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### Taxation—The Tax Benefit Rule of *Perry* Overruled

In *Alice Phelan Sullivan Corporation v. United States*<sup>1</sup> taxpayer, a California corporation, received two parcels of land, each of which it had previously donated and claimed as a charitable deduction.<sup>2</sup> The first donation, valued at 4,243.49 dollars, was made in 1939; the second, valued at 4,463.44 dollars, was made in 1940. Under the tax rates applicable in those years,<sup>3</sup> the claimed deductions resulted in an aggregate tax benefit of 1,877.49 dollars to taxpayer. The conveyances, however, were made subject to the condition that the realty be used either for religious or educational purposes. In 1957 the donee decided not to use the property and therefore reconveyed it to taxpayer. The Commissioner of Internal Revenue, characterizing the reconveyances as taxable at the 1957 corporate rate,<sup>4</sup> included in taxpayer's gross income the amount of 8,706.93 dollars<sup>5</sup>—the value of the charitable deductions previously claimed and allowed.<sup>6</sup> Relying on *Perry v. United States*,<sup>7</sup> taxpayer paid and sued for refund<sup>8</sup> in the Court of Claims on the theory that the reconveyances constituted a return of capital<sup>9</sup> and that a proper assessment could require no more than payment to the government of the tax benefit originally obtained.<sup>10</sup> The court held that recovery

<sup>1</sup> 381 F.2d 399 (Ct. Cl. 1967).

<sup>2</sup> See INT. REV. CODE of 1954, § 170.

<sup>3</sup> The corporate tax rate in 1939 was 18 per cent; in 1940, 24 per cent.

<sup>4</sup> The applicable corporate tax rate in 1957 was 52 per cent.

<sup>5</sup> This resulted in a deficiency assessment of 4,527.60 dollars.

<sup>6</sup> Gross income normally includes only the amount of the previous deduction regardless of any increase in value. See *Buck Glass Co. v. Hofferbert*, 176 F.2d 250 (4th Cir. 1949); *Commissioner v. First State Bank*, 168 F.2d 1004 (5th Cir. 1948); *Crabb v. Commissioner*, 119 F.2d 772 (5th Cir. 1941); *Perry v. United States*, 160 F. Supp. 270 (Ct. Cl. 1958).

<sup>7</sup> 160 F. Supp. 270 (Ct. Cl. 1958). In this case taxpayers in 1944, 1945, 1946, 1947, and 1948 made charitable gifts of cash and securities to a town for the purpose of constructing an addition to a library. Taxpayers deducted the appropriate amount from their gross income each year. In 1953 the gifts were returned to taxpayers. It was held that taxpayers should have added to their income tax the amount by which their income taxes in previous years had been decreased.

<sup>8</sup> The amount of the refund sought was 2,650.11 dollars.

<sup>9</sup> See *Perry v. United States*, 160 F. Supp. 270, 271 (Ct. Cl. 1958), in which the court stated: "As stated, the return to the taxpayer of the property he had tried to give away cannot possibly be considered as income—he merely got back his own property."

<sup>10</sup> That is, 1,877.49 dollars instead of the Commissioner's assessment of 4,527.60 dollars.

of charitable contributions for which full tax benefit had been enjoyed is properly classified as income taxable at the current rate at the time of recovery. The *Perry* decision, with its new tax benefit rule,<sup>11</sup> was expressly overruled.<sup>12</sup> However, Judge Collins, even though writing the opinion for the court, criticized the holding.<sup>13</sup> Upon examination of the law and scrutiny of the court's reasoning, it is justifiable to conclude that the decision is more legally correct than equitably just.<sup>14</sup>

The recovery of charitable contributions removes the equitable basis<sup>15</sup> upon which previous deductions were taken. The rule requiring taxation of such recoveries<sup>16</sup> or an appropriate adjustment<sup>17</sup> in favor of the government is necessary to prevent the unjust enrichment of a taxpayer and to offset the tax benefit of deductions which subsequent facts have rendered unwarranted.<sup>18</sup> Recoveries have been taxed as income under the theory that since deducted items result in the non-taxation of a part of gross income, these

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<sup>11</sup> The *Perry Case* set forth what has been called the "new tax benefit rule" or the "tax dollar benefit rule." That is, a taxpayer who recovers gifts is required to add to his income tax in the year of recovery no more than the amount of taxes saved in prior years due to charitable contribution deductions. See 33 TUL. L. REV. 247 (1959).

<sup>12</sup> Concluding its opinion, the court says:

Since taxpayer in this case did obtain full tax benefit from its earlier deductions, those deductions were properly classified as income upon recoupment and must be taxed as such. This can mean nothing less than the application of that tax rate which is in effect during the year in which the recovered item is recognized as a factor of income.

