Equitable Recoupment: Revisiting an Old and Inconsistent Remedy

Camilla E. Watson

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Associate Professor, University of Georgia School of Law. I wish to thank Brookes Billman, Walter Hellerstein, Margaret V. Sachs, and Alan Watson for their helpful comments on an earlier draft of this Article. I also wish to thank Patricia Bryant and David Gunderson for their research assistance.

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EQUITABLE RECOUPMENT: REVISITING AN OLD AND INCONSISTENT REMEDY

Camilla E. Watson*

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"It will not do to decide the same question one way between one set of litigants and the opposite way between another."1

INTRODUCTION

The federal tax system operates in a paradoxical way. On the one hand, it functions as a system of voluntary compliance,2 but, on the other hand, it is based on statutory rules, many of which are so complex and intricate that they are comprehensible only to a tax expert.3 Because of this paradox and the important role of the system in

2. Although this is the popular belief, there are contrary views. See, e.g., Kenneth L. Harris, On Requiring the Correction of Error Under the Federal Tax Law, 42 Tax Law. 515, 515 (1989) (arguing that the system is actually one of coercion because of the legal obligations to file and to pay, and because of the system of penalties that serve as a backup to these obligations); Tom Herman, Tax Report: A Special Summary and Forecast of Federal and State Tax Developments, Wall St. J., June 29, 1994, at A1 (quoting statement of IRS Chief Margaret Milner Richardson who referred to a sarcastic letter she received because she frequently refers to the tax system as "voluntary": "He told me I must be from Mars if I really believe the U.S. has a voluntary tax system").
the functioning of the federal government, it is crucial that the public perceive the system to be fair.\(^4\) Thus, general principles are incorporated into the statutory scheme that are designed to promote fairness while the system is preserved as an all-important source of revenue.

One example of such a principle is the statute of limitations.\(^5\) The statute bars both the government and the taxpayer from asserting a claim against the other after the expiration of a specified time period.\(^6\) The policy behind such a time bar is not only fairness but also administrative efficiency.

From the government's perspective, the statute of limitations affords a final determination of revenue available for a particular period without threat of a refund claim by the taxpayer. From the taxpayers' perspective, the statute eliminates the duty to maintain records indefi-

\(^4\) See generally M.H. Hoeflich, Of Reason, Gamesmanship, and Taxes: A Jurisprudential and Games Theoretical Approach to the Problem of Voluntary Compliance, 2 Am. J. Tax Pol'y 9, 11-12 (1983) (arguing that tax reform is necessary not just to increase revenues, but "to deal with the widespread perception amongst the public that . . . the wealthy are able to avoid their fair share of the tax burden").


\(^6\) The general statutory period for assessment is three years from the later of the due date of the return or the date the return is filed. I.R.C. § 6501(a)-(b) (1994). The statutory period for filing a claim for refund or credit of an overpayment is the later of three years from the date the return is filed or two years from the date of payment. I.R.C. § 6511(a) (1994); see also Commissioner v. Lundy, 116 S. Ct. 647, 657 (1996) (holding that two-year period applies if taxpayer receives a notice of deficiency and has not yet filed a return); Richards v. Commissioner, 37 F.3d 587, 590-91 & n.7 (10th Cir. 1994) (discussing jurisdictional distinctions between the Tax Court and the Federal District Court of initially filing a return within three years after payment), cert. denied, 116 S. Ct. 813 (1996); Nunziato v. United States, No. Civ. 95-30205, 1996 WL 437538, at *2 (D. Mass. May 7, 1996) (distinguishing the two-year and three-year statutory periods).

Under some circumstances, however, the normal statutory period may be extended. See, e.g., I.R.C. § 6501(e)(1)(A) (1994) (providing six-year period for omission of substantial item of income); I.R.C. § 6501(c)(1), (3) (1994) (providing that no statutory period will run if there is fraud or if no return is filed); I.R.C. § 6501(c)(4) (1994) (providing for extension of statute by agreement of the parties). Procedurally, the statute may be extended 90 days plus an additional 60 days if a statutory notice of deficiency is issued by the government. I.R.C. §§ 6212-6213 (1994). Further, if the taxpayer chooses to file a petition in the Tax Court, the statute is tolled until the decision of the court becomes final. See I.R.C. § 6512 (1994); see also I.R.C. § 7481(a)(1) (1994) (providing that, if no appeal, decision becomes final when period for appeal has run); I.R.C. § 7483 (1994) (providing that notice of appeal runs for 90 days after entry of decision); I.R.C. § 7459(c) (1994) (providing that date of entry of decision is date decision is entered on records of the Tax Court).
nately and reduces the risk of incurring a tax liability long after the receipt of the corresponding income. The closure provided by the limitations bar prevents the litigation of stale claims, which carries with it the inherent problems of limited availability of witnesses and documents, faded memories, and the possibility of perjury.\footnote{7} Thus, the statute lessens the likelihood of a wrong result on these grounds.

An example of a more revenue-oriented principle is the concept of the taxable year, an artificial tax accounting concept in which income, deductions, and credits are cabined into a consecutive twelve-month period.\footnote{8} Each taxable year is a discrete taxable period and must be considered separately and independently of any other taxable year. Thus, items of income and deduction attributable to one taxable year may not be used as a general adjustment in computing the tax liability of another taxable year.\footnote{9} This principle ensures that each taxpayer pays a fair share of taxes for the proper annual accounting period and

\footnote{7} Rothensies v. Electric Storage Battery Co., 329 U.S. 296, 301 (1946); see also Geneva Constr. Co. v. Martin Transfer & Storage Co., 122 N.E.2d 540, 549 (Ill. 1954) (noting that the basic policy of statutes of limitations is "to afford a defendant a fair opportunity to investigate the circumstances upon which liability against him is predicated while the facts are accessible"); David N. McConnell, \textit{The Doctrine of Recoupment in Federal Taxation}, 28 Va. L. Rev. 577, 602 (1942) (discussing the function of federal tax statutes of limitations).

