8 T.C. 1170 (1947)

The recovery of an item previously deducted from taxable income is includible in gross income in the year of recovery to the extent the prior deduction resulted in a tax benefit.

Summary

Lloyd H. Faidley deducted an investment loss in 1930. In 1941, he recovered the investment. The Tax Court held that the recovery was taxable as ordinary income in 1941 to the extent the 1930 deduction reduced his taxable income. The court reasoned that Faidley received a tax benefit from the earlier deduction, and the subsequent recovery offset that benefit, triggering income recognition under the tax benefit rule. The court also suggested an estoppel argument, because the statute of limitations had run on the earlier return.

Facts

Faidley invested $22,500 in an oil venture between 1928 and 1930. His brother guaranteed the investment against loss. The oil venture failed in 1930. Faidley deducted the $22,500 loss on his 1930 income tax return. He described the investment as "a complete loss, there being no salvage." The deduction reduced his 1930 taxable income. In 1941, Faidley recovered $22,600 from his brother's estate based on the guaranty. He reported the interest portion as income but not the principal.

Procedural History

The Commissioner of Internal Revenue determined a deficiency in Faidley's 1941 income tax, arguing the recovered amount was taxable income. Faidley petitioned the Tax Court for review. The Tax Court upheld the Commissioner's determination.

Issue(s)

Whether the recoupment in 1941 of an investment loss, which the taxpayer deducted in 1930, is includible in the taxpayer's gross income for 1941; and if so, whether it is taxable as a capital gain or as ordinary income?

Holding

Yes, because the taxpayer received a tax benefit from the deduction in the prior year, the recovery is taxable as ordinary income in the year of recovery to the extent of the prior tax benefit.

Court's Reasoning

The court relied on the tax benefit rule, citing *Dobson v. Commissioner*. The rule

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states that the recovery of an item previously deducted is taxable income in the year of recovery to the extent the prior deduction reduced taxable income. Because Faidley's 1930 deduction reduced his taxable income, the 1941 recovery was taxable. The court noted the taxpayer stated in the original return that the investment was a "complete loss, there being no salvage." The court also suggested that estoppel principles could prevent Faidley from arguing the recovery was not taxable, as the statute of limitations barred amending the 1930 return. Judge Hill concurred, stating that the action of the respondent should be sustained regardless of estoppel.

Practical Implications

This case reinforces the tax benefit rule, a fundamental principle in tax law. It clarifies that taxpayers cannot deduct an expense and then exclude the recovery of that expense from income. Legal practitioners should analyze whether a prior deduction generated a tax benefit when advising clients on the taxability of recoveries. Later cases cite *Faidley* to apply the tax benefit rule where a taxpayer recovers an item previously deducted, even if the initial deduction was questionable. Business should consider the tax implications of recoveries when evaluating the overall economics of a transaction or investment. The case illustrates the importance of consistent tax treatment and the potential for estoppel arguments where taxpayers attempt to benefit from inconsistent positions across different tax years.

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