381 F.2d 399, 403 (Ct. Cl. 1967).

<sup>13</sup> In the words of Judge Collins,

This opinion represents the views of the majority and compiles with existing law and decisions. However, in the writer's personal opinion, it produces a harsh and inequitable result. Perhaps, it exemplifies a situation 'where the letter of the law killeth; the spirit giveth life.'

*Id.* at 403, n.5.

<sup>14</sup> In the instant case, the court says of *Perry* that "it achieved a result which was more equitably just than legally correct." *Id.* at 403.

<sup>15</sup> See INT. REV. CODE of 1954, § 170.

<sup>16</sup> See *Rothensies v. Electric Storage Battery Co.*, 329 U.S. 296 (1946); *Estate of Block v. Commissioner*, 39 B.T.A. 338 (1939), *aff'd sub nom. Union Trust Co. v. Commissioner*, 111 F.2d 60 (7th Cir. 1940), *cert. denied*, 311 U.S. 658 (1940).

<sup>17</sup> See *Perry v. United States*, 160 F. Supp. 270 (Ct. Cl. 1958).

<sup>18</sup> See *Plumb, The Tax Benefit Rule Today*, 57 HARV. L. REV. 129, 176 (1943).

<sup>19</sup> See *National Bank of Commerce v. Commissioner*, 115 F.2d 875 (9th Cir. 1940); *Estate of Collins*, 46 B.T.A. 765 (1942). *But see, Helvering v. State-Planters Bank & Trust Co.*, 130 F.2d 44 (4th Cir. 1942), where another theory relying on estoppel or implied waiver is set forth.

items when recovered must stand in the place of the gross income which previously escaped taxation.<sup>19</sup> The lack of adequate statutory treatment of recoveries, however, has led to extensive litigation.<sup>20</sup>

The only exception to the taxation of recoveries is found in the equitable tax benefit rule<sup>21</sup> whereby recovered items may be excluded from income so long as their previous deduction did not provide a tax saving.<sup>22</sup> Initially, the rule was not accepted unanimously, some courts adopting the view that a recovery of a deducted item is includible in taxable income regardless of whether the deduction resulted in a tax benefit.<sup>23</sup> However, the tax benefit rule achieved limited statutory recognition in 1942.<sup>24</sup> Moreover, its overall equitable policy was guaranteed expanded recognition by the Supreme Court in *Dobson v. Commissioner*.<sup>25</sup> Today the tax benefit rule has been broadened by both the Internal Revenue Code of 1954<sup>26</sup> and by the Income Tax Regulations.<sup>27</sup> The goal of the tax benefit rule has been regarded as commendable by both courts<sup>28</sup> and writers.<sup>29</sup>

In denying taxpayer's claim in the instant case the court rightly determined that the present regulations on the tax benefit rule controlled the tax consequences of the recovery of charitable contributions.<sup>30</sup> The principle applies not only to bad debts, prior taxes and

<sup>20</sup> For collected cases see 1 J. MERTENS 1962 FEDERAL INCOME TAXATION §§ 7.34-7.37.

<sup>21</sup> See *Dobson v. Commissioner*, 320 U.S. 489 (1943).

<sup>22</sup> See Lassen, *The Tax Benefit Rule and Related Problems*, 20 TAXES 473 (1942); Plumb, *The Tax Benefit Rule Today*, 57 HARV. L. REV. 129 (1943); 33 TUL. L. REV. 247 (1959); 44 VA. L. REV. 639 (1958).

<sup>23</sup> See *Commissioner v. United States & Int'l Sec. Corp.*, 130 F.2d 894 (3d Cir. 1942), *modified*, 138 F.2d 416 (3d Cir. 1943).

<sup>24</sup> INT. REV. CODE of 1939, § 22(b)(12), added by 56 STAT. 812 (1942). The statute applied to only bad debts, prior taxes and delinquency amounts.

<sup>25</sup> 320 U.S. 489 (1943).

<sup>26</sup> INT. REV. CODE of 1954, § 111. See also INT. REV. CODE of 1954, § 1016(a)(2), which makes the tax benefit rule applicable to excessive deductions based upon wear and tear, amortization, obsolescence and depletion.

<sup>27</sup> TREAS. REG., § 1.111-1 (1956).

<sup>28</sup> See *Dobson v. Commissioner*, 320 U.S. 489 (1943); *California Hawaiian Sugar Ref. Corp. v. United States*, 311 F.2d 235 (Ct. Cl. 1962).

<sup>29</sup> See Eustice, *Cancellation of Indebtedness and the Federal Income Tax: A Problem of Creeping Confusion*, 14 TAX L. REV. 225, 252 (1959), where it is said: "The role of the tax-benefit doctrine as an approach to taxability in the cancellation of indebtedness area has been far from clear. As a general proposition, the theory seems logical and fair. . . ." See also Lassen, *The Tax Benefit Rule and Related Problems*, 20 TAXES 473 (1942); Plumb, *The Tax Benefit Rule Today*, 57 HARV. L. REV. 129 (1943).