\footnote{8} See I.R.C. § 441 (1994). Such a period may be either a calendar year or a fiscal year. \textit{Id.} §§ 441(d)-(e). An item of income must be included in the taxable year in which it is received, unless the taxpayer's accounting method indicates that the item is includable in another taxable year. I.R.C. § 451(a) (1994); Treas. Reg. § 1.451-1 to -2 (as amended in 1957); see also I.R.C. § 442 (1994) (discussing change of annual accounting period); I.R.C. § 443 (1994) (setting out guidelines for accounting periods of less than twelve months); I.R.C. § 446 (1994) (outlining tax accounting methods); I.R.C. § 461 (1994) (describing proper taxable year for deductions).

It is not always a simple matter to determine the taxable year in which an item of income should be included. For example, when income is received under a contingency which may result in the taxpayer having to repay later all or a portion of this amount, an issue that often arises is which taxable year or accounting period is the proper reporting period. \textit{See, e.g.,} North Am. Oil Consol. v. Burnet, 286 U.S. 417, 424 (1932) (delineating the claim of right doctrine); Fifth Ave. Coach Line v. Commissioner, 281 F.2d 556, 561-63 (2d Cir. 1960) (discussing tax consequences of legal contingencies under the accrual method of tax accounting), \textit{cert. denied}, 366 U.S. 964 (1961). Because of the artificiality of the taxable year and the uncertainty of whether and when income is includable, errors frequently occur. When they do, the concept of the taxable year fosters a tunnel-visioned approach which prevents correction of any errors unless either the statutory mitigation provisions or one of the equitable remedies applies. \textit{See infra} text accompanying notes 262-85 (discussing statutory mitigation provisions); \textit{see also infra} parts I-II (enumerating equitable remedies).

\footnote{9} Burnet v. Sanford & Brooks Co., 282 U.S. 359, 365-66 (1931). Thus, if an error is made in one taxable year and no correction occurs in a later year, the fisc either loses revenue or unfairly benefits. On the other hand, if the error is corrected in the open year, it renders the entire transaction inaccurate. Note that correction of the error may not be exact because of the differences in tax rates, filing status, and the concept of the time value of money. Steve R. Johnson, \textit{The Taxpayer's Duty of Consistency}, 46 Tax L. Rev. 537, 547-48 & n.59 (1991) [hereinafter Johnson, \textit{Duty of Consistency}].
that the government receives the appropriate amount of revenue attributable to that period.

Occasionally, a conflict in the interrelationship between two or more statutes of limitations may give one party an unfair advantage over the other. A common example is the conflict between the limitations periods on related income tax and estate tax returns. In some instances, after the expiration of the statute of limitations on an estate tax return the statute may remain open on the decedent's final income tax return. If an income tax deficiency is assessed during this open period, the liability reduces the taxable estate, resulting in a corresponding estate tax overpayment. Because the estate tax refund would be barred by the statute of limitations, the estate would be double taxed.

The excessive taxation of some taxpayers presents a public policy problem because the federal tax system in general could be undermined if the public perceives it as unfair. On the other hand, if taxpayers derive double benefits because the government is precluded from assessing a tax liability due to the statutory bar, those taxpayers who pay their fair share of tax liability are victimized.

In cases in which equity demands relief, the remedy of recoupment might apply to lift the statutory bar. Recoupment is not necessarily confined to federal tax cases or, for that matter, to cases involving the statute of limitations. See, e.g., Coar v. Kazimir, 990 F.2d 1413, 1420-21 (3d Cir.) (holding that pension fund was entitled to recoupment in offsetting benefits against liabilities of a fiduciary who breached his duty to the fund), cert. de-

10. Such a situation could arise due to the fact that the statute of limitations on the income tax return may have a different starting point than the statute of limitations on the estate tax return. Compare I.R.C. § 6072(a) (1994) (setting out due dates for filing income tax returns) and Treas. Reg. § 1.6072-1(b) (1980) (providing that decedent's income tax return is due the fifteenth day of the fourth month following the close of the 12-month period which began with the first day of the fractional part of the year) with I.R.C. § 6075(a) (1994) (providing that estate tax return is due nine months after the date of decedent's death). The general statute of limitations for both returns is three years from the later of the due date or the date the return was actually filed. See supra note 6. There also may be instances in which the statute of limitations on either the income tax return or the estate tax return is extended; for example, where there is fraud on the income tax return, but not on the estate tax return. See infra text accompanying notes 239-50.

11. Interestingly, one policy rationale that does not apply is increased revenue loss. While in strict economic terms the government loses revenue if a taxpayer is allowed a double benefit (although, conversely, there is a revenue gain if a taxpayer is double taxed), in absolute terms there is no more revenue lost overall through the inconsistent tax treatment than through a single mistake resulting in a tax benefit in one taxable year.

Although the taxpayer technically receives a double benefit in the former case, as opposed to a single benefit in the latter case, in the former case one of the "benefits" the taxpayer receives is a correction of the earlier mistake. But the correction results in the taxpayer receiving the "net benefit" to which she was entitled. Thus, there is, technically, no revenue loss in the later year. The result in both cases is a revenue loss attributable to only one taxable year. See McConnell, supra note 7, at 601-02 (explaining this theory).

