The Taxation of Tax Indemnity Payments: Recovery of Capital and The Contours of Gross Income

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I. INTRODUCTION

In Clark v. Commissioner,1 a 1939 opinion perennially popular with income tax casebook authors,2 the Board of Tax Appeals considered whether a taxpayer who incurred an unnecessarily large federal income tax liability because of an error by his tax return preparer, and who later received reimbursement from the preparer for the excess tax liability, was required to include the reimbursement in gross income. The Board ruled that he was not, on the grounds that the reimbursement was "compensation for a loss which impaired petitioner's capital."3 After an initial non-acquiescence in Clark,4 the Service finally acquiesced in 1957.5

More recently—in 1987 and 1989—the Service has issued two letter rulings which considered whether the rationale of Clark should be extended to so-called tax indemnity payments received in connection with the purchase and sale of assets.6 To the surprise of some, the two letter rulings held that the indemnity payments at issue in the rulings were not taxable.7 However, the Service has withdrawn both rulings for reconsideration.8

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1 40 B.T.A. 333 (1939).


3 Clark, 40 B.T.A. at 335.

4 1939-2 C.B. 45.

5 1957-1 C.B. 4.


7 See Kanter & Banoff, Tax Reimbursements are not Taxable, 69 J. Tax’n 367 (1988) (prior to the issuance of Letter Ruling 8748072, parties to contracts containing tax indemnity provisions generally assumed that tax indemnity payments were taxable).

8 See note 6.
A tax indemnity payment is made when a seller represents to a purchaser that the asset being sold is eligible for favorable tax treatment, and it later develops that the representation was inaccurate. The payment compensates the purchaser for the federal income taxes it had to pay, which it would not have owed if the representation had been correct. Such payments commonly are required by express contractual tax indemnity agreements, especially in connection with leveraged lease transactions, in which a taxpayer (the lessor) acquires property to lease to another party for use in that other party's trade or business, and in which the lessor expects to be able to claim depreciation deductions on the leased property.\(^9\) In some situations, tax indemnity payments may be required by law, even in the absence of express agreement.\(^{10}\)

This article considers the proper tax treatment of tax indemnity payments. The next section briefly describes the facts and analysis of *Clark* and the two letter rulings. The article then considers whether *Clark* was correctly decided and concludes that, although the case raises surprisingly difficult and fundamental questions concerning recovery of capital and the scope of the definition of gross income, on balance *Clark* probably is correct. The article then examines whether *Clark* should be extended to typical tax indemnity payments, such as those involved in the two recent letter rulings. It concludes that such tax indemnity payments present issues not raised by *Clark*, and that extension of the *Clark* rationale to such payments is not appropriate.

II. *Clark* and the Letter Rulings

On the advice of their tax counsel, Mr. and Mrs. Clark filed a joint return for 1932. The election to file a joint return, rather than separate returns, was irrevocable.\(^{11}\) After their return was audited and a deficiency assessed, the Clarks discovered that their tax liability for 1932 would have been almost $20,000 less if they had filed separate returns. Their tax counsel admitted that the additional tax liability resulting from the filing of a joint return was due to his mistake, and paid the amount of that liability to the Clarks.\(^{12}\)


\(^{10}\) Sharp v. Coopers & Lybrand, 649 F.2d 175, 190-91 (3d Cir. 1981), cert. denied, 455 U.S. 938 (1982) (holding that unavailability of promised tax benefits is properly considered in assessing damages for violation of federal securities law).

\(^{11}\) Downes v. Commissioner, 5 B.T.A. 1029 (1927). The irrevocability rule is now included in § 1.6013-1(a)(1) of the regulations.

\(^{12}\) Clark v. Commissioner, 40 B.T.A. 333, 334 (1939).
The Commissioner claimed that the payment made by the return preparer was taxable income to the Clarks, citing the Supreme Court's opinion in Old Colony Trust Co. v. Commissioner.\textsuperscript{13} In Old Colony, the president of a large corporation was paid a stated salary of approximately $1 million in 1918. In addition, the corporation agreed to pay the federal income tax on the salary, with the hoped-for result that the president would be entitled to keep the entire stated salary.\textsuperscript{14} The government, however, argued that payment by the corporation of the tax liability constituted additional taxable income, and the Supreme Court agreed.\textsuperscript{15} The Court reached this conclusion easily, reasoning that the employer had conferred an economic benefit on its president by paying his liability, and had done so as part of his compensation.\textsuperscript{16} The result in Old Colony was necessary in order to protect the fundamental proposition that the income tax base is tax-inclusive—that is, that the amount paid as federal income tax is not deductible in determining the amount of income subject to tax.\textsuperscript{17} If Old Colony had been decided in favor of the taxpayer, the exclusion of the taxes paid on the employee's behalf by the employer would have been the functional equivalent of a deduction by the employee for federal income taxes paid.\textsuperscript{18}

In Clark, the Board of Tax Appeals rejected the government's argument. It distinguished Old Colony on the grounds that "Petitioner's [Mr. Clark's] taxes were not paid for him by any person—as rental, compensation for services rendered, or otherwise. He paid his own taxes."\textsuperscript{19} By itself, this is an absurd basis for distinguishing Old Colony. It suggests that the president of Old Colony would not have been taxed if he initially had paid his own taxes on his salary, and his employer then had reimbursed him for those taxes, despite the fact that the economic substance of that arrangement is identical to the arrangement the Supreme Court held taxable in Old Colony.

\textsuperscript{13} 279 U.S. 716 (1929); see Clark, 40 B.T.A. at 334-35.

\textsuperscript{14} Old Colony, 279 U.S. at 719-20.

\textsuperscript{15} Id. at 729.

\textsuperscript{16} Id.

\textsuperscript{17} IRC § 275(a)(1). For any given flat rate tax-inclusive income tax, there is an equivalent tax-exclusive income tax with a higher rate. For example, under a 20% flat rate tax-inclusive tax, a taxpayer with $1 million income pays $200,000 in tax and keeps $800,000. An identical result would be reached under a 25% tax-exclusive tax: a $200,000 tax liability is 25% of $800,000 ($1 million income reduced by the tax liability). Despite this equivalence, the 20% tax-inclusive tax is preferable in practice, because it avoids the computational complexities that arise when the amount of tax depends on the tax base and the tax base depends on the amount of tax. See generally Graetz, Implementing a Progressive Consumption Tax, 92 Harv. L. Rev. 1575, 1582-84 (1979).

\textsuperscript{18} The result in Old Colony is reflected in § 1.61-14(a) of the regulations, which states: "Another person's payment of the taxpayer's income taxes constitutes gross income to the taxpayer unless excluded by law."