<sup>30</sup> The court said:

Drawing our attention to the broad language of this regulation

delinquency amounts,<sup>31</sup> but also "to all other losses, expenditures, and accruals made the basis of deductions from gross income for prior taxable years."<sup>32</sup> In applying the principle the court rejected taxpayer's argument that the reconveyances represented merely the return of capital. In doing so it relied upon the authority of numerous cases<sup>33</sup> and also the reasoning expressed in the dissenting opinion of the *Perry* case to the effect that "[h]aving been written off, the later realization of the claim was, *again for tax purposes*, like a windfall to the taxpayer, and within the broad definition of taxable income."<sup>34</sup> But for the fact that taxpayer deducted the value of the contributions from his gross income, it is difficult to see why the return to taxpayer of property he had given away is income.<sup>35</sup> In any event, the label placed on the reconveyances should not be controlling as to the equitable tax consequences.

The primary point of controversy between the government and taxpayer arises because the tax benefit statute<sup>36</sup> and the income tax regulations<sup>37</sup> are silent as to the tax rate applicable to recoveries.<sup>38</sup> Taxpayer suggested that the fair solution would be to add the amount of tax saved in previous years due to the gift deductions to its tax for the year in which the property was returned. Thus, the precise amount of the tax benefit enjoyed would be restored to the government.<sup>39</sup> This equitable solution was rejected by the court

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[TREAS. REG., § 1.111-1], the Government insists that the present recovery must find its place within the scope of the regulation and, as such, should be taxed in a manner consistent with the treatment provided for like items of recovery, i.e., that it be taxed at the rate prevailing in the year of recovery. We are compelled to agree.

381 F.2d 399, 402 (Ct. Cl. 1967).

<sup>31</sup> INT. REV. CODE of 1954, § 111.

<sup>32</sup> TREAS. REG. § 1.111-1 (1956).

<sup>33</sup> *Rothensies v. Electric Storage Battery Co.*, 329 U.S. 296 (1946); *California & Hawaiian Sugar Ref. Corp. v. United States*, 311 F.2d 235 (Ct. Cl. 1962); *Citizens Fed. Sav. & Loan Ass'n v. United States*, 290 F.2d 932 (Ct. Cl. 1961); *Estate of Block v. Commissioner*, 39 B.T.A. 338 (1939), *aff'd sub nom. Union Trust Co. v. Commissioner*, 111 F.2d 60 (7th Cir. 1940), *cert. denied*, 311 U.S. 658 (1940).

<sup>34</sup> *Perry v. United States*, 160 F. Supp. 270, 273 (Ct. Cl. 1958).

<sup>35</sup> *Id.* at 271.

<sup>36</sup> See note 32 *supra*.

<sup>37</sup> See note 27 *supra*.

<sup>38</sup> See definition of "recovery exclusion" in INT. REV. CODE of 1954, § 111(b)(4).

<sup>39</sup> For a good discussion, see Pavenstedt, *The United States Court of Claims as a Forum for Tax Cases*, 15 TAX L. REV. 201 (1960).

on the ground that it exceeded the legal limits of both statutory and judge-made law.<sup>40</sup> In arriving at its decision to tax the recoveries at the current rate in the year of recovery, the court relied upon such policy considerations as annual accounting,<sup>41</sup> the statute of limitations,<sup>42</sup> general administrative ease,<sup>43</sup> and the lack of judicial power to legislate.<sup>44</sup> Strong as these policy considerations are, they should not outweigh the need for justice. The court's interpretation of the present tax benefit rule necessarily promotes injustice.<sup>45</sup> The recoveries, for example, may come in a year of high income so that the taxpayer pays a much greater tax on the recoveries than he saved by the deductions. Also, the recoveries may come in years when tax rates have increased. Moreover, the inclusion in one year of deductions taken in several years inevitably pushes the taxpayer into a higher tax bracket.<sup>46</sup> This is not to say, however, that the present tax benefit rule cannot work in favor of the taxpayer<sup>47</sup> although the odds are against it. To remedy this injustice the taxpayer could file an amended return for the year in which

<sup>40</sup> See *Bird v. United States*, 241 F.2d 516 (1st Cir. 1957); *Friehofer Baking Co. v. Commissioner*, 151 F.2d 383 (3d Cir. 1945); *Boehm v. Commissioner*, 146 F.2d 553 (2d Cir. 1945); *Ben Bimberg & Co., Inc. v. Helvering*, 126 F.2d 412 (2d Cir. 1942); *Universal, Inc. v. Commissioner*, 109 F.2d 616 (7th Cir. 1940); *National Forge & Ordnance Co. v. United States*, 151 F. Supp. 937 (Ct. Cl. 1957); *United States v. Detroit Moulding Corp.*, 56 F. Supp. 754 (E.D. Mich. 1944); *H. Sheldon Mfg. Co. v. Commissioner*, 13 B.T.A. 1296 (1928); *Birmingham Terminal Co. v. Commissioner*, 17 T.C. 1011 (1951). See also S. SURREY & W. WARREN, *FEDERAL INCOME TAXATION* 538 (1960); J. MERTENS, *FEDERAL INCOME TAXATION* § 7.37 (1962); Rev. Rul. 59-141, 1959-1 CUM. BULL. 17.