12. Recoupment is not necessarily confined to federal tax cases or, for that matter, to cases involving the statute of limitations. See, e.g., Coar v. Kazimir, 990 F.2d 1413, 1420-21 (3d Cir.) (holding that pension fund was entitled to recoupment in offsetting benefits against liabilities of a fiduciary who breached his duty to the fund), cert. de-
above example, the estate would be allowed to credit the barred estate tax overpayment against the open income tax deficiency in order to reduce or eliminate the deficiency despite the statutory bar. But if the barred refund claim is greater than the alleged deficiency, the taxpayer cannot obtain a refund of the excess amount because recoupment is in the nature of a defense; therefore, it does not sanction affirmative recovery.

Similarly, the remedy could apply in favor of the government to credit a barred deficiency against an open refund claim. Because the government is, likewise, not entitled to affirmative recovery, it cannot assess a deficiency against the taxpayer if the barred deficiency is greater than the open refund claim.

Although it is relatively simple to articulate how recoupment applies, determining when the remedy should apply is an altogether different matter. One problem is that equitable remedies must be used sparingly when there is any potential conflict with a statute.

It has been suggested, however, that the rigidity and finality of the statute of limitations warrant special consideration in federal tax controversies because of the difficulty of categorizing items of income at the time of receipt, and similarly, of categorizing items of deduction. A further consideration is the inequity of allowing a party, whether the taxpayer or the government, to take advantage of the statute of limitations to claim a double benefit. See McConnell, supra note 7, at 601.


14. See Bull v. United States, 295 U.S. 247, 262 (1935) ("[R]ecoupment is in the nature of a defense arising out of some feature of the transaction upon which the plaintiff's action is grounded."); see also infra text accompanying notes 375-86 (discussing the nature of recoupment as a defense in the Dalm case). If affirmative recovery were permitted, it would violate the closure policy behind the statute of limitations and obfuscate any final settlement. Moreover, recoupment as an equitable remedy cannot override the direct application of a statutory remedy. See infra text accompanying note 258.

15. See infra note 352.

16. See O'Brien v. United States, 766 F.2d 1038, 1049 (7th Cir. 1985) (holding that doctrine of equitable recoupment applies only as a credit of a barred liability against an open refund claim, and may not result in the collection of the barred tax itself).

17. Some courts, however, do not regard equitable remedies as appropriate in federal tax cases under any circumstances. See, e.g., Webb v. United States, 850 F. Supp. 489, 493 (E.D. Va. 1994) ("[T]ax statutes of limitations . . . operate in both directions in that the government is given a limited period of time in which to make assessments, and taxpayers are given a limited period of time to seek refunds."), aff'd, 66 F.3d 691 (4th Cir. 1995), petition for cert. filed, 64 U.S.L.W. 3593 (U.S. Feb. 23, 1996) (No. 95-1360); Blatt v. United States, 830 F. Supp. 882, 888 (W.D.N.C. 1993) ("Tax cases do not lend themselves to an equitable solution. The Tax Code and regulations are tech-
ble year, arise from statutory laws rooted in compelling public policy which must be given preference over any equitable remedy.

Recoupment has no statutory underpinnings.\textsuperscript{18} It is a special, judicially created remedy grounded solely in equity and resting on the potential conflict between the voluntary compliance aspect of the federal tax system and the importance of its revenue-raising function. Recoupment applies only when certain poorly defined but stringent elements are met. These elements were established by the Supreme Court in four cases decided between 1935 and 1946.\textsuperscript{19}

Under the first element, either the taxpayer or the government must attempt to assert an inconsistent position while claiming the protection of the statute of limitations. This position, if successfully asserted, would result in a double benefit for the taxpayer or, conversely, a double tax for the government.\textsuperscript{20} The second element is that the inconsistent claims must arise from the same transaction\textsuperscript{21} and must involve the same taxpayer, or two or more taxpayers who share an identity of interest.\textsuperscript{22}

Unfortunately, in establishing these elements, the Supreme Court did not clearly articulate its reasoning, and since 1946, the Court has not substantively addressed the issue of recoupment.\textsuperscript{23} This has led to an inconsistent application of the remedy in the lower courts, thereby obscuring the main thrust of the Supreme Court decisions.\textsuperscript{24} The inconsistencies, in turn, lead to forum shopping and relegate recoupment to the ranks of an ineffective remedy, even in the narrow technical and must be interpreted accordingly, like a game which must be played strictly in accordance with the rules."\textsuperscript{19}\textsuperscript{9}, aff'd, 34 F.3d 252 (4th Cir. 1994).

18. In this respect, equitable recoupment is very different from the remedy of set-off. See infra part II.A (discussing Lewis v. Reynolds, 284 U.S. 281, modified, 284 U.S. 599 (1932)).

19. See infra part II.B.


21. Another way of stating this is: equitable recoupment is based on the concept that "one taxable event should not be taxed twice, once on a correct theory and once on an incorrect theory, and that to avoid this happening the statute of limitations will be deemed waived." Minskoff, 490 F.2d, at 1285 (citation omitted) (quoting Minskoff v. United States, 349 F. Supp. 1146, 1149 (S.D.N.Y. 1972)). A rationale for this requirement is that otherwise "[e]very assessment of deficiency and each claim for refund would invite a search of the taxpayer's entire tax history for items to recoup." Rothensies v. Electric Storage Battery Co., 329 U.S. 296, 302 (1946).

22. See infra text accompanying notes 145-46 and part IV.B.3 (discussing identity of interest).

23. The Court has, however, addressed the issue from a procedural perspective in the case of United States v. Dalm, 494 U.S. 596 (1990). For a discussion of Dalm, see infra text accompanying notes 366-74.

