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A tax accrues when all events have occurred that fix the amount of the tax and determine the taxpayer's liability to pay it; furthermore, under the tax benefit rule, recovery of an amount previously deducted as a bad debt is only included in gross income to the extent the prior deduction resulted in a tax benefit.

Summary

National Bank of Commerce of Seattle sought to deduct capital stock tax at an increased rate for 1939 and exclude bad debt recoveries from income. The Board of Tax Appeals held that the increased capital stock tax rate, enacted in 1940, could not be accrued and deducted in 1939 because the liability was not fixed until the law changed. It further held that bad debt recoveries should be excluded from 1939 income because the deductions in prior years did not result in a tax benefit due to net losses.

Facts

The National Bank of Commerce of Seattle, operating on an accrual basis, sought to deduct capital stock tax for the year ending June 30, 1940, at a rate increased by the Revenue Act of 1940. It also excluded from 1939 income certain amounts recovered on debts previously written off as bad debts in 1933, 1934, and 1935.

Procedural History

The Commissioner of Internal Revenue disallowed the increased capital stock tax deduction and included the bad debt recoveries in the bank's 1939 income. The National Bank of Commerce of Seattle appealed the Commissioner's determination to the Board of Tax Appeals.

Issue(s)

1. Whether the petitioner, on the accrual basis, could deduct capital stock tax for the year ending June 30, 1940, at the increased rate enacted in the Revenue Act of 1940, in the tax year 1939.
2. Whether the petitioner was required to include in 1939 taxable income amounts recovered on debts previously written off as bad debts in 1933, 1934, and 1935, when the deductions did not result in a tax benefit in the years they were taken.

Holding

1. No, because the event that fixed the amount of the increased tax liability was the enactment of the Revenue Act of 1940, which occurred after the 1939 tax year.
2. No, because Section 116 of the Revenue Act of 1942 excludes from gross income amounts recovered on debts previously charged off where the deductions did not result in a reduction of the taxpayer's income tax.

Court's Reasoning

Regarding the capital stock tax, the court applied the principle from *United States v. Anderson*, 269 U.S. 422, that a tax accrues when all events have occurred which fix the amount of the tax and determine the taxpayer's liability to pay it. The court reasoned that the increased tax rate was not fixed until the enactment of the Revenue Act of 1940; therefore, the increased amount could not be accrued and deducted in 1939.

Regarding the bad debt recoveries, the court noted that Section 116 of the Revenue Act of 1942, which was retroactive to 1939, excluded from gross income amounts recovered on debts previously charged off if the deductions did not result in a reduction of the taxpayer's income tax. Because the bank had net losses in the years the bad debts were deducted, the deductions did not provide a tax benefit, and the recoveries were excluded from 1939 income.

Practical Implications

This case illustrates two important tax principles. First, the accrual of tax liabilities requires that all events fixing the amount and the taxpayer's liability have occurred. Taxpayers cannot deduct taxes in advance of the legal obligation being firmly established. Second, it demonstrates the application of the tax benefit rule, now codified in Section 111 of the Internal Revenue Code, which dictates that the recovery of an item previously deducted is only taxable to the extent the prior deduction resulted in a tax benefit. This principle ensures that taxpayers are not taxed on recoveries that did not previously reduce their tax liability. Later cases applying the tax benefit rule often cite this case as an example of the rule's application. The application of Section 116 of the Revenue Act of 1942, retroactively, highlights the ability of Congress to clarify existing tax law and to apply the clarification to previous tax years.

