TERRITORY OF HAWAII

DEPARTMENT OF THE ATTORNEY GENERAL

HONOLULU

45

November 5, 1941

OPINION NO. 1789

TAXATION, NET INCOME;

Income Taxable:

In the event of a refund of federal taxes illegaly collected, which have been deducted as taxes paid on the return for an earlier year, where the amount of tax due for the earlier year still can be adjusted ordinarily such adjustment should be made and the refund does not constitute income in the year of its receipt.

SAME, SAME:

Income Taxable.
Estoppel.

A taxpayer who does not include in his gross income a refund of taxes illegally collected may be assessed therefor only if he is estopped from showing that the taxes refunded were illegally collected.

Campbell C. Crozier, Esq.
Acting Tax Commissioner
Territory of Hawaii
Honolulu, Hawaii

Attention: Mr. Earl Fase, Deputy
Tax Commissioner

Dear Sir:

Tour letter of October 7 requests our opinion in the following matter:

"In 1936 the Federal Government assessed the following amounts in respect to an individual's income tax return filed for the calendar year 1930 (the individual having died on August 15, 1933):

| | |
|---|---|
| Additional Income Taxes . . . . | $ 65,020.68 |
| Interest thereon . . . . . | .19,559.65 |
| Total. . . . . | $ 84,580.33 |

The above amount was paid by the Executor of the estate and deducted on the Executor's 1936 Territorial Income Tax Return.

In addition to the above, the Federal Government assessed and the Executor paid and deducted in the 1936 Territorial Return the following amounts:

| | |
|---|---|
| Federal Estate Tax (portion) . . | $ 2,952.86 |
| Interest thereon . . . . . | 370.03 |
| Total . . . . . | $ 3,322.89 |

After the shove deductions the Executor's 1936 Territorial Income Tax Return showed a loss of 97,253.97.

Eliminating the above deductions the return would show a loss of $9,350.75.

During 1940 the Executor of the Estate received the following payments from the U.S. Treasury Department:

| Item No. | |
|---|---|
| 1. Refund over-assessed 1930 Income Tax . . . . | $65,020.68 |
| 2. Refund over-assessed interest paid 1936 . . | 19,559.65 |
| 3. Interest at 6% on above amounts . . . . . | 18,198.67 |
| 4. Refund over-assesssd portion of Federal Estate Tax . . . . . | 2,952.86 |
| 5. Refund over-assessed portion of interest . . | 370 .03 |
| 6. Interest at 6% on items 5 and 6 . . . . . | 773.00 |

The Executor of the Estate prepares the Territorial Income Tax Returns on the cash basis. In preparing the 1940 return the Executor included the amount of interest as shown above in items 3 and 6 as taxable income. The question now arises as to whether or not the amounts shown in items 1, 2, 4 and 5 are includable under the provisions of Chapter 65, Revised Laws of Hawaii, 1935, as amended, as taxable income in the Executor's 1940 return."

In my opinion items 1, 2, 4, and 5 are not includable as taxable income in the Executor's 1943 return. Instead, the 1936 return should be amended so as to eliminate the deductions taken on account of the payment of the sums so refunded. You state that this would leave the 1936 return still showing a loss of $9,350.70. Therefore no additional tax is involved.

The federal rulings distinguish between taxes legally collected and later refunded, and taxes illegally collected and later refunded. Thus in Mim. 3958, C.B. XI - 2, 33 the Commissioner of Internal Revenue said:

> " * * * In the former case the customs duties were illegally collected and were, therefore, void from the beginning. It follows that the deductions from gross income were improperly taken and the income tax liability erroneously computed. When the illegality of these payments was later established the refunds made did not constitute income, since the original payments were payments made to the collector under mistake. Readjustment of the returns for the years in which the mistakes were made was the logical method for remedying the situation.* * *
>
> "* * * It sometimes happens that duties or taxes are legally or properly collected, but by reason of some subsequent event are refunded. An example of this type of case is the refund under the drawback provisions of the law where the importer pays the customs duties but later secures a refund by showing that the goods imported on which the duties were paid have gone into a manufactured article which was later exported. In such a case the collection of the customs duties was entirely legal and the refund thereof did not constitute the correction of a mistake because no mistake had been made. Therefore, legal and proper colections of customs duties and taxes should be distinguished from those illegally or improperly made. Refunds

> of customs duties or taxes, the collection of which was legally or properly made, should be treated as home for the year in which refunded."