\textsuperscript{19} Clark v. Commissioner, 40 B.T.A. 333, 335 (1939).
The Board also, however, offered another more plausible explanation for its conclusion that the reimbursement was not taxable. It reasoned that in paying nearly $20,000 in additional tax liability caused by their preparer’s negligence, the Clarks had sustained a loss. The reimbursement properly was treated as a tax-free recovery of capital: “It was, in fact, compensation for a loss which impaired petitioner’s capital.”

Although the opinion quoted the traditional narrow definition of income as being “derived from capital, from labor or from both combined,” which the Supreme Court later rejected in Glenshaw Glass, the conclusion that the reimbursement should be treated as a tax-free recovery of capital does not depend on that narrow definition and thus is unaffected by Glenshaw Glass.

After an initial nonacquiescence, the Service acquiesced in Clark in 1957. Also in 1957, the Service issued Revenue Ruling 57-47, which held that a payment similar to the payment in Clark was a tax-free return of capital.

In Letter Ruling 8748072, the taxpayer purchased a mortgage-backed certificate from D. D represented that the certificate was backed exclusively by mortgages on property located in jurisdiction K, so that the income from the certificates would be eligible for favorable tax treatment under § 936. The taxpayer later discovered that the certificate was backed by mortgages from other jurisdictions and thus did not qualify for favorable tax treatment. The taxpayer sued D for misrepresentation. The taxpayer and D reached an agreement, under which D purchased the certificate from the taxpayer, and sold the taxpayer a new certificate which qualified under § 936. In addition, the parties contemplated an agreement that D would reimburse the taxpayer for the taxes it had to pay during the time it held the nonqualifying certificate—that is, the taxes it would not have had to pay if the certificate had been backed by K mortgages. The ruling, relying on Clark, concluded that the reimbursement would be a nontaxable recovery of capital.

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20 Id. The Board noted that the recovery was not taxable under the tax benefit rule, because the loss had not been deductible. Id.
21 Id.
23 1939-2 C.B. 45.
25 Rev. Rul. 57-47, 1957-1 C.B. 45. The taxpayer described in the revenue ruling was unable to seek a refund from the government because the statute of limitations had expired before the error was discovered. Id.
26 LTR 8748072 (Sept. 3, 1987). G.C.M. 39697 (Jan. 27, 1988) considers the same facts and reaches the same conclusion as the letter ruling.
27 LTR 8748072 at 6. The ruling noted that the reimbursement was intended to put the taxpayer in the same economic position it would have been in if the certificate had qualified under § 936. The amount of reimbursement needed to do this would, of course, be greater if the reimbursement were taxable. Accordingly, D would be obligated under the contemplated
Letter Ruling 8923052 considered the income tax consequences of a payment made to purchaser-lessee M from seller-lessee N under the tax indemnity provision of a safe harbor lease. The payment compensated M for its increased federal income tax liability resulting from N's inaccurate representation concerning the tax consequences of the transaction. N had represented that all of the property involved in the transaction was "qualified lease property" eligible for safe harbor leasing, when, in fact, some of it was not. Since M was not treated as the owner of the nonqualified property for federal income tax purposes, it was not entitled to certain anticipated tax benefits with respect to that property—investment tax credits, interest expense deductions and accelerated cost recovery deductions. Without citing Clark, the ruling held that the reimbursement for the additional federal income tax liability M incurred due to N's misrepresentation was a tax-free recovery of capital.

III. Is Clark Correct?

This section considers whether Clark was decided incorrectly. The arguments are: (1) that Clark is inconsistent with the holding of Old Colony; (2) that allowing a tax-free recovery of a nondeductible loss is inconsistent with the congressional decision that the loss should be nondeductible; (3) that allowing a tax-free recovery of a nondeductible loss results in inconsistent treatment of similarly situated taxpayers; and (4) that Clark is at odds with fundamental principles of annual accounting in general, and with the Supreme Court's opinion in Burnet v. Sanford & Brooks Co. in particular. It concludes that none of these arguments is persuasive and that the case was decided correctly.

agreement to increase (gross up) the amount of the payment if the reimbursement was determined to be taxable. As a result, the party with the economic interest in the taxability of the reimbursement was D rather than the taxpayer.


29 The loss of these expected benefits was partially offset by the fact that M was not treated as having taxable rental income with respect to the nonqualified property.

30 LTR 8923052, at 17. The ruling derived its recovery of capital analysis primarily from Revenue Ruling 81-227, 1981-2 C.B. 14, which treated as a recovery of capital a payment made by a contractor to a customer in settlement of the customer's claim against the contractor for incomplete performance. LTR 8923052, at 6-7.

31 282 U.S. 359 (1931).
A. Is Clark Inconsistent With Old Colony?

The conclusion of the Board of Tax Appeals in Clark follows readily enough, once one accepts the characterization of the payment of the additional taxes as a loss. The difficult question, however, is how to reconcile that characterization with Old Colony. Not every payment of federal taxes can be characterized as a loss. If it could, every reimbursement for federal income taxes paid would be a tax-free recovery of capital, and there would be nothing left of Old Colony. What then justifies treating the taxes in Clark as a loss, even though it is clear from Old Colony that payments of federal income tax ordinarily cannot be so treated? The answer must be that the Board in Clark implicitly drew a distinction between (1) taxes that were clearly and unavoidably owed given the taxpayer’s economic situation (such as taxes on salary), which cannot be characterized as a loss, and (2) excess taxes that were not necessarily owed given the taxpayer’s economic situation, but were paid through a mistake of some sort, which can be characterized as a loss because of the mistake. Such excess taxes reasonably can be characterized as losses, without undermining the reasoning of Old Colony with respect to ordinary taxes.

There is room for debate as to what should qualify as a loss-creating mistake for purposes of making the recovery of the loss nontaxable. Clearly there is a loss-creating mistake if a taxpayer incorrectly calculates his tax liability as being higher than it really is. It is universally agreed that a refund resulting from such a mistake is not taxable.\textsuperscript{32} If no refund is available because the statute of limitations has run, but the taxpayer recovers an equivalent amount from his negligent return preparer, it is equally clear that there has been a loss-creating mistake and that the recovery is free of tax.\textsuperscript{33} By contrast, one could argue that in Clark there was no mistake and no excess tax, because the Clarks in fact paid the proper amount of tax, given the election to file a joint return. If one accepts the argument that the Clarks simply paid the proper amount of tax, Clark becomes indistinguishable from Old Colony, and the recovery should be taxable. That argument seems hypertechnical, however, given that the Clarks could have paid a smaller amount of taxes based on exactly the same economic facts, but for the ill-advised election which had no effect other than to increase unnecessarily their tax liability.