24. See infra text accompanying notes 295-301 (discussing the Court's failure to distinguish between the terms "transaction" and "taxable event," resulting in varying interpretations).
circumstances in which it ought to apply. In fact, although equitable recoupment has been raised in a number of cases since 1946, the remedy has seldom been applied to provide relief either to the taxpayer or to the government. As a result, very few treatises on equity even mention recoupment as a remedy.

Nearly ten years ago Professor Arthur Andrews, in an illuminating article, attempted to quantify recoupment and its use in federal tax controversies. So effective was Professor Andrews's article that few substantive articles on recoupment have been written since. But the courts have continued to struggle with recoupment issues, although relatively few seemed to have grasped the theory behind this extraordinary remedy. The reason is that the remedy itself is highly problematic, primarily because its elements are so poorly defined.

As a fairness doctrine, however, recoupment deserves more careful consideration than it has received because it is the only flexible, broadly based remedy available to address abuses of the statute of limitations. Yet recoupment has become highly ineffective because frequently courts do not apply the remedy when the facts otherwise indicate that they should. This Article suggests that the reason is that courts have lost sight of the equitable nature of the remedy. Instead, recoupment is treated as a quasi-legal remedy in which fact patterns are forced into rigid, and often inconsistent, judicial views of the remedy's established elements.

This Article examines the development of recoupment by first comparing and contrasting other equitable remedies. Because discussions

25. See infra part VII (discussing examples of confusion and misapplication regarding recoupment).
26. See, e.g., Estate of Mann v. United States, 731 F.2d 267, 279 (5th Cir. 1984) (denying recoupment to government on ground of failure of single transaction element); Kramer v. United States, 406 F.2d 1363, 1371 (Ct. Cl. 1969) (denying recoupment to government on ground of insufficient identity of interest); Minskoff v. United States, 349 F. Supp. 1146, 1149 (S.D.N.Y. 1972) (denying recoupment to taxpayer on ground of failure of single transaction element), aff'd, 490 F.2d 1283 (2d Cir. 1974).
27. See Andrews, supra note 13.
29. See infra part VII.
30. The statutory mitigation provisions allow closed years to be opened under certain specific, narrowly construed circumstances. See I.R.C. §§ 1311-1314 (1994) (setting out requirements and method of adjustment); see also infra text accompanying notes 262-85 (discussing statutory mitigation provisions). In addition, the mitigation provisions presumably apply only to income taxes. See I.R.C. § 1314(e) (1994) (providing that mitigation does not apply to employment taxes). But see Chertkof v. United States, 676 F.2d 984, 986-92 (4th Cir. 1982) (applying mitigation in a case of income tax refund arising as a result of valuation of securities for estate tax purposes). For a discussion of the Chertkof case and its ramifications, see Willis, Limits, supra note 13, at 652-59.
of related equitable remedies have filled tomes in themselves,\textsuperscript{31} this Article concentrates only on the more salient aspects of these remedies as they pertain to the development of recoupment in the federal tax context. Next, the established elements of recoupment will be discussed in depth, with particular emphasis on the views of Professor Andrews. The Article questions whether Professor Andrews's views represent the most effective analysis of the recoupment criteria in light of the judicial inconsistencies.

In discussing the ineffectiveness of recoupment as a modern remedy, this Article also addresses jurisdictional problems inherent in the remedy and contrasts statutory mitigation with recoupment. Finally, in an effort to achieve a fairer, more viable remedy, the Article proposes an expansion of the established elements and a shift in focus to the individual equities of each case.

I. RELATED EQUITABLE REMEDIES AND THEIR USE IN FEDERAL TAX LITIGATION

Courts have applied several equitable remedies in federal tax controversies when the bounds of fairness might otherwise have been exceeded and a potentially unconscionable injury might have resulted. These remedies are all flexible and are applied on an \textit{ad hoc} basis, which presents several problems in application. First, there is no absolute right to an equitable remedy. The right exists only when the court decides that the facts warrant it. Thus, the application tends to be inconsistent.\textsuperscript{32} Second, judicial decisions frequently fail to indicate that an equitable remedy has been applied even though the result may indicate otherwise.\textsuperscript{33} When this happens, there is no clear precedent, and therefore no substantive body of law upon which to draw in subsequent cases. Third, courts frequently take very restrictive views of equitable remedies and often refuse to apply them even in cases of unfairness so fundamental that an equitable remedy otherwise seems tailor-made.\textsuperscript{34} The result is an inadequate remedy, in turn leading to

\textsuperscript{31} See, e.g., William Q. de Funiak, Handbook of Modern Equity (1950); Henry L. McClintock, Handbook of the Principles of Equity (2d ed. 1948); Thomas W. Waterman, A Treatise on the Law of Set-off, Recoupment, and Counter Claim (2d ed. 1872).

\textsuperscript{32} See Lawrence J. Brannian, Note, \textit{Finality of Informal Tax Settlements—Estoppel as a Bar to Refund}, 21 Sw. L.J. 350, 358 (1967) (criticizing the lack of consistency among circuits in regard to whether an informal settlement agreement is binding).

\textsuperscript{33} See, e.g., United States v. Pennsylvania Indus. Chem. Corp., 411 U.S. 655, 674-75 (1973) (applying estoppel, ostensibly to allow PICCO to present proof that it was misled by a government agent into committing a criminal act); United States v. Hodgekins, 28 F.3d 610, 614-15 (7th Cir. 1994) (applying estoppel, ostensibly to prevent the government from changing a term in a closing agreement to the taxpayer's detriment).