The reasoning of the Commissioner of Internal Revenue in this ruling is in my opinion sound, and is supported, insofar as taxes illegally collected are concerned, which is the point involved in your matter, by Inland Products Co. v. Blair, 31 Fed. (2d) (C.C.A. 4) 867. In that case the federal government, after over-collecting beverage taxes, refunded the amount erroneously collected and then adjusted the income tax return for the years in which such taxes were paid. This action was sustained, the court saying:

> " * * * The whole question involved is one of correction of mistake; and, having accepted the correction on the part of the government with one hand, the taxpayer will not be allowed to hold on with the other to the benefit which it received by reason of the mistake. To readjust the returns for the years 1918 and 1919, by eliiminating the deduction in question, will place both parties to the mistake exactly where they would have been, if it had not occurred. * * *"

Since the government may adjust the return for the year in which the taxes were paid it is clear that the taxpayer also may do so, unless he is estopped. The theory of the adjustment is that the amounts paid as taxes were later determined not to be taxes and should not have been deducted as taxes. If the mistake as to the amount of federal taxes is innocently made, as in this instance, the mistake may be corrected by the taxpayer, so long as

adjustment of the earlier year is not barred. Under Section 2050, R.L. 1935, as amended, such adjustment is not barred as to the 1936 return filed in 1937 until 1942. After adjustment of the 1936 return the situation is seen to be the same as if money deposited with the federal government were returned by it, a situation which does not give rise to income in the year of the refund.

If the earlier tax return could not be adjusted a different situation would be presented. On this point the rulings of the Commissioner of Internal Revenue have not been consistent as to taxes illegally collected. In Mim. 4564, C.B. 1937-1, 93 it was stated that in such a situation the refund instituted gross income in the year of the refund, as to a taxpayer on the case basis. In I.T. 3278, C.B. 1939-1,76, it was decided that if the prior deduction did not have the effect of offsetting taxable income, the amount refunded should not be treated as taxable income, but in I.T. 3390, C.B. 1940-28-10325, this position was reversed, so that the position taken by the Commissioner of Internal Revenue now is that where the earlier year is barred the refund constitutes income in the year in which made (in the case of a taxpayer on the cash basis) whether or not a benefit was enjoyed through the deduction taken in the earlier year. This position is contrary to that taken by the Board of Tax Appeals. Central

Loan and Investment Company, 39 B.T. A. 981; Snell Milling Co., B.T.A. Mem. Op., Dec. 11, 337 B, C. C.H. (1941) #7082Z. The Commissioner relies upon Lake View Trust and Savings Bank, 27 B.T.A. 290. This is a bad debts case, and while the Commissioner of Internal Revenue has treated the collection of a debt charged off as worthless the same as the refunding of taxes illegally collected (c.f. G.C.N. 20854 C.B. 1939-1, 102; G.C.N. 22163, C.B. 1940-28-10324), in my opinion they do not necessarily stand on the same basis. It also should be noted that the later case of National Bank of Commerce of Seattle, 40 B.T.A. 72, is contrary to Lake View Trust and Savings Bank supra.

In the courts, the refund of taxes illegally collected, where the earlier return is barred, has been treated as giving rise, to income in the year of the refund. Nash v. Commissioner, 88 Fed. (2d) (C.C.A. 7) 477, cert. den. 301 U.S. 700; Universal, Inc. v. Commissioner, 109 Fed. (2d)(C.C.A. 7) 616; Union Trust Co. of Indianapolis v. Comissioner, 111 Fed. (2d) (C.C.A. 7) 60, but in at least one case, the Union Trust Co. case, the enrichment which otherwise would be unjustly enjoyed by the taxpayer was emphasized.

We are not now concerned with the treatment of a tax refund where the earlier income tax year is barred, but I have felt it necessary to review the rulings on these matters, first, in order to determine what effect, if any, such rulings

have upon the position here taken that the assessment for the earlier year should be adjusted since it is possible to do so, and secondly, because in Ops. Atty. Gen. (1925-6) No. 1325, it was assumed that tax refunds were income, without full examination of the circumstances or of the distinctions te be made according to the different states of fact.

To summarize my conclusions on this matter, it is my opinion that whenever there is nothing to preclude a showing that the taxes supposedly paid were void, the tax refund is generally recognized to be the same as the return of money advanced, and hence not income in the year of repayment. This is the rule where the payments would not have been deductible in the first place even if legally collected (I.T. 3218, C.B. 1938-2,107), or where, as above noted, the mistake made in regarding such payments as tax payments may still be corrected. Where, however, a taxpayer receives a refund and is precluded from showing that it is a mere reimbursement on account of payment of void taxes, the refund constitutes income in the year of its receipt (assuming the taxpayer is on the cash basis). The question therefore is whether or not a taxpayer is precluded form showing that the supposed taxes paid by him were void, and the answer to this question depends upon principles of estoppel.

Because of such estoppel income tax refunds undoubtedly do constitute income in the year of receipt of the refund in at least some instances. But where, as here, (a) the earlier year is not barred, and (b) there is no deliberate misleading, no election, no instance of a position deliberately chosen and prosecuted for the taxpayer's own purposes, or the like, then clearly there is no estoppel, and the earlier year may be and should be adjusted.

Respectfully,

(s) Rhoda V. Lewis
Rhoda V. Lewis
Deputy Attorney General

APPROVED:

Attorney General