365 So. 2d at 688.

58. Brief for Appellant at 11-15, S.R.G. Corp. v. Department of Revenue, 365 So. 2d 687 (Fla. 1978) (on file *University of Miami Law Review*).

59. 365 So. 2d at 688-89.

60. *Id.* at 688.

61. *Id.* at 688-89.

62. *Id.* at 689.

63. "We find and hold that Chapter 220 only authorizes taxation of gain which is realized by the taxpayer after January 1, 1972 . . . ." *Id.*

during the period of constitutional prohibition, such income could not be taxed upon recognition in a later year.[64] The Department of Revenue's argument that recognition, not realization, should trigger taxation is correct, at least in tax theory.[65] But the unusual expression in the Florida Code, of income in terms of the time of realization, dealt a severe blow to tax theory and opened Pandora's box.

The court, in *Leadership,* had dealt with the first problem to emerge by depending on the misstated concept of section 220.02(4)(a), but it failed to recognize the effect of its own broad language on other issues. Next came the federal realization-nonrecognition problem. The stage had been set. The court expanded the earlier case, apparently without perceiving the ramifications of the internal conflict within the Florida Code or of its own decision. Its opinion offered no solution.

The decision in *S.R.G.* is fraught with inconsistencies. Within two consecutive paragraphs, the court expressly rejected the recognition timing rule, an essential requirement to the viability of the piggyback doctrines of the Florida Code, and then relied on section 220.02(3), which piggybacks federal concepts into Florida income tax law, to bootstrap what it considered to be the federal definition of realization into the Florida Code in order to decide the case.[66] The court concluded that "gain becomes true taxable income when it is *realized* at the time of sale or other disposition of the property."[67] This intricate logic, sufficient to "challenge the interpretative skills and ingenuity of the Delphic Oracle or even the Gaon of Vilna,"[68] was probably unnecessary. Reliance upon the unorthodox concept of combining timing with realization in section 220.02(4)(a) would have been sufficient.

In its unusual reasoning, the court failed to appreciate that the realization doctrine was misstated in the Florida Code. While the court could not rewrite the Florida Code, a more thoughtful approach to the problem would have been appropriate.

Justice England, the chief draftsman of the Florida Code, filed a lengthy, and somewhat defensive, dissent.[69] He criticized the majority opinion, saying it erroneously focused on realization when it should have focused on the basis provisions of the Internal Revenue Code which had become a part of the Florida Code through the

64. *Id.* at 688-89.
65. I.R.C. § 1001(c).
66. 365 So. 2d at 688-89.
67. *Id.* at 689 (emphasis in original).
68. Harris, 51 T.C. 980, 984 (1969) (acq. 1969-1 C.B. 188).
69. 365 So. 2d at 689-94 (England, J., dissenting).

piggybacking provisions.[70] Since the federal basis provisions pertaining to a realization-nonrecognition transaction, such as the one in *S.R.G.*, require a basis in the property reflecting the postponed recognition, the dissent's proposition is actually an indirect method of asserting that the recognition doctrine should govern the time at which income is to be taxed. The proposition has ingenious appeal, however, because it gives a definitive answer which increases revenue in this case while completely avoiding section 220.02(4)(a) and the realization-nonrecognition controversy. Nevertheless, references to basis cloud the issue. The real question before the court was whether the time at which income was to be taxed would be determined by the realization or the recognition rules. This does not constitute a problem for federal purposes because realization carries no timing concept there. In Florida, however, a timing concept has been superimposed upon the realization doctrine. Therefore, the answer is unclear. Undoubtedly, Justice England thought the Florida Code called for recognition as the time for taxation.[71] But, prior cases had called for a different conclusion. Perhaps the dissent was motivated in part by Justice England's idea of how he had originally intended the Florida Code to be interpreted.