\textsuperscript{34} See, e.g., United States v. Dalm, 494 U.S. 596, 598 (1990) (refusing to apply equitable recoupment where taxpayer was double taxed on money derived from an estate); Webb v. United States, 66 F.3d 691, 701-02 (4th Cir. 1995) (refusing to apply
confusion and inconsistency in the law. Fourth, some equitable remedies are closely related and their elements may overlap. Thus, the wrong remedy may easily be applied. This creates a problem in some cases because the choice of remedy could determine the ultimate result.\textsuperscript{35}

A. Estoppel and Quasi-Estoppel

Estoppel, or some form of it, has long been applied to prevent one party from obtaining an unfair advantage as a result of that party's earlier misleading conduct.\textsuperscript{36} Estoppel has been said to "cut[ ] across substantive principles in order to promote an assumed fairness thought to be more important than an adherence to conventional legal considerations."\textsuperscript{37}

Despite this broad language, estoppel has proven to be a generally inadequate remedy in federal tax controversies because historically it has been applied unevenly in favor of the government.\textsuperscript{38} One reason equitable tolling where government refused to refund gift taxes paid on behalf of defrauded taxpayer because statute of limitations had run), petition for cert. filed, 64 U.S.L.W. 3593 (U.S. Feb. 23, 1996) (No. 95-1360). For a full discussion of Dalm, see infra text accompanying notes 366-74.

35. See Webb, 66 F.3d at 701 (refusing to apply principle of equitable tolling, relying on the reasoning of Dalm, an equitable recoupment case with different elements); Richard de Y. Manning, The Application of the Doctrine of Estoppel Against the Government in Federal Tax Cases, 30 N.C. L. Rev. 356, 376-77 (1952) ("Unfortunately, . . . the cases do not always make a distinction between the doctrine of election and that of estoppel. Such a distinction is important, for some courts attach different legal consequences to the two situations." (footnotes omitted)).

36. See generally Joseph M. Jones, Estoppel in Tax Litigation, 26 Geo. L.J. 868 (1938) (discussing the role of estoppel in litigation of federal tax cases); Manning, supra note 35 (same).

37. Sugar Creek Coal & Mining Co. v. Commissioner, 31 B.T.A. 344, 346 (1934). Estoppel is an affirmative defense that must be raised in the pleadings, but relatively recently courts have allowed the defense to be raised for the first time in a motion for summary judgment. Carland, Inc. v. United States, No. 84-0195-CV, 1988 WL 68047, at *5 (W.D. Mo. Jan. 29, 1988); see also Barnwell & Hays, Inc. v. Sloan, 564 F.2d 254, 255 (8th Cir. 1977) (per curiam) (holding that failure to use specific terminology does not necessarily mean that defendant's answer is insufficient to raise affirmative defense of waiver).

38. See generally John M. Maguire & Philip Zimet, Hobson's Choice and Similar Practices in Federal Taxation, 48 Harv. L. Rev. 1281 (1935) (surveying various means, including estoppel, courts use to keep pace with the rapidly changing federal tax system). Maguire and Zimet explain this uneven application as attributable to public policy:

The picture suggested is in part that of a revenue official not entirely free from political insecurity, not very high up the departmental ladder, not very well paid, not too sure he wishes to stay permanently in government service. Persuasively opposed to the official is a lawyer or accountant—sometimes a group of such men, visible or invisible—highly trained, acutely interested in the particular case, keen from knowledge that fees depend on success. Entirely without any suggestion of impropriety or crookedness, the observer will suspect that private interest is likely to be better served than public interest.
for this uneven application was that primary emphasis was placed on a misrepresentation of fact intended to induce reliance and subsequent action. 39

Id. at 1301 (footnote omitted); see also Elrod Slug Casting Mach. Co. v. O'Malley, 57 F. Supp. 915, 920 (D. Neb. 1944) ("The assessment and collection of revenues is a governmental function, and the doctrine of estoppel [against the government] has no place here."); Grand Cent. Pub. Mkt., Inc. v. United States, 22 F. Supp. 119, 127 (S.D. Cal.) ("[C]ourts have quite generally afforded relief to the government, by invoking the doctrine of estoppel in those cases where the taxpayer has, by his past conduct, induced the government to forego some right or remedy which it would have asserted had it not been for the action or representation, express or implied, of the taxpayer."). appeal dismissed, 98 F.2d 1023 (9th Cir. 1938); Manning, supra note 35, at 357 (discussing whether estoppel is an appropriate remedy against the government and, if so, when it should be applied); cf. Sugar Creek Coal, 31 B.T.A. at 347-48 (holding that the government could not assert estoppel against the taxpayer where there was no fraud involved and where the Commissioner was, to some extent, also wrong).

In Mt. Vernon Trust Co. v. Commissioner, 75 F.2d 938 (2d Cir.), cert. denied, 296 U.S. 587 (1935), a taxpayer erroneously included an item of income in the taxable year 1928 instead of in the correct year, 1929. A closing agreement executed for the 1928 taxable year barred a refund attributable to that year. The Commissioner assessed a tax liability attributable to the 1929 taxable year. The taxpayer argued that the Commissioner was estopped from collecting on this assessment because the tax liability had already been collected in 1928, in accordance with the terms of the closing agreement. The court held that estoppel does not apply when the government accepts an erroneous return. Id. at 940.

A contrary argument has been advanced in favor of the taxpayer but to little apparent avail:

Of course, too, there is another and very different picture in which the taxpayer, often a little fellow, yet sometimes of size and importance, is bewilderingly bludgeoned by governmental numbers, borne down by departmental deadweight, blocked by stupid official obstinacy. Maguire & Zimet, supra, at 1302.