<sup>41</sup> INT. REV. CODE of 1954, § 441. See also *Burnet v. Sanford & Brooks Co.*, 282 U.S. 359, 365 (1931), where the court said:

It is the essence of any system of taxation that it should produce revenue ascertainable, and payable to the government, at regular intervals. Only by such a system is it practicable to produce a regular flow of income and apply methods of accounting, assessment, and collection capable of practical operation.

<sup>42</sup> INT. REV. CODE of 1954, § 6511.

<sup>43</sup> See cases cited in note 40 *supra*.

<sup>44</sup> "[T]he court cannot legislate and any change in the existing law rests within the wisdom and discretion of the Congress." 381 F.2d 399, 403 (Ct. Cl. 1967).

<sup>45</sup> See Plumb, *The Tax Benefit Rule Today*, 57 HARV. L. REV. 129, 176-77 (1943).

<sup>46</sup> This, of course, is less likely in the case of a corporate taxpayer.

<sup>47</sup> The taxpayer would benefit if the deduction was taken in a profitable year, while the recovery came in a loss year or a year of low income or in a year when tax rates were lower. See *Inland Prod. Co. v. Blair*, 31 F.2d 867 (4th Cir. 1929).

the deduction was allowed thereby making a fair adjustment with the government.<sup>48</sup>

Although the remedy of an amended return would violate the concepts of annual accounting and undoubtedly would cause some administrative inconvenience, such drawbacks have never prevented change.<sup>49</sup> The tax benefit rule itself deviates from the concept of annual accounting.<sup>50</sup> Congress, in the name of equity, has deviated from the statute of limitations and annual accounting and has accepted administrative inconvenience by enacting provisions covering the carryover-carryback of losses,<sup>51</sup> recoveries from unconstitutional processing of taxes,<sup>52</sup> inconsistently treated items,<sup>53</sup> and periods of abnormally high income.<sup>54</sup> To allow an amended return for recoveries of charitable contributions would be no greater departure.

If the court was correct in its holding that judicial legislation<sup>55</sup> cannot go as far as the taxpayer wished, it is submitted that Congress should reevaluate the tax benefit rule. Legislation granting the taxpayer an option to account for the recovery of a charitable contribution in the year of recovery or to file an amended return for a previous year would not only achieve substantial justice,<sup>56</sup> but also would promote public policy by encouraging taxpayers to make contributions to charity.<sup>57</sup>

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<sup>48</sup> See, Plumb, *The Tax Benefit Rule Today*, 57 HARV. L. REV. 129, 177 (1943).

<sup>49</sup> *Id.* at 178-79.

<sup>50</sup> See *Hearings Before House Ways and Means Committee on Revenue Revision of 1942*, 77th Cong., 2d Sess., Vol. I, 80, 87-88 (1942).

<sup>51</sup> See INT. REV. CODE OF 1954, § 172(b).

<sup>52</sup> *Id.* § 1346.

<sup>53</sup> *Id.* § 1311.

<sup>54</sup> *Id.* at 1301-1304.

<sup>55</sup> See *Commissioner v. Beck's Estate*, 129 F.2d 243, 245 (2d Cir. 1942), where the court said:

Judicial legislation is one of the facts of life, an inescapable and necessary one. But courts may not, as legislatures may, roam at large, confined only by the Constitution; their function, when dealing with legislative legislation, does not go beyond that of filling in small gaps left by the legislature—and to closing those gaps in accordance with what appears to have been the legislative purpose.

<sup>56</sup> Although some may not agree that granting an option to the taxpayer achieves substantial justice, this would be in accord with other sections of the Code, such as section 1341.

<sup>57</sup> For additional discussions of the tax benefit rule, see Eustice, *Cancellation of Indebtedness and the Federal Income Tax: A Problem of Creeping Confusion*, 14 TAX L. REV. 225 (1959); Lassen, *The Tax Benefit Rule and Related Problems*, 20 TAXES 473 (1942); Pavenstedt, *The United States Court of Claims as a Forum for Tax Cases*, 15 TAX L. REV. 201 (1960); Plumb, *The Tax Benefit Rule Today*, 57 HARV. L. REV. 129 (1943); 33 TUL. L. REV. 247 (1959); 44 VA. L. REV. 639 (1958).