B. Is Clark Inconsistent With the Nondeductibility of the Loss?

Not allowing a deduction for a loss, but treating a recovery of the loss in a later year as a return of capital, yields the same result—no net in-

\textsuperscript{32} M. Chirelstein, Federal Income Taxation § 3.01(b) (6th ed. 1991).
\textsuperscript{33} Rev. Rul. 57-47, 1957-1 C.B. 45.
come—as allowing a deduction for the loss and taxing the recovery.\textsuperscript{34} This observation suggests a possible objection to \textit{Clark}: Allowing tax-free recovery of a nondeductible loss is the equivalent of allowing a deduction for the loss, and thus is inconsistent with the congressional determination that the loss should not be deductible.\textsuperscript{35} This objection would not apply to the exclusionary aspect of the tax benefit rule, expressed in § 111(a), which provides that gross income does not include the recovery of an amount deducted in an earlier year to the extent the earlier deduction did not produce a tax benefit.\textsuperscript{36} In situations covered by § 111(a), Congress has determined that a given type of expense or loss should be deductible, but the taxpayer’s particular circumstances precluded a benefit from the deduction.

The basic answer to this objection to \textit{Clark} is that allowing an exclusion for a recovery of a nondeductible loss is much narrower than allowing a deduction for the original loss. The former allows the loss to offset only a recovery of the loss, while the latter would allow the loss to offset any income. Allowing the loss to offset the recovery, so as to prevent the creation of taxable income from a transaction which was an economic wash, is not necessarily inconsistent with a refusal to allow a deduction of the loss against unrelated income. Since there are various reasons for the nondeductibility of losses and expenses, it is necessary to consider separately the recovery of different types of items, in order to determine whether the exclusion of a particular recovery is inconsistent with the policy justifying the nondeductibility of the original loss or expense.

Consider an easy case first. Suppose a taxpayer pays a nondeductible fine.\textsuperscript{37} Suppose, further, that in a later year it is determined that the taxpayer had not engaged in the conduct for which it was fined, and the fine is refunded to the taxpayer. The justification for § 162(f) is that allowing a deduction for a fine would lessen the impact of the fine, thereby frustrating to some extent the public policy of the governmental entity imposing the fine.\textsuperscript{38} Taxing the refund of a fine improperly imposed would mean taxing the taxpayer—who had not, in fact, engaged in conduct subject to penalty—on more than his economic income. Nothing in the justification for § 162(f) requires, or even supports, taxing the refund.

\textsuperscript{34} The two treatments will not, of course, produce identical results in terms of timing.
\textsuperscript{35} This point is noted in W. Klein & J. Bankman, Teacher’s Manual to Federal Income Taxation 53 (8th ed. 1990).
\textsuperscript{36} IRC § 111(a).
\textsuperscript{37} IRC § 162(f) (providing that a business expense deduction is not allowable “for any fine or similar penalty paid to a government for the violation of any law”).
Clark is also an easy case in this respect. Section 275(a)(1), which denies taxpayers a deduction for federal income taxes, has the purpose of specifying that the income tax base is tax-inclusive, rather than tax-exclusive. That purpose is served fully simply by disallowing a deduction for taxes paid. It does not require taxing individuals on more than their economic income by including in income a refund of overpaid taxes. By the same token, it does not require inclusion in income of money received from a tax return preparer as reimbursement for excess taxes paid because of the taxpayer’s negligence.

It is conceivable that not taxing the recovery of some types of nondeductible items would be inconsistent with the policy underlying the nondeductibility of the item. Even if such situations exist, however, Clark is clearly not one of them.

C. Does Clark Result in Inconsistent Treatment of Similarly Situated Taxpayers?

At first glance, the result in Clark appears attractive as a matter of equity, because it puts the Clarks in the same economic position as a married couple whose preparer never made an ill-advised election to file a joint return. They would not pay an extra $20,000 in taxes, they would not receive a reimbursement from their preparer and they would have no taxable income arising from their dealings with their preparer. However, taxpayers whose preparer never made a mistake are not the only possible comparison. The Clarks also might be compared to a couple who suffered the same nondeductible loss as the Clarks, but who never recovered that loss; for example, taxpayers who, through their own ignorance or negligence, filed a joint return. If the Clarks are allowed to exclude their recovery, they will have the same tax liability as another couple identical in all respects except for their failure to recover their loss. This seems unfair, since the Clarks are, in fact, $20,000 better off than the taxpayers who did not recover their loss. Or one might compare the Clarks to a

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39 See note 17 and accompanying text.
40 For example, Congress might make a particular type of loss nondeductible because of concern that deductibility would lead to many false and difficult-to-audit claims of losses, and there might be a similar concern that taxpayers would claim falsely that certain receipts were recoveries of that type of loss. (This seems unlikely, however: A taxpayer inclined to cheat with respect to a recovery would be much more likely simply to fail to report it, than to report it but treat it as a tax-free recovery of a supposed loss.)
41 Any exclusion can be objected to on the grounds that for tax purposes it treats identically a person who receives an excludable amount and a person who does not, even though the person who receives the amount is in a better economic position than the person who does not. Consider, for example, two tort victims who suffer identical personal injuries, one who receives a large award excludable under § 104(a)(2) and the other who receives nothing because his tortfeasor is judgment proof. See Andrews, Personal Deductions in an Ideal Income Tax, 86 Harv. L. Rev. 309, 334 (1972).
taxpayer who suffers the same loss and never recovers it from her preparer, but who miraculously finds $20,000 in the street the next year.\textsuperscript{42} If the Clarks are allowed to exclude their recovery, they will have a lower tax liability than this taxpayer, despite the fact that they are in identical economic positions.

In the end, this comparison of the Clarks with other taxpayers in similar but not identical situations neither supports nor undermines Clark. If the Clarks are allowed the exclusion, they are treated equitably compared to some taxpayers and too favorably compared to other taxpayers. If they are not allowed the exclusion, they are treated equitably compared to some taxpayers and too harshly compared to other taxpayers. The basic point is that, once a decision has been made by Congress not to allow a deduction for a particular kind of loss, a taxpayer who later recovers such a loss is going to be taxed unfairly as compared with someone else, no matter how the recovery is treated.\textsuperscript{43}

\textit{D. Does Clark Conflict with Basic Principles of Annual Accounting and the Sanford & Brooks Opinion?}

Clark treats the receipt of a conceded economic benefit in the current year as not includable in gross income because it has a nexus with an earlier nondeductible loss, which nexus supports treating it as a tax-free recovery of that loss. Despite the plausibility of that analysis, it is diffi-

\textsuperscript{42} W. Klein, J. Bankman, B. Bittker & L. Stone, note 2, at 190. This taxpayer would not, of course, be allowed to exclude the $20,000 found in the street on the grounds that it constituted a recovery of the $20,000 lost through her return preparer's negligence. The nexus between loss and recovery, which supported exclusion of the recovery in Clark, is missing in the case of the found money. Even if the taxpayer believed that finding the money was fate's way of making good her earlier loss, it is clear that for tax purposes, there would be no nexus between the loss and the windfall. If the taxpayer were allowed to treat any receipt of $20,000 as a tax-free recovery of her loss, despite the absence of a nexus (more substantial than her idiosyncratic view of fate) between the loss and the recovery, the effect would be the same as if the loss were deductible in the first place.

