

STATE OF ALABAMA,
DEPARTMENT OF REVENUE,

vs.

HYRDO-MAC FOOD AND VENDING
SERVICES, INC.
P.O. Box 9303
Montgomery, AL 36108,

Taxpayer.

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STATE OF ALABAMA
DEPARTMENT OF REVENUE
ADMINISTRATIVE LAW DIVISION

DOCKET NO. INC. 88-179

FINAL ORDER

The Revenue Department assessed income tax against Hydro-Mac Food and Vending Services, Inc. (Taxpayer) for the fiscal year ending September 30, 1986. The Taxpayer appealed to the Administrative Law Division and a hearing was conducted on October 15, 1992. The Taxpayer's representative, Grant McDonald, informed the Administrative Law Division prior to the hearing that he would not attend and that the matter should be decided on the facts submitted by the Department. Assistant counsel Dan Schmaeling appeared for the Department.

FINDINGS OF FACT

The Taxpayer transferred various assets to a related corporation, Automatic Food Services, Inc., during the fiscal year ending September 30, 1986. The Taxpayer had depreciated the assets on its prior Alabama returns but a portion of the depreciation had not resulted in a tax benefit to the Taxpayer.

The Taxpayer recognized a gain on the transfer of the assets as required by Code of Ala. 1975, §40-18-8(f). However, the Taxpayer also reduced the amount of the gain by that portion of the previously claimed depreciation that had not resulted in a tax benefit. The Taxpayer's action was based on the tax benefit rule.

The Department's position is that the tax benefit rule is not applicable in Alabama (except concerning income tax refunds). Accordingly, the Department increased the Taxpayer's gain to include the depreciation that the Taxpayer had deleted. The assessment in issue is based on the Department's adjustment.

The Department also argues in the alternative that if the Taxpayer is allowed to reduce the amount of the gain based on the tax benefit rule, then the transferee's basis in the property should be reduced accordingly.

CONCLUSIONS OF LAW

The 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 So.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 concedes that the tax benefit rule was recognized in Edelman, but argues that Edelman should be limited to only tax refund situations. However, there is nothing in Edelman 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.

Applying the tax benefit rule to this case, the Taxpayer's gain on the transfer of the assets should be reduced by that portion of the previously claimed depreciation that did not result in a tax benefit to the Taxpayer. Consequently, the Department's adjustments are incorrect and no additional tax is owed by the Taxpayer. However, the Department is correct that the transferee's basis in the assets should be reduced by a corresponding amount.

This Final Order may be appealed to circuit court within 30 days pursuant to Code of Ala. 1975, §40-2A-9(g).

Entered on October 22, 1992.

BILL THOMPSON
CHIEF ADMINISTRATIVE LAW JUDGE