In fact, the majority had no choice; it had to base its opinion on realization. Properly stated, realization, not recognition, identifies the taxable event and quantifies the income. Realization occurred in an earlier year, 1963, with respect to part of the gain recognized in the later year, 1975. Recognition had been postponed for federal purposes by IRC section 1033. That portion of the recognized gain which had been realized in the earlier year cannot again be realized, even at the time of recognition. Thus, the full amount recognized for federal purposes was not properly taxable in Florida since prior cases had interpreted the Florida Code as permitting only the gain realized during the year to be subjected to taxation. The dissent's position that the federal basis must be used for Florida purposes in computing the tax finds no direct support in the statute. Although the federal basis provisions are, along with recognition, indirectly made a part of the Florida Code through piggybacking, realization must occur before gain can be recognized and thus piggybacked into the computation of Net Income. Section 220.02(4)(a) creates income when it is realized; *Leadership* and *Clearwater Federal* confirm that income is taxable in the year realized. Since realization occurred in a prior year, it cannot be taxed merely upon

70. *Id.* at 689.

71. England, *supra* note 13, at 10.

federal recognition in a later year.

Other portions of the dissent also invite analysis. The dissent agreed with the result of *Clearwater Federal,* stating that the one and only taxable event in that case "took place in a year prior to the effective date of the Florida Code";[72] liability for payment of tax in a later year "arose as a result of 'realization' before our tax law became effective."[73] The dissent then analogized *Clearwater Federal* to installment sales under IRC section 453, explaining that an attempt by Florida to tax federal taxable income which arose from installment sales which occurred prior to 1972 would be "outside the permissible reach of the Florida tax,"[74] but for the special installment sale provisions of the Florida Code.[75] A constitutional bar would appear to form the basis for this conclusion.[76] The dissent had previously attempted to distinguish *S.R.G.* by stating that Florida was only trying to tax "the 1975 realization event."[77] This distinction is erroneous and the analogy to section 453 undermines the dissent's proposition, instead of supporting it, unless further modifications[78] are made to the federal concept of realization. The dissent argues that there is only one "realization event" in which Florida is interested. That event took place in 1975, and the amount in which Florida is interested is the difference between the "ultimate sales price . . . 'realized' "[79] and the IRC section 1033 basis.

This proposition ignores the fact that gain was realized in 1963 by arguing that the entire gain was realized in 1975. The dissent thus redefines the concept of realization, notwithstanding section 220.02(3)[80] calling for adoption of federal concepts in the Florida Code. The realization element of the federal realization-nonrecognition transaction was cancelled by the dissent and redefined to occur at a different moment, the moment of recognition. According to the dissent, there is no longer any identification or quantification of income upon the initial transaction under a realization-nonrecognition provision. This assertion is clearly at odds with federal concepts. In the federal system, realization takes place upon the initial transaction; this is the taxable event. The nonrecognition provision intervenes, however, to postpone the tax

72. 365 So. 2d at 694.
73. *Id.*
74. *Id.*
75. FLA. STAT. § 220.13(1)(c) (1977).
76. 365 So. 2d at 694 n.19.
77. *Id.* at 692-93.
78. *I.e.,* in addition to superimposing a timing concept upon the realization doctrine.
79. 365 So. 2d at 693.
80. FLA. STAT. § 220.02(3) (1977).

liability. The gain, if any, has already been quantified and identified through realization. This amount cannot be realized again upon the occurrence of any subsequent event. The recognition at a later date does not revive the realization.

The only other explanation of the dissent's position is the creation of a second realization at the time of the recognition. Under this explanation, realization occurs once at the time of the initial realization-nonrecognition transaction and again, in an amount equal to the original realization plus any further gain, upon the subsequent recognition event. This explanation also fails, however, because the dissent says there were "obviously . . . not two 'realizations' with respect to the property sold in 1975."[81] Accordingly, it appears that the only viable explanation of the dissent's position is that it fails to understand properly the realization doctrine.

In its petition for rehearing, the Department of Revenue argued that the holding of *S.R.G.* required taxation of all realized income, regardless of the presence of a federal realization-nonrecognition provision.[82] In denying the petition, the court said merely that the Department of Revenue had failed to consider the date on which the constitutional prohibition was removed, repeating that realization in the present case had occurred prior to that date.