\textsuperscript{43} This point is noted in W. Klein & J. Bankman, note 35, at 52-53.

An observation which may make the result in Clark more attractive is that it is closely analogous to the treatment of a sale of a personal use asset. Suppose $A$ and $B$ both buy $20,000 diamond rings for personal use, thereby each obtaining a $20,000 basis. Several years later, $A$ sells his ring for $20,000, and $B$ sells his ring for $50 (or, perhaps more realistically, the ring became worthless). $A$ offsets his amount realized with his basis, and has no taxable gain. $B$ has a nondeductible $20,000 personal loss, giving $B$ the same tax result as if he had no basis in the ring. $A$ is $20,000 richer than $B$, but their tax liabilities are identical. $A$ is treated equitably as compared with a taxpayer who never spent $20,000 on a ring, but $A$ is treated more favorably than a taxpayer (such as $B$) who spent $20,000 on a ring, but was unable to recover any of that expenditure. $A$'s position thus corresponds with that of the Clarks, who are treated equitably as compared with the taxpayers with a nonnegligent preparer, but more favorably than the taxpayers who are unable to recover from their negligent preparer. The consistency of Clark with an aspect of the income tax as fundamental as the treatment of the sale of personal use assets supports the Clark result.
cult to reconcile Clark with the Supreme Court's opinion in Burnet v. Sanford & Brooks Co. The taxpayer in that case had a contract with the United States to dredge a river. From 1913 to 1916, its dredging expenses exceeded its dredging receipts by about $176,000. The taxpayer received no tax benefit from these expenses, since it had no income against which to deduct the expenses, and the loss was not eligible for carryover under the very limited net operating loss carryover provision then in existence. The taxpayer sued the United States for breach of warranty concerning the nature of the material to be dredged and eventually was awarded compensation for its $176,000 loss (plus interest, which was clearly taxable). The government attempted to tax the $176,000, but the taxpayer argued it should be treated as a recovery of its earlier expenses (which were nondeductible, as a practical matter). The Supreme Court rejected the taxpayer's argument and used the case as an occasion for an essay on the income tax system's use of annual, as opposed to transactional, accounting. The Court viewed the taxpayer's claim that the payment should be characterized as the recovery of an earlier loss, as an impermissible attempt to replace annual accounting with transactional accounting. Because of its bearing on the correctness of Clark, the opinion is worth quoting at some length:

That the recovery made by respondent in 1920 was gross income for that year within the meaning of [the statute] cannot, we think, be doubted. The money received was derived from a contract entered into in the course of respondent's business operations for profit. While it equalled, and in a loose sense was a return of, expenditures made in performing the contract, still, as the Board of Tax Appeals found, the expenditures were made in defraying the expenses incurred in the prosecution of the work under the contract, for the purpose of earning profits. They were not capital investments, the cost of which, if converted, must first be restored from the proceeds before there is a capital gain taxable as income.

The thrust of Sanford & Brooks seems to be that, under annual accounting, the receipt of an economic benefit in the current year cannot be excluded from income simply because, under a broader transactional analysis, the benefit may be viewed as the recovery of an earlier nondeductible expenditure. It is not readily apparent how Clark can be recon-

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44 282 U.S. 359 (1931).
45 Revenue Act of 1918, ch. 18, § 204(b), 40 Stat. 1057, 1061 (1919). The much more generous net operating loss carryover provision of current law is contained in § 172.
46 Sanford & Brooks, 282 U.S. at 361-62.
47 Id. at 363-64.
ciled with Sanford & Brooks. The Clark opinion makes no mention of Sanford & Brooks, although the case had been decided by the Supreme Court eight years earlier.

In determining what influence Sanford & Brooks should have on the vitality of Clark, it is first necessary to assess the vitality of Sanford & Brooks. To be blunt, Sanford & Brooks certainly is wrong in its reasoning and probably is wrong in its specific holding. The opinion explains at some length why an income tax system based on annual accounting is preferable to a system based on transactional accounting. It notes the impracticality of “postponing the assessment of the tax until the end of a lifetime, or for some other indefinite period, to ascertain more precisely whether the final outcome of the period, or of a given transaction, will be a gain or a loss.” It explains that a practical system of taxation must “produce revenue ascertenable, and payable to the government, at regular intervals,” because “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.” It indicates that a system “by which the tax could be assessed, wholly or in part, on the basis of the finally ascertained results of particular transactions,” would probably be impractical and, in any event, was not contemplated by Congress.

In short, the Sanford & Brooks opinion contains an admirable essay in praise of the annual accounting system, which explains why the case frequently is cited as standing for the proposition that the income tax is based on annual (rather than transactional) accounting. The opinion argues convincingly that it would not be practical to have an income tax system in which a taxpayer routinely could defer taxation on the grounds that a transaction was not yet complete. In other words, the system should not and generally does not permit taxpayers to leave transactions open for tax purposes, pending developments in later years.

The only problem with the opinion is that its paean to annual accounting has nothing to do with the issue in the case. The taxpayer was not arguing that the tax consequences of its receipt of $176,000 in 1920 should depend on events in subsequent years. Rather, the taxpayer was

48 “It is difficult to reconcile the two cases except at a superficial level.” W. Klein & J. Bankman, note 35, at 56.
49 Sanford & Brooks, 282 U.S. at 365.
50 Id.
51 Id.
52 See, e.g., Hillsboro Nat’l Bank v. Commissioner, 460 U.S. 370, 377 (1983) (citing Sanford & Brooks for the proposition that “[a]n annual accounting system is a practical necessity if the federal income tax is to produce revenue ascertenable and payable at regular intervals”); Alice Phelan Sullivan Corp. v. United States, 381 F.2d 399, 403 (Cl. Ct. 1967) (“Ever since [Sanford & Brooks] the concept of accounting for items of income and expense on an annual basis has been accepted as the basic principle upon which our tax laws are structured.”).
merely arguing that the Court should have looked back to events of earlier years—in particular, the earlier losses which gave rise to the payment in 1920—for the purpose of characterizing the receipt in 1920. The horrors of indeterminacy and deferral cited by the Court as defects of transactional accounting relate to leaving transactions open pending events in later years, and not to characterizing receipts based on events in earlier years. Looking back to an earlier year to characterize a receipt in the current year is, in fact, entirely consistent with fundamental principles of the income tax system. When § 1001 provides that gain or loss realized on the sale or other disposition of an asset is to be determined by subtracting basis from amount realized, it decrees that the income tax consequences of the disposition are to be determined by looking back to the events of an earlier year to determine the taxpayer’s basis in the asset. Few provisions of the Code are more fundamental than § 1001. Sanford & Brooks Co. asked for nothing more than treatment analogous to § 1001; that is, to be treated as if its losses in the earlier years gave it a $176,000 basis in its claim against the government. Whatever may be said about the merits of the taxpayer’s position, its success would have wreaked no more havoc with the income tax’s annual accounting system than § 1001 has wreaked.

