

STATE OF ALABAMA,
DEPARTMENT OF REVENUE,

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STATE OF ALABAMA
DEPARTMENT OF REVENUE
ADMINISTRATIVE LAW DIVISION

vs.

W. T. BOOTH CONSTRUCTION, INC.
P. O. Box 305
Helena, AL 35080,

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DOCKET NO. INC. 87-105

Taxpayer.

OPINION AND PRELIMINARY ORDER

The Revenue Department assessed income tax against W. T. Booth Construction, Inc. (Taxpayer) for the year ending September 30, 1985. The Taxpayer appealed to the Administrative Law Division and the matter was submitted on a joint stipulation of facts. Grant McDonald represented the Taxpayer. Assistant counsel Mark Griffin represented the Department.

FINDINGS OF FACT

The Taxpayer depreciated certain vehicles and equipment on its Alabama domestic income tax return for the fiscal year ending September 30, 1982. The Taxpayer reported a net loss of \$16,807.00 on the 1982 return.

The Taxpayer disposed of the vehicles and equipment during the fiscal year ending September 30, 1985 and reported the resulting gain as income in that year. The Taxpayer also claimed a reconciliation adjustment (deduction) on the 1985 return in the amount of \$11,109.00. The adjustment consisted of (1) depreciation of \$7,829.00 claimed on the 1982 return for which no tax benefit

was received in that year, and (2) interest expense of \$3,280.00.

The Department disallowed both adjustments and entered the assessment in issue. The Taxpayer does not contest the disallowed interest expense, but does argue that the depreciation adjustment should be allowed based on the "tax benefit rule".

CONCLUSIONS OF LAW

The only issue in this case is whether the tax benefit rule should be recognized for Alabama income tax purposes.

The tax benefit rule evolved in the federal courts as a method for correcting the transactional disparity that sometimes occurs when events relating to the same item of income or deduction occur in different tax years. The rule treats those events for tax purposes as if they had occurred in the same tax period. As stated in Home Mut. Ins. Co. v. C.I.R., 639 F.2d 333, beginning at page 343:

A taxpayer should not be permitted to take advantage of the tax system's need to treat transactions as final at the end of the accounting year so that tax consequences can be calculated. The (tax benefit) rule allows accurate taxation of a whole transaction that may span several accounting periods.

The tax benefit rule provides that the receipt or recovery of an item previously deducted must be reported as income in the year of recovery, although the amount may not technically constitute gross income (the rule of inclusion). Conversely, that portion of

the recovery which did not actually result in a tax benefit in the prior year should be excluded from gross income (the rule of exclusion). See generally, First Trust and Savings Bank of Taylorville v. U.S., 614 F.2d 1142; Home Mut. Ins. Company v. C.I.R., supra.

Congress partially codified the tax benefit rule with enactment of 26 U.S.C.A. §111. Section 111 initially covered only the recovery of bad debts, prior taxes and delinquent accounts. The rule was expanded, however, by Treasury Reg. 1.111-1 to include "all other losses, expenditures, and accruals made the basis of a deduction from gross income for prior taxable years". Congress amended §111 in 1984 to provide that "gross income does not include income attributable to the recovery during the taxable year of any amount deducted in any prior taxable year to the extent such amount (previously deducted) did not reduce the amount of the tax imposed by this chapter". In effect, the tax benefit rule now applies to all items previously deducted.

The Department argues that the tax benefit rule should not be recognized for Alabama purposes because Alabama has not enacted a statute similar to federal §111. But the rule is extra-statutory in nature and therefore is not dependent on a statute for its existence. Case law interpreting a federal statute should be followed in interpreting a similar Alabama statute. Best v. State, Department of Revenue. 417 So.2d 197. Likewise, because the

Alabama income tax system is patterned after the federal system, the same general principles and rules that govern the federal system should be recognized by Alabama. Accordingly, the tax benefit rule as recognized for federal purposes should also be recognized and followed for Alabama purposes.

The Alabama Supreme Court has also recognized and adopted the tax benefit rule in State v. Edelman, 114 S.2d 261. As in this case, the Department in Edelman argued that the rule should not be recognized in the absence of a statute. The Supreme Court rejected the Department's argument and adopted the principle behind the exclusionary aspect of the rule as follows, at page 263;

The answer to that question (the taxation of the refund), 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 be considered as income.

The Department argues that Edelman should be limited to only tax refund situations. However, there is nothing in the opinion showing the Court's intent to limit the rule. Rather, the Court generally adopted both the exclusionary and inclusionary aspects of the rule as follows, at page 262.

The recovery of a debt previously charged off as worthless, the refund or abatement of a tax, the recoupment of a loss, the rebate or cancellation of an expense, and similar adjustments affecting items deducted in prior years are not in this strict sense a part of income.

Nevertheless, such recoveries or cancellations are as a general rule said to be subject to income tax. See, Plumb, The Tax Benefit Rule Today, 57 Harvard Law Review 129, 130.

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We are not concerned here with the question as to which theory is correct. If the first theory is accepted, considerations of equity and fair dealing forbid that the waiver or the acquiescence be carried beyond the benefit received and the same applies if it be considered as an estoppel.

The second theory allows recovery by the taxing authority because of a tax benefit previously received by the taxpayer. If there was no tax benefit because of the deduction, there should be no taxation of the refund.

The above considered, the depreciation reconciliation deduction in issue should be allowed. The Department is directed to recompute the Taxpayer's 1985 liability accordingly and inform the Administrative Law Division of the adjusted amount due. A Final Order will then be entered from which either party may appeal pursuant to Code of Ala. 1975, §40-2A-9(g).

Entered on October 5, 1992.

BILL THOMPSON
Chief Administrative Law Judge