39. See P.V. Baker & P. St. J. Langan, Snell's Equity 568 (29th ed. 1990) (discussing development of the doctrine of estoppel at common law). The misrepresentation must be one of fact, rather than law. Such a misrepresentation may arise not only from affirmative assertions, but also from inaction creating a mistaken impression. Id. at 569; see also Commissioner v. Union Pac. R.R., 86 F.2d 637, 639-40 (2d Cir. 1936) ("An estoppel cannot originate in a mere statement of law or in silence due to an error of law."). There is a presumption that everyone knows and generally understands the law. Consequently, if one is misled by a misrepresentation of law, it is because of one's own negligence; such a misrepresentation is considered merely the opinion of an administrative official, and estoppel is not considered an appropriate remedy. See Note, The Emerging Concept of Tax Estoppel, 40 Va. L. Rev. 313, 315 (1954) [hereinafter Va. Note] (stating that taxpayer must know that tax liability is "determined by the law and not by what some administrative official thought was the law" (quoting Langstaff v. Lucas, 9 F.2d 691, 693 (W.D. Ky. 1925), aff'd, 13 F.2d 1022 (6th Cir.), cert. denied, 273 U.S. 721 (1926))). Because of the complexity of the tax laws, however, this presumption should not apply to federal tax statutes. Note, Estoppel of Taxpayer to Set Up Statute of Limitations Where Government is Led to Defer Tax Assessment by Taxpayer's Misrepresentation of Law, 45 Yale L.J. 178, 180 (1935) [hereinafter Yale Note] ("[T]he present uncertainty in the tax law makes so theoretical an assumption utterly inappropriate for the practical problem of collecting revenue."); cf. Schuster v. Commissioner, 312 F.2d 311, 317 (9th Cir. 1962) ("[A] person might sustain such a profound and unconscionable injury in reliance on the Commissioner's action as to require, in accordance with any sense of justice and fair play, that the Commissioner not be allowed to inflict the injury."). But see Leck Co. v.
Estoppel does not apply to a mistake of law. It was relatively easy for this essential element to work to the disadvantage of the taxpayer, because omitting an item of income could be considered a misrepresentation of fact, but it very seldom worked to the disadvantage of the government. Another, and more important, reason for the general difficulty in asserting estoppel against the government was that most courts were reluctant to estop the government on the basis of misstatements of its agents, unless fraud or malfeasance were proved.

United States, 73-2 U.S. Tax Cas. (CCH) § 9694, at 82,250 (D. Minn. 1973) ("[W]aiver and estoppel are applied with 'great caution' against the Government, particularly in the tax field.").

Most courts continue to adhere to a double standard, however, when the government is involved. See, e.g., Office of Personnel Management v. Richmond, 496 U.S. 414, 419 (1990) ("From our earliest cases, we have recognized that equitable estoppel will not lie against the Government as against private litigants."); Bosley v. United States, No. C-89-081, 1990 U.S. Dist. LEXIS 19810, at *3-4 (E.D. Wash. Apr. 17, 1990) (stating that if the government is the defendant, the taxpayer must meet an additional burden and prove that the government's affirmative misrepresentation or concealment of a material fact caused a serious injustice to the taxpayer, and that the public interest will not be damaged by the use of estoppel).

40. See Estate of Vitt v. United States, 706 F.2d 871, 874 (8th Cir. 1983) (holding that government was not equitably estopped from asserting inconsistent position as a matter of law). But see Yale Note, supra note 39, at 180 (noting that such an assumption is inappropriate in tax law because of the law's uncertainty).

41. See Crane v. Commissioner, 68 F.2d 640, 641 (1st Cir. 1934) ("[F]ailure, however innocent, to report this income, constituted in effect a statement that no such income was received . . . ."). But see Union Pac. R.R., 86 F.2d at 640 ("An unqualified application of the rule that failure to report income creates estoppel would mean that an equitable remedy can serve to nullify the substantive provisions of the statute of limitations as well as the statutory policy that income is to be allocated to its appropriate year, despite the loss of revenue." (citations omitted)).

42. See, e.g., Taylor v. Commissioner, 89 F.2d 465, 467 (7th Cir.) (stating that, although the proper year of inclusion is a question of law, not fact, it may of necessity involve questions of fact), cert. denied, 302 U.S. 727 (1937); Shamrock Oil Co. v. Commissioner, 77 F.2d 553, 555-56 (5th Cir.) (holding that taxpayer was estopped from denying transferee liability for tax and validity of executed waivers where taxpayer had at all times held itself out as a consolidation of the predecessor corporation and had obtained tax advantages as such), cert. denied, 296 U.S. 632 (1935).

When the court held in favor of the taxpayer, it often did so on the basis of very unusual facts. See, e.g., Commissioner v. Yates, 86 F.2d 748, 750 (7th Cir. 1936) (holding that estoppel does not apply against the taxpayer to invalidate an executed closing agreement when there is no evidence of fraud or malfeasance); Union Pac. R.R., 86 F.2d at 639-40 (holding that elements of estoppel are not present when misrepresentation rested on innocent mistake of law and the government, asserting estoppel, was not ignorant of the true facts); Leck Co., 73-2 U.S. Tax Cas. (CCH) at 82,252 ("The limited situations in which estoppel has been applied against the Commissioner usually have involved matters of a purely administrative nature.").

43. See, e.g., Utah Power & Light Co. v. United States, 243 U.S. 389, 409 (1917) (holding that estoppel did not apply against the government when taxpayer condemned federal land for purposes of harnessing hydroelectricity even though taxpayer claimed to have acted on the assurances of government agents); Bookwalter v. Mayer, 345 F.2d 476, 478 (8th Cir. 1965) (noting that there is no "tax" estoppel in absence of false or fraudulent representations by government agents).