It is easy enough to conclude that the Sanford & Brooks opinion is poorly reasoned. It is harder to decide what is the appropriate stance to take towards the case, given that it is not only an opinion of the Supreme Court, but an opinion frequently and approvingly cited. The frequent approving citations should probably be given little weight because the citations typically call on the opinion to bless the annual accounting system in the most general way, but do not consider whether the actual holding in the case was compelled by the annual accounting system. The way in which the case is cited suggests it has become a classic in the Mark Twain sense: an opinion which people praise and don’t read.

Even assuming, however, that the frequent citations add little or nothing to the authority of the case, there remains the problem of its inherent

53 Sanford & Brooks, 282 U.S. at 362.
54 IRC § 1001(a).
55 The analogy between the treatment sought by the taxpayer in Sanford & Brooks and the treatment of sales and dispositions of assets under § 1001 is noted in Grauer, The Supreme Court’s Approach to Annual and Transactional Accounting for Income Taxes: A Common Law Malfunction in a Statutory System?, 21 Ga. L. Rev. 329, 394 (1986).
56 See note 52. But see United States v. Rexach, 482 F.2d 10, 23-24 (1st Cir.), cert. denied, 414 U.S. 1039 (1973) (following Sanford & Brooks on similar facts; Rexach is discussed at text accompanying notes 68-69); H.W. Nelson Co. v. United States, 308 F.2d 950, 955-56 (Ct. Cl. 1962) (following Sanford & Brooks on somewhat similar facts, without considering the effect of the exclusionary tax benefit rule on the continuing vitality of Sanford & Brooks).
57 "Classic." A book which people praise and don’t read.” Pudd’nhead Wilson’s New Calendar ch. 25.
authority as an opinion of the Supreme Court. It is possible that Sanford & Brooks implicitly has been overruled by the enactment of the exclusionary aspect of the tax benefit rule. According to § 111(a), “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 did not reduce the amount of tax imposed by this chapter.” When Sanford & Brooks was decided in 1931, the predecessor of § 111(a) had not been enacted, and the exclusionary aspect of the tax benefit rule had not been firmly established by judicial or administrative action. The facts of Sanford & Brooks seem to fall within the language of § 111(a), thus suggesting that Congress has overruled Sanford & Brooks.

There are judicial suggestions that the holding in Sanford & Brooks survives the exclusionary tax benefit rule, but they are not convincing. In the Supreme Court case of Dobson v. Commissioner, the taxpayer had sold 100 shares of stock of National City Bank at a loss of approximately $41,000 in 1930 and another 100 shares of National City stock at a loss of approximately $28,000 in 1931. The taxpayer derived no tax benefit from the capital losses. In 1939, the taxpayer received a payment in settlement of his claim that he had been induced to purchase the National City stock by fraudulent representations. Approximately $23,000 of the payment was allocable to the stock sold in 1930 and approximately $6,000 to the stock sold in 1931. The taxpayer argued that the payment in 1939 should be treated as a return of capital, that is, as a partial recovery of the capital losses which had produced no tax benefit in 1930 and 1931. The Board of Tax Appeals ruled in the taxpayer’s favor, apply-


59 The history is reviewed in Tye, The Tax Benefit Doctrine Reexamined, 3 Tax L. Rev. 329 (1948).

60 Under § 111(c), a deduction is treated as reducing the tax imposed on a taxpayer if it results in “an increase in a carryover which has not expired before the beginning of the taxable year in which the recovery . . . takes place.” Section 172(b) permits net operating losses to be carried forward for fifteen years. Thus, assuming that § 111(c) does overrule Sanford & Brooks to exclude recoveries of deductions which produced net operating losses, it would do so only in the case of long-delayed recoveries. The apparent overruling of Sanford & Brooks by § 111(a) would assume greater practical significance if the number of years net operating losses could be carried forward were reduced, or if § 172 were repealed entirely.

61 320 U.S. 489 (1943).

62 Id. at 492.
ing the exclusionary tax benefit rule without explicit statutory authority to do so, as a matter of judge-made law,63 and the Supreme Court affirmed the Board's decision.

The government argued that the statutory enactment in 1942 (after the year at issue in Dobson) of a limited exclusionary tax benefit rule,64 not applicable by its terms to recoveries of capital losses, indicated that there should be no judicially created exclusionary tax benefit rule for recoveries not excluded by statute.65 The government also argued that the exclusionary tax benefit rule was inconsistent with Sanford & Brooks.66 In Dobson, the point of this argument was that the exclusionary tax benefit rule should not be extended judicially beyond its statutory scope. In a case within the statutory scope (which today includes any recovery of an item deducted without tax benefit), the point of this argument would be that Sanford & Brooks has been overruled legislatively. Rather than accepting the government's argument, however, the Court distinguished Sanford & Brooks by quoting the statement in Sanford & Brooks that the expenses in Sanford & Brooks "were not capital investments, the cost of which . . . must first be restored . . . before there is a capital gain taxable as income."67 Although that served as a factual distinction between Dobson and Sanford & Brooks, it does not serve as a more general explanation of why Sanford & Brooks does not conflict with the exclusionary tax benefit rule. Since the exclusionary tax benefit rule applies to recoveries of amounts which were currently deductible (but which happened to produce no tax benefit), it makes no sense to say § 111(a) would not apply today on the Sanford & Brooks facts because the recovered expenditures were not capital investments.