It would appear, however, that the short opinion of Justice Overton, denying the petition for rehearing, contradicts his own majority opinion. The conclusion that recognition should not be the timing mechanism for Florida income tax purposes was explicit in the majority opinion. In holding against the Department of Revenue, the majority stated "the Department of Revenue asserts that recognition . . . is the event which brings the Florida tax into operation. We disagree."[83] The majority had quoted section 220.02(4) as well, "Income . . . shall be . . . created . . . *at such time as said income is realized,*"[84] and concluded: "We find and hold that Chapter 220 only authorizes taxation of gain which is realized by the taxpayer after January 1, 1972 . . . ."[85]

The rules are clear. Income becomes subject to taxation immediately upon realization, assuming that realization takes place on or after January 1, 1972; income realized prior to January 1, 1972 is immune from taxation. Nevertheless, the opinion denying rehearing

81. 365 So. 2d at 693.
82. *Id.* at 694.
83. *Id.* at 688-89.
84. *Id.* at 688 (emphasis by the court).
85. *Id.* at 689.

stated that taxation "immediately upon realization of a gain, with no deferment being allowed if such is provided in the Internal Revenue Code . . . is without foundation."[86] The conclusion reached by the opinion denying rehearing was no doubt intended by the Florida Legislature. Unfortunately, however, the result is unclear from the Florida Code itself, troublesome after *Leadership* and *Clearwater Federal,* and difficult after the majority opinion in *S.R.G.*

Apparently, the court realized that it had painted itself into a corner. The treatment of the realization concept in the majority opinion lent credibility to the argument that all realizations are taxable, even though federal recognition is postponed through a realization-nonrecognition provision in the Internal Revenue Code. In its opinion denying the petition for rehearing, the court refused to shed any light upon its reasoning. The argument that mere realization can trigger income, notwithstanding an applicable federal nonrecognition provision, now appears to have some validity in Florida. Whether the court was successful in rescuing itself through its opinion on the petition for rehearing is yet to be seen.

## V. SUGGESTED SOLUTIONS

The legislature should consider codifying the correct result of *S.R.G.* by amending the Florida Code. Generally, the amendment could provide for a subtraction from federal taxable income where property, which has a basis determined in whole or in part by reference to the basis of other property, has been sold or disposed of in a transaction in which income is recognized for federal income tax purposes. The amount of the subtraction would be equal to the gain realized but not recognized for federal income tax purposes in the prior sale or disposition. To prevent *S.R.G.* from being interpreted, as it may, to permit taxation in Florida of all transactions with respect to which there was a realization, the Florida Code should be amended further to make it clear that the federal nonrecognition provisions apply in Florida. This could be accomplished through a provision prohibiting an increase in federal taxable income, in determining Net Income, for any amount omitted from federal taxable income because it was not recognized or excluded therefrom, unless the Florida Code specifically permits such an increase.

Even without statutory amendment, there is an argument that all realized income cannot be taxed in Florida. Section 220.02(4)(c), which provides that income realized "shall be taxed in the manner

86. *Id.* at 694.

and to the extent provided in this [Florida] Code,"[87] has not been fully explored. Once income is realized, it may be taxed only "to the extent"[88] provided by the Florida Code. The computation of Net Income starts with federal taxable income, which does not include the amount of income not recognized. Since there is no specific provision in the Florida Code requiring inclusion in Net Income of such amounts, it should not in fact be taxed. Although section 220.02(4)(c) is mentioned in Justice England's dissent,[89] no consideration was given to whether it should, or could, dictate that piggybacking supersedes the realization problem of section 220.02(4)(a). Arguably, the language "to the extent" provides such a result. No doubt the chief draftsman of the Florida Code, Justice England, thought it did, but other members of the judiciary did not agree. Section 220.02(4)(c) may provide the statutory support sought by Justice England.

87. FLA. STAT. § 220.02(4)(c) (1977).
88. *Id.*
89. 365 So. 2d at 691 n.7.