

STATE OF ALABAMA  
DEPARTMENT OF REVENUE,

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STATE OF ALABAMA  
DEPARTMENT OF REVENUE  
ADMINISTRATIVE LAW DIVISION

§

v.

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DOCKET NO. INC. 86-142

H. C. BLACKWELL CO., INC.  
P. O. Box 428  
Adamsville, AL 35005,

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Taxpayer.

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ORDER

The Revenue Department assessed income tax against H. C. Blackwell Company, Inc. ("Taxpayer") for the calendar year 1983.

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. H.C. Blackwell Company, Inc. (hereinafter referred to as "Taxpayer") is an Alabama domestic corporation.
2. On its calendar year 1983 corporate state income tax return, Taxpayer reported "federal net income before any net operating loss deduction and special deductions" in the amount of \$311,650.00. A copy of the 1983 corporate state income tax return of Taxpayer is attached to the Stipulation of Facts as Exhibit "A" and includes a copy of the Taxpayer's federal 1983 income tax return.
3. Taxpayer claimed an additional deduction from the net income figure in the amount of \$209,600.00, which was labeled "depreciation deductions providing no Alabama tax benefits".

4. During 1983, Taxpayer sold twelve cement mixer trucks. Information concerning the sales is detailed in I.R.S. Form 4797 of Exhibit "A". On a worksheet attached to the corporate return, the Taxpayer detailed the depreciation claimed by year with respect to each truck, the state taxable income for each year and the unused depreciation deduction for each year, which resulted in a total exclusion from state income in the amount of \$209,600.00.

5. The Department of Revenue (hereinafter referred to as the "Department") audited the 1983 return of Taxpayer.

6. The Department disallowed the deduction in the amount of \$209,600.00 as claimed by the Taxpayer. The disallowance is based on the Department's position that there is no "tax benefit rule" in the State of Alabama. The disallowance resulted in additional tax liability for 1983.

7. The 1983 return was received by the Department on March 12, 1985. The Department imposed a 25 percent delinquent penalty on the tax, as a result of the late filing.

8. Attached to the Stipulation of Facts as Exhibit "B" is the Department's adjustment on the 1983 corporate income tax liability of Taxpayer.

9. Based on the Department's adjustment, a preliminary assessment was issued on May 19, 1986. A copy of the preliminary assessment of 1983 corporate income tax issued against Taxpayer for 1983 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 the 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 of 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 15th day of August, 1988.

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BILL THOMPSON  
Chief Administrative Law Judge