On facts remarkably similar to Sanford & Brooks, the First Circuit held, in United States v. Rexach,68 that the exclusionary tax benefit rule did not apply. However, the court based its holding on its conclusion that the exclusion is available only for recoveries of amounts actually deducted, not for amounts that could have been deducted but were not.69 That was enough to decide Rexach, since the taxpayer had not claimed the deductions in that case. Rexach does not, however, explain why the tax benefit rule should not apply on facts identical to Sanford & Brooks,

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64 See text accompanying note 58.
65 Dobson, 320 U.S. at 505-06.
66 Id. at 504.
67 Sanford & Brooks, 282 U.S. at 364, quoted in Dobson, 320 U.S. at 504.
68 482 F.2d 10 (1st Cir.), cert. denied, 414 U.S. 1039 (1973). The case involved the taxpayer's claim for additional compensation under a dredging contract with the government of the Dominican Republic. The taxpayer claimed the material was more difficult to dredge than had been represented by the government. 482 F.2d at 21-22.
69 Id. at 24.
since the opinion in that case indicates that the taxpayer had claimed the
deductions. In fact, by basing its conclusion that the exclusionary tax
benefit rule did not apply solely on the taxpayer’s failure to claim deduc-
tions, Rexach suggests that the exclusionary tax benefit rule has over-
rulled Sanford & Brooks in other situations.

In sum, although no court has so held expressly, Sanford & Brooks
appears to have been overruled on its facts by § 111(a). The question
then arises as to whether the reasoning of Sanford & Brooks continues to
apply in situations—such as Clark—not within the scope of § 111(a) be-
cause the earlier loss was not deductible. There is no clearcut answer to
that question.

As a matter of policy, there would be reason to distinguish the Clark
situation—or any situation involving the recovery of a nondeductible
loss—from situations covered by § 111(a), only if exclusion of the recov-
ery would conflict with the congressional decision not to allow a deduc-
tion for the original loss. As explained above, exclusion of the recovery
in Clark would not conflict with the nondeductibility of federal income
taxes.

Apart from policy, however, there is the further question of whether
the fact that Congress legislated the exclusionary tax benefit rule, but did
not legislate an exclusion for the recovery of nondeductible items, indi-
cates a congressional intent that the reasoning of Sanford & Brooks
should survive in situations where the original loss was not deductible.
The answer is probably, “No.” Congress enacted the predecessor of
§ 111(a) as a limitation on the judicially developed inclusionary tax bene-
fit rule, which generally taxed the recovery of amounts earlier ded-
ucted. By contrast, there was not the same need for Congress to
legislate an exclusion for recovery of nondeductible items, because no
judicial doctrine imposing tax on such recoveries had been developed.
To the contrary, just three years before the enactment of the predecessor
of § 111(a), Clark had held that a recovery of a nondeductible loss was
not taxable.

Thus, although § 111(a) does not absolutely preclude the application
of the reasoning of Sanford & Brooks to Clark and other recoveries
outside the scope of the exclusionary tax benefit rule, it is sensible to view
§ 111(a) as indicating at least a lack of congressional enthusiasm for any
application of the Sanford & Brooks rationale. That lack of enthusiasm
may or may not be enough to justify treating the Sanford & Brooks anal-
ysis as entirely without force. When coupled with the fact that the

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70 See text accompanying notes 34-40.
71 The history is set forth in Dobson, 320 U.S. at 504-06.
72 Treating the Sanford & Brooks analysis as without force would not preclude citation of
the opinion’s dictum concerning the necessity of an annual accounting system, as opposed to a
Sanford & Brooks analysis simply makes no sense, the lack of congressional enthusiasm is certainly enough, however, to justify limiting the case very narrowly to its facts. In other words, a court would be entirely justified in making a special effort to distinguish Sanford & Brooks.

In a situation like Clark, there are at least two ways in which a court could distinguish Sanford & Brooks. The first would be to read the Sanford & Brooks holding as based on a determination that there was an insufficient nexus between the expenditures and the damage award to justify treating the award as a tax-free recovery of the expenditures. This reading is supported by the statement in the opinion that the 1920 payment was a return of the earlier expenditures only "in a loose sense." It is not clear why the Court considered the payment a recovery of the expenditures only in a loose sense, given that the amount of expenditures was the explicit measure of the recovery. Be that as it may, a court faced with a situation similar to Clark readily could distinguish Sanford & Brooks on the grounds that the payment from the taxpayer's negligent tax adviser was a recovery of the excess taxes "in a strong sense."

The other means of distinguishing Sanford & Brooks would involve reading that opinion as being founded on the Court's unwillingness to give taxpayers the equivalent of basis for current business expenses. The Court apparently recognized that the taxpayer was, in effect, asking that it be treated as having a basis of $176,000 in its claim against the government. The Court rejected that request, explaining that the expenditures which gave rise to the claim "were not capital investments, the cost of which, if converted, must first be restored from the proceeds before there is a capital gain taxable as income." Arguably, then, all Sanford & Brooks really stands for is the Supreme Court's unwillingness to allow the creation of basis from current business expenses. If so, the case readily can be distinguished from Clark, which involves no such problem.

Neither of these means of distinguishing Sanford & Brooks would be persuasive if the case had significant continuing vitality. Either, however, seems adequate to distinguish a case which is based on faulty analysis and has been legislatively overruled on its facts. Thus the likely and appropriate fate of Sanford & Brooks is that: (1) it will not be overruled formally. (2) It will continue to be cited, in the most general way, for the proposition that the income tax system is based on annual, rather than transactional, accounting. (3) Its actual holding will be treated as being

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73 See text accompanying notes 53-55.
74 Sanford & Brooks, 282 U.S. at 363.
75 Id. at 364.
so narrowly limited to its facts that it will seldom, if ever, actually be followed.\textsuperscript{76}

IV. \textbf{Should the Clark Analysis Be Extended to Tax Indemnity Payments?}\n
Having concluded that Clark was and remains correct on its facts, this article now considers whether exclusion of the tax indemnity payments at issue in the two letter rulings described above\textsuperscript{77} logically follows from the acceptance of Clark. The article concludes that there are crucial differences between the Clark situation and the situations described in the letter rulings, which make extension of Clark to those situations inappropriate.

\textit{A. Letter Rulings: Misrepresentation of the Tax Status of Income from an Asset}

In Letter Ruling 8748072,\textsuperscript{78} the seller of mortgage-backed certificates falsely represented to the taxpayer-purchaser that the certificates met the § 936 requirements for favorable tax treatment of the income from the certificates. When the taxpayer discovered the representation was false, the seller made an indemnity payment to the taxpayer, designed to put the taxpayer in the same economic position he would have been in had the certificates qualified under § 936. Although the § 936 aspect of the ruling may make its facts appear rather esoteric, the facts are typical of a large category of payments, made by sellers of assets to indemnify purchasers for tax which the purchasers would not have owed if the sellers’ representations had been correct. Analogous payments are commonly made, for example, pursuant to tax indemnity provisions in leveraged leases.

