

STATE OF ALABAMA
DEPARTMENT OF REVENUE,

§ STATE OF ALABAMA
DEPARTMENT OF REVENUE
§ ADMINISTRATIVE LAW DIVISION

v.

§ DOCKET NO. INC. 86-219

TEH INVESTMENTS, INC.
300 Vestavia Office Park
Birmingham, AL 35216,

§

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Taxpayer.

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ORDER

The Revenue Department assessed income tax against TEH Investments, Inc. ("Taxpayer") for the fiscal year ending September 30, 1985. The Taxpayer appealed to the Administrative Law Division and the matter was submitted on a joint stipulation of facts. The parties were represented by assistant counsel Mark D. Griffin, for the Department, and Grant McDonald, for the Taxpayer. Based on the stipulation entered into by the parties, the following findings of fact and conclusions of law are hereby made and entered.

FINDINGS OF FACT

The facts, as stipulated by the parties, are as follows:

1. TEH Investments, Inc. (hereinafter referred to as "Taxpayer") is an Alabama domestic corporation. Taxpayer was incorporated on December 22, 1981 for the sole purpose of serving as the general partner in Timberleaf Apartments Partners, Ltd.

2. Taxpayer made no investment in the limited partnership in return for its general partnership interest, nor did it ever receive any real income from the limited partnership. The partnership reported the following accounting losses:

September 30, 1982	\$	12
September 30, 1983		20,203
September 30, 1984		1,606
September 30, 1985		<u>163</u>

Total Losses Claimed \$21,984

3. During the tax period ended September 30, 1985, the Taxpayer was released of its general partnership obligation and reported the \$21,984 of prior losses as income on its federal return. On the federal return, this income was offset by a net operating loss in the amount of \$22,135.

4. On its 1985 fiscal year corporate state income tax return, Taxpayer reported net income in the amount of \$21,494.00. A copy of the 1985 fiscal year corporate return filed by Taxpayer is attached as Exhibit "A", which includes the federal corporate return for the same year.

5. On said return, Taxpayer also reported a reconciliation adjustment in the amount of \$21,984.00. Taxpayer submits that it is entitled to this adjustment pursuant to the "tax benefit rule".

6. The Department audited the 1985 corporate return of Taxpayer. The Department disallowed the adjustment in the amount of \$21,984.00. The Department's position is based on the fact that the "tax benefit rule" does not apply in the State of Alabama. A copy of the Department's adjustment to Taxpayer's 1985 tax liability is attached as Exhibit "B".

7. Based on the Department's adjustment, a preliminary assessment of corporate income tax was issued against Taxpayer on June 9, 1986. A copy of the preliminary assessment is attached as Exhibit "C".

CONCLUSIONS OF LAW

The determinative issue is whether the tax benefit rule is applicable in Alabama. The tax benefit rule is "both a rule of inclusion and exclusion; recovery of an item previously deducted must be included in income; that portion of the recovery not resulting in a prior tax benefit is excluded." Home Mut. Ins. Co. v. C.I.R., 639 F.2d 333, at p. 343, quoting Putoma Corp. v. Comm., 601 F.2d 743.

The rule had a federal case law beginning, and remains extra-statutory in nature despite its partial codification through enactment of 26 U.S.C. §111 in 1942. Section 111 mentions only bad debts, prior taxes, and delinquent accounts. However, Treasury Regulations have expanded the rule to include "all other losses, expenditures, and accruals made the basis of deductions from gross income for prior taxable years". See Reg. §1.111-1 and Putoma Corp. v. Comm., supra at p. 742.

The scope of the rule was discussed in Home Mut. Ins. Co. v. C.I.R., supra, at p. 343 as follows:

The tax benefit rule is a well established judge-made rule that despite partial codification in §111 remains substantially extra-statutory in nature and affects a taxpayer's taxable income beyond the literal meaning of the Code itself. thus, it is not sufficient to rebut the invocation of the tax benefit rule to argue that the statute makes no provision for its use here . . .

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In short, the inclusionary aspect of the rule, which is based entirely on case law, "recognizes the 'recovery' in the current year of taxable income earned in an earlier year but offset by the item deducted." Because such recoveries are reportable due to the existence of previous deductions, recoveries should be included in income only to the extent that the earlier deduction had in fact served to reduce its taxable income in the year in which the deduction was taken. This exclusionary aspect of the tax benefit rule was not conclusively accepted until 1942, when Congress enacted the statutory predecessor to current §111. Although §111 expressly provides for such exclusion only for the recovery of previously deducted bad debts, taxes, and delinquency amounts, it is well settled that this aspect of the tax benefit extends beyond the literal terms of the statute. Thus, although the exclusionary part of the tax benefit rule finds a statutory anchor, the entire rule remains in essence an extra-statutory judicial rule permitting retroactive adjustments so that some transactions substantially altered in years subsequent to the original

accounting period may be taxed virtually as though the entire transaction had occurred in one accounting period.

Alabama also recognizes the tax benefit rule, although it has no statute comparable to 26 U.S.C. §111. In State v. Edelman, 114 So.2d 261 (1958), the Alabama Supreme Court recognized the rule as follows:

We have given careful consideration to the State's insistence that we should not apply the tax benefit rule in the absence of legislative action. Our attention is called to the fact that the Congress of the United States enacted legislation in regard to the tax benefit rule in 1942.

Our research discloses, however, that the adoption of those statutes came about as a result of the fact that the Supreme Court of the United States had never passed on the question and that other federal courts and administrative agencies were far from consistent in their holdings.

As we see it, the question before us is the extent to which tax refunds are taxable as income. The answer to that question, in our opinion, is dependent upon whether or not a taxpayer has gotten a benefit from the refund. Unless he has received such benefit, there is no reason, moral or legal, why the refund should not be considered as income.

Since Edelman received no tax benefit from the \$20,000 refund sought to be taxed, the trial court correctly vacated the assessment of the State Department of Revenue. Our holding here is not in conflict with our holding in State v. Yellow Pine Lumber Co., supra. In that case we were not called upon to consider the question as to whether the tax benefit rule should apply. (emphasis added)

The reasoning in Edelman was adopted by the Department through Reg. 810-3-14-.04, which is limited to tax refund situations. However, Alabama's income tax system is modeled after federal law

and general principles applicable to federal income tax must also be applied in administering the Alabama income tax. Best v. State, Dept. of Revenue, 417 So.2d 187. Consequently, the tax benefit rule is fully applicable in Alabama and must be recognized in computing Alabama income tax.

The above considered, the assessment in issue should be reduced and made final showing no tax due.

Entered this 31st day of August, 1988.

BILL THOMPSON
Chief Administrative Law Judge