There have been several reasons proffered for this stance. First, taxes are the lifeblood of the government and must be collected despite the potential for an occasional
Later, however, the elements were liberalized to provide a more even application. The remedy then became known as "quasi-estoppel," and while its elements are theoretically the same as those of pure estoppel, in practice the principal focus has shifted from intent to injustice. Second, the agent generally has no power to bind the government informally. Third, judicial perception often casts the government agent as a low-paid, overworked, politically insecure underdog laboring in the public interest, as contrasted to a well-paid, highly educated lawyer or accountant motivated by self-interest. See Maguire & Zimet, supra note 38, at 1301-04. With respect to the latter rationale, however, a contrary perception could be conjured of the lone, individual taxpayer outgunned by the manpower and resources of the government and confused by the complexity of the tax laws. See id. at 1302.

More recently, other reasons have been suggested to explain the double standard in estoppel cases: (1) some courts adhere to the fading doctrine of sovereign immunity and will grant relief to the taxpayer only in the most compelling situations; (2) the taxpayer usually does not suffer a detrimental change of position by relying on the statement of the government agent (instead, the taxpayer is merely forced to pay her just share of the tax burden so she is, therefore, no worse off); and (3) most of the more deserving cases are settled administratively and thus never get to court. See generally Walter B. Melton & Yale F. Goldberg, Equitable Estoppel in Tax Administration, 62 Taxes 77 (1984) (proposing that more estoppel cases should be settled administratively by the IRS).

44. Most courts require (1) a misrepresentation by an agent of the government acting within the apparent scope of his authority, (2) lack of contrary knowledge by the taxpayer where he might reasonably be expected to rely on the agent's assertions, (3) actual reliance, (4) detriment, and (5) a resulting unconscionable injury in the absence of equitable relief. See Theodore S. Lynn & Mervyn S. Gerson, Quasi-Estoppel and Abuse of Discretion as Applied Against the United States in Federal Tax Controversies, 19 Tax L. Rev. 487, 488-89 (1964) (discussing elements of estoppel); see also Melton & Goldberg, supra note 43, at 78-82 (discussing elements determining when the remedy should apply).

The general equitable defenses such as laches and unclean hands also apply to quasi-estoppel. See Note, Displacement of the Doctrine of Laches by Statutes of Limitations—Crystallization of the Equitable Rule, 79 U. Pa. L. Rev. 341, 344-47 (1930) [hereinafter Pa. Note] (discussing the erosion of the doctrine of laches and of equitable remedies in general).

45. See, e.g., McGraw-Hill, Inc. v. United States, 623 F.2d 700, 706 (Ct. Cl. 1980) (holding that equitable estoppel applies whenever the government cannot be placed in the same position it was in when the agreement was executed); Bookwalter, 345 F.2d at 478 (stating that there can be no tax estoppel without false or fraudulent representations by government agents); cf. Joyce v. Gentsch, 141 F.2d 891, 897 (6th Cir. 1944) (holding that taxpayer was not estopped from filing refund claim where taxpayer and government had reached an accord and satisfaction on a deficiency, because government had facts at its disposal in time to assess, although it failed to do so); Lawrence Zelenak, Should Courts Require the Internal Revenue Service To Be Consistent?, 40 Tax L. Rev. 411, 432 (1985) (discussing reasonable reliance).
Thus, the facts and circumstances upon which the claim is based must be so egregious as to override any remedy at law.47

46. See Maguire & Zimet, supra note 38, at 1321-28. Note that the party against whom estoppel is urged need not have received any benefit. Id. at 1307. Instead, the focus is on the claimant and the detriment that party has suffered or will suffer if estoppel is not applied. See United States v. Asmar, 827 F.2d 907, 915 (3d Cir. 1987) (reversing lower court on ground that there was no finding of detriment); Gentsch, 141 F.2d at 897 (“Estoppel is not properly invoked, moreover, for the reason that appellee has failed to show that he has been damaged.”).

47. See, e.g., Schuster v. Commissioner, 312 F.2d 311, 317-18 (9th Cir. 1962) (applying estoppel against government to prevent assertion of transferee liability against taxpayer and concluding that if Commissioner prevailed, taxpayer would suffer “profound and unconscionable injury” as a result of reliance on Commissioner’s representations); Mayfair Minerals, Inc. v. Commissioner, 56 T.C. 82, 88 (estopping taxpayer from excluding income derived from earlier wrongful deductions because taxpayer had misled the government), aff’d, 447 F.2d 484 (9th Cir. 1971). But see Melton & Goldberg, supra note 43, at 82 (suggesting that estoppel should be more liberally applied in taxpayers’ favor and that most estoppel cases should be settled administratively without resort to the courts).

Consider the statement of the district court in Grand Central Public Market, Inc. v. United States, 22 F. Supp. 119 (S.D. Cal.), appeal dismissed, 98 F.2d 1023 (9th Cir. 1938):

Equitable estoppels are invariably invoked in order to further equity and justice in a given case—by preventing a party from asserting his rights under a technical rule of law, when he has so conducted himself that it would be contrary to equity and good conscience for him to allege and prove the truth.

Id. at 127.

There are three general circumstances in which estoppel has been applied in the tax context: (1) when one party attempts to change its position to the detriment of the other party, which can involve oral assertions by an IRS agent (although in this situation it is very difficult for the taxpayer to prevail), a retroactive revocation of a favorable ruling, or a change of position by the taxpayer when the IRS is barred from following suit; (2) when the taxpayer attempts to renege on an agreement with the IRS (note that the agreement may or may not rise to the level of a binding closing agreement); and (3) when a party who has a duty to act fails to do so. See id.