Superficially, these cases seem to fit within the Clark analysis: A taxpayer should be entitled to exclude a payment which merely reimburses him for extra taxes he was required to pay because of the fault (negligence in Clark, misrepresentation in these cases) of another. Recall, however, that the propriety of the result in Clark depends on distinguishing the Supreme Court’s opinion in Old Colony, which indicates that ordinarily the payment of federal income taxes cannot be properly

\textsuperscript{76} This is essentially the same status as that of Eisner v. Macomber, 252 U.S. 189 (1920), which continues to be cited for its discussion of the realization principle, and which has never been formally overruled, but the actual holding of which (concerning the constitutionality of taxing unrealized appreciation) is considered virtually a dead letter. For a discussion of Eisner v. Macomber, see 1 B. Bittker & L. Lökken, Federal Taxation of Income, Estates and Gifts \textsuperscript{5} 1.2.4 (2d ed. 1989).

\textsuperscript{77} See text accompanying notes 26-30.

\textsuperscript{78} Discussed at text accompanying notes 26-27.
characterized as a loss, the recovery of which is nontaxable. Clark can be reasonably distinguished from Old Colony on the grounds that the Clarks, unlike the taxpayer in Old Colony, could have paid less tax without any change in the nontax facts of their situation, if their preparer had simply made a different tax election.

In cases like that of the letter ruling, however, the tax the taxpayers were required to pay was only the correct tax, in the sense that they could not have paid any less tax based on the nontax facts as they actually existed (i.e., the certificates did not meet the requirements of § 936). If the tax liability was as low as possible, based on the actual nontax facts, none of the tax should be characterized as a Clark-type excess tax loss; without that loss characterization, the cases are governed by Old Colony and the payments are taxable. The contrary argument is that the taxes for which the taxpayer is indemnified can be properly characterized as a loss, because they would not have been owed if the facts were as represented by the seller. The problem with this argument is that it permits private parties to manufacture a “loss” out of nothing, with no regard to the actual nature of the asset in question, through the simple means of a misrepresentation by the seller.

A numerical example will help to explain the fallacy of the argument that the reimbursed taxes should be treated as a loss, the recovery of which is not taxable. Suppose A issues a bond to B for $100, which bears interest at an annual rate of 10% and which A inaccurately claims meets the requirements of § 103 for tax exemption of the interest payments. Upon B’s discovery of the false representation, A is required to pay B the amount necessary to put B in the same economic position he would be in if the interest on the bond were tax exempt.

Assume that B is subject to federal income tax at a marginal rate of 20%. Thus, prior to receipt of the indemnity payment from A, B’s after-tax rate of return on the bond is 8% (10% pretax return, reduced by the 20% income tax). This compares with the 10% after-tax return B would have received if the bond had qualified under § 103. The additional amount A must pay B to raise B’s after-tax return to 10% depends on

79 See text accompanying notes 32-33.
80 Id.
81 In the early 1980’s, there was considerable interest in tax audit insurance, which would (subject to certain conditions) reimburse a taxpayer for any additional taxes it was required to pay as a result of an IRS audit. It is clear that any tax audit insurance payments received by a taxpayer should be taxable under Old Colony. Since the tax liability determined on audit is the correct liability based on the nontax facts, the taxes for which the taxpayer is reimbursed cannot be characterized as a Clark-type excess tax loss. For discussions of tax audit insurance concluding that tax audit insurance proceeds are taxable, see N.Y. St. Bar Ass’n, Tax Section, A Report on Tax Audit Insurance, reprinted in 22 Tax Notes 53, 55 (Jan. 2, 1984); Popkin, Taxing Personal Insurance: The Case of Tax Audit Insurance, 4 Va. Tax Rev. 379, 398-99 (1985).
whether the additional amount is itself subject to tax. If the additional amount is taxable, the required additional amount is the equivalent of an additional 2.5% interest payment.\textsuperscript{82} The required additional amount if it is not taxable, is the equivalent of an additional 2% interest payment. Thus, in order to provide $B$ with the represented 10% after-tax return, $A$ must pay 12.5% on the bond if the indemnity payment is taxable, or 12% if it is not.

If the additional payment were not taxable, the effect would be to enable $A$ to issue a bond paying a tax-favored return, although the bond did not qualify for tax-favored status under § 103 (or any other Code provision). The bond would then be tax favored in that 2% of its return would be free of tax.\textsuperscript{83} Such a partially tax-favored return is inconsistent with the bond's failure to satisfy any statutory requirements for tax-favored status. Because the indemnity payment functions as additional return on the bond and the certificate does not qualify to pay tax-favored income, the indemnity payment should be fully taxable.\textsuperscript{84} By contrast, the payment from the negligent return preparer in Clark was not in connection with an asset sale, so that treating that payment as nontaxable did not have the effect of creating a form of tax-favored investment income not authorized by statute.

The numerical example confirms that it is inappropriate to characterize as a loss the taxes owed on the bond interest as a result of the bond’s failure to qualify under § 103. If the taxpayer could not have paid any less tax based on the actual nontax facts, there is no loss which can be recovered tax free. A contrary result would be at odds with Old Colony, and would permit the creation of tax-favored investment income not authorized by statute.\textsuperscript{85} Thus, the tax indemnity payments described in Letter Ruling 8748072 should be taxable.

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\textsuperscript{82} After application of the 20% tax, the additional 2.5% raises the after-tax return on the certificate from 8% to 10%.

\textsuperscript{83} This partial exemption effect increases as $B$’s marginal tax rate increases. For example, suppose the same facts except $B$’s marginal tax rate is 50%. $A$ should have to pay $B$ 20% interest to generate a 10% after-tax return to $B$. But if $A$ can initially pay $B$ allegedly tax-exempt 10% interest, and later pay $B$ a tax-free 5% indemnity, $A$ could provide $B$ with a 10% after-tax return at the cost to $A$ of only a 15% payment. $A$ would thus be able to pay $B$ the equivalent of 5% tax-free interest (compared with only 25% in the example in the text).

\textsuperscript{84} On these facts, it should be fully taxable as interest (or the functional equivalent of interest) under § 61(a)(4).

\textsuperscript{85} One commentator has argued that indemnity payments of this type should be taxable, if they are used intentionally as a means of creating unauthorized tax-favored income. Horowitz, note 9, at 804-05. Horowitz fails to recognize, however, that the effect of the unauthorized creation of tax-favored income occurs independently of the good or evil intentions of the taxpayer and the seller, with the result that such payments should always be taxable regardless of the state of mind of the parties.

Similarly, Jassy, note 9, at 12, 19-22, and 26-28, observes that a tax indemnity payment in connection with a leveraged lease could be characterized as taxable additional rent. He cites § 1.61-8(c) of the regulations (stating that “[a]s a general rule, if a lessee pays any of the
The contemplated indemnity payments at issue in Letter Ruling 8748072 were to compensate the taxpayer for tax liabilities it would incur up to the year the payments were made. The analysis developed above also would apply if the seller continued to make annual indemnity payments in the future. Suppose, however, that instead of continuing to make annual indemnity payments in the future, A made one payment as a lump sum settlement (in addition to the payments for tax liabilities incurred by B up to the year of settlement). For example, the parties might observe that B's annual after-tax return of $8 ($10 interest less $2 tax) would equal the guaranteed 10%, if B's investment were only $80, rather than $100. A would make a lump sum payment of $20 to B, leaving B with a net investment of $80. (There may be a nontax problem with this kind of settlement, since it does not give B the full benefit of his bargain—he gets the promised 10% return, but only on $80, not $100.) How should the tax system treat this kind of payment? It is intuitively appealing to treat the payment as an adjustment of the purchase price of the bond, i.e., tax free, but reducing B's basis from $100 to $80. This would be recovery of capital treatment, but not in the same sense as Clark. Here, the recovered capital would be part of the cost of the investment, not amounts paid in tax. A closer analysis supports the intuitive result. After the adjustment, A is paying B $10 per year on B's $80 investment—an annual return of 12.5%. That is precisely what A should have to pay to give B a 10% after-tax return (12.5% less 2.5% tax at 20%, leaves a 10% after-tax return), so neither party gains any inappropriate tax advantage through treating the $20 as a nontaxable purchase price adjustment.\footnote{There is considerable precedent in contexts other than tax indemnities for treating payments as tax-free purchase price adjustments or partial refunds, in appropriate circumstances, so this treatment does not require any great conceptual leap. See, e.g., Rev. Rul. 81-277, 1981-2 C.B. 14 (treating payment from contractor to buyer based on contractor's failure to fulfill construction contract as a return of capital). The purchase price adjustment analysis is discussed in Jassy, note 9, at 30-36.}

B. The Failed Safe Harbor Lease Letter Ruling

Letter Ruling 8923052\footnote{Discussed at text accompanying notes 28-30.} involved tax indemnity payments pursuant to a failed safe harbor lease. Stripped of legal fictions, the now-repealed safe
harbor leasing rules allowed a taxpayer who could not use the tax benefits associated with ownership of an asset to sell the tax benefits to a taxpayer who could use them. In economic reality, it was a direct sale of tax benefits, rather than a sale of a tax-favored asset. Given the repeal of safe harbor leasing, the issue considered by the letter ruling may seem to be of only historical interest. In fact, however, essentially the same issue could arise today in connection with a failed nonsafe harbor sale-leaseback.

Consider the following example: L Corporation owned a building in which it operated a department store. L contracted with P Corporation for what the parties characterized as a sale of the building from L to P, followed immediately by a lease of the building from P to L, so that L’s use of the building continued without interruption. Under the terms of the contract of sale, P made a down payment to L of $100, and issued a note to L for the balance of the sales price. The note provided for scheduled payments of principal and interest over a period of time which equaled the remaining useful life of the building. The term of the lease was for the same period of time as the payments on the note, and the scheduled lease payments from L to P exactly equaled the scheduled payments of principal and interest from P to L on the note. Thus, the down payment was the only net cash flow in the transaction.

P anticipated certain federal income tax benefits from the transaction, in the form of depreciation and interest deductions. These benefits depended on the transaction being characterized as a sale and leaseback for federal income tax purposes. L agreed to indemnify P for the value of those tax benefits, if it should be finally determined that the benefits were not allowable. The Service determined that the purported sale and leaseback lacked economic substance and therefore disallowed P’s claimed depreciation and interest deductions. (The Service also determined, however, that P was not taxable on its supposed rental income from L.) The matter was litigated, and the court ruled in favor of the Service, holding that P did not purchase or lease a building, but rather paid a fee (the down payment) for tax benefits.

Pursuant to the contract, L then made an indemnity payment to P, measured by the value of the tax benefits P would have received if the form of the transaction had been respected for tax purposes. The payment was $150, which reflected the detriment to P of not being entitled to the depreciation and interest deductions, net of the benefit of not having taxable rental income.

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89 For an opinion based on similar reasoning, see Rice’s Toyota World, Inc. v. Commissioner, 752 F.2d 89, 95 (4th Cir. 1985).
The analysis of the proper tax consequences of this indemnity payment is straightforward. $P$ has incurred no tax liability which reasonably can be characterized as a loss, so that the indemnity payment could be distinguished from *Old Colony* as the recovery of a loss. $P$ has paid the correct amount of taxes. Whatever $P$'s tax liability was for its income (all of which was, of course, unrelated to the failed sale-leaseback), it was exactly what it should have been, based on the facts of $P$'s situation. The argument for exclusion would have to be that $150 of the taxes paid by $P$ should be characterized as a loss, because $P$ would not have owed those taxes if the attempted sale-leaseback had succeeded. But a sham transaction cannot turn the tax on unrelated income into a loss, so as to exempt the reimbursement of that tax from the *Old Colony* doctrine. If it could, the integrity of *Old Colony* would be at the mercy of every sham transaction and every abusive tax shelter. If the payment of the taxes one properly owes can be characterized as a loss—thus making the recovery of that payment tax free—because one *might have* reduced one's tax liability by making a legitimate tax shelter investment, then the Supreme Court might as well overrule *Old Colony*.

This does not mean, however, that $P$ should be required to treat the entire $150 as taxable income. Looking at the transaction as a whole, $P$ has realized an economic gain of only $50: the excess of the $150 indemnity payment $P$ received over the $100 payment $P$ originally made to $L$. Thus, the $150 payment should be treated as consisting of $100 tax-free recovery of capital and $50 of taxable gain. However, the $100 capital $P$ should be allowed to recover free of tax is the $100 $P$ paid to $L$, and *not* any income taxes paid by $P$.

V. Conclusion

The issue in *Clark* is not easy. It involves fundamental questions concerning the recovery of capital doctrine and the scope of the § 61 definition of gross income. It also requires consideration of the implications of two major early Supreme Court income tax opinions, *Old Colony* and *Sanford & Brooks*. This article concludes that *Clark* is probably correct, but this conclusion requires distinguishing *Old Colony* (on the grounds that the Clarks should be considered to have suffered a loss by having been required to pay excess taxes, whereas the taxpayer in *Old Colony* suffered no such loss) and treating *Sanford & Brooks* as virtually a dead letter (because it is based on faulty reasoning, and because Congress has implicitly repudiated it by enacting the exclusionary tax benefit rule). Even granting the correctness of *Clark*, however, tax indemnity payments such as those involved in the two letter rulings should be taxable under *Old Colony*. Those payments are not distinguishable from the payments in *Old Colony*, because the taxpayers receiving the payments paid
no excess taxes. They paid only the proper amount of taxes based on the facts of their situations, and so cannot be viewed as having suffered losses that they can recover free of tax.