There are also general circumstances in which estoppel will not apply. First, the mere acceptance of a return by the government will not give rise to an estoppel. Mt. Vernon Trust Co. v. Commissioner, 75 F.2d 938, 940 (2d Cir.), cert. denied, 296 U.S. 587 (1935); Va. Note, supra note 39, at 315 (“To constitute estoppel there must be a representation of a fact or a wrongful misleading silence with respect to a fact.... A person knowing the facts or in a position to know them can not claim the benefit of estoppel.” (quoting Gaylord v. Commissioner, 153 F.2d 408, 416 (9th Cir. 1946))).

Second, the government may retroactively amend regulations and rulings in order “to correct misinterpretations, inaccuracies, or omissions... and thereby to affect cases in which the taxpayer’s liability had not been finally determined.” Helvering v. R.J. Reynolds Tobacco Co., 306 U.S. 110, 116 (1939); see also I.R.C. § 7805(b) (1994) (granting to Secretary of the Treasury the discretionary power to retroactively apply any ruling or regulation relating to the internal revenue laws). Where the regulation is not in harmony with the statute, the regulation is void ab initio. Thus, a subsequent regulation may apply retroactively because, technically, the previous regulation never took effect. See Manhattan Gen. Equip. Co. v. Commissioner, 297 U.S. 129, 135 (1936) (“[T]he amended regulation in effect became the primary and controlling rule...”); see also Automobile Club v. Commissioner, 353 U.S. 180, 185-86 (1957) (holding that Commissioner did not abuse his discretion in retroactively revoking ruling based on mistake of law); cf. Lesavoy Found. v. Commissioner, 238 F.2d 589, 594 (3d Cir. 1956) (holding that Commissioner abused his discretion when he retroactively revoked individual ruling that had not been based on mistake).
In general, quasi-estoppel has been a more successful remedy for the taxpayer, although it is still generally agreed that the government may not be estopped on the same terms as a private litigant.\textsuperscript{48} For instance, a party seeking estoppel against the government must also establish affirmative misconduct beyond mere negligence.\textsuperscript{49} The mere acceptance of a return by the government does not create an estoppel against the government,\textsuperscript{50} nor, on the other hand, does the running of the statute of limitations create an estoppel in its favor.\textsuperscript{51} Further, there must be a balancing of the often conflicting interests of fair treatment of taxpayers and protection of the federal fisc.\textsuperscript{52}

There is currently a split among the circuits as to whether the government is estopped from denying an express promise in an unofficial government publication as to the prospective application of any subsequent adverse modification of a specific regulation. \textit{Compare} Gehl Co. v. Commissioner, 795 F.2d 1324, 1334 (7th Cir. 1986) (holding that government is estopped from applying regulation retroactively) \textit{and} LeCroy Research Sys. Corp. v. Commissioner, 751 F.2d 123, 128 (2d Cir. 1984) (same) \textit{with} CWT Farms, Inc. v. Commissioner, 755 F.2d 790, 804 (11th Cir. 1985) (upholding retroactivity), \textit{cert. denied}, 477 U.S. 903 (1986).

\textsuperscript{48} See, e.g., Howard Bank v. United States, 759 F. Supp. 1073, 1078 (D. Vt.) ("[H]olding the government accountable for the mistakes of its officials has an impact on taxpayers generally, and courts are reluctant to provide an incentive for an individual taxpayer to gain advantage from such mistakes.""); \textit{aff'd}, 948 F.2d 1275 (2d Cir. 1991); Bosley v. United States, No. C-89-081, 1990 U.S. Dist. LEXIS 19810, at *3 (E.D. Wash. Apr. 17, 1990) (stating additional criteria that should be applied to the government); Leck Co. v. United States, 73-2 U.S. Tax Cas. (CCH) ¶ 9694, at 82,250 (D. Minn. 1973) ("Even if there are proper grounds for invoking [estoppel] against private citizens, "the government stands in a different position."""); \textit{cf.} Heckler v. Community Health Servs., 467 U.S. 51, 60 (1984) (leaving open question of whether estoppel applies against the government); Miller v. United States, 949 F.2d 708, 712 (4th Cir. 1991) ("[C]ourts expressly have prohibited the application of the doctrine of equitable estoppel in cases involving the IRS."); Va. Note, supra note 39, at 313 (noting that some courts have expressed doubts about whether estoppel applies at all against the government).

There are some circumstances under which it has been acknowledged that the government cannot be estopped—for instance, in the case of a retroactive revocation or amendment of a regulation in order to correct "misinterpretations, inaccuracies, or omissions." \textit{R.J. Reynolds Tobacco Co.}, 306 U.S. at 116.

\textsuperscript{49} Mere misstatement of the law does not represent the government's position and therefore is not binding on the government. See \textit{Priv. Ltr. Rul.} 94-26-002 (Feb. 14, 1994) (ruling that IRS agent's statement that pension income was taxable did not create an estoppel against the government).

\textsuperscript{50} See \textit{supra} note 47.

\textsuperscript{51} See \textit{Van Antwerp} v. United States, 92 F.2d 871, 876 (9th Cir. 1937) (holding that government was not entitled to assert estoppel against taxpayer who filed refund claim one day before expiration of statute of limitations; no misrepresentation was involved, and Commissioner neglected to reaudit return); \textit{Davis v. Commissioner, 29 T.C.} 878, 896 (1958) (postulating that detriment must be "real and substantial" and stating that it is not enough that the statute of limitations has run).

\textsuperscript{52} See \textit{Schuster v. Commissioner, 312 F.2d} 311, 317 (9th Cir. 1962) ("[T]he policy in favor of an efficient collection of the public revenue outweighs the policy of the estoppel doctrine in its usual and customary context."); \textit{Bosley}, 1990 U.S. Dist. LEXIS 19810, at *3 (stating that estoppel will apply against the government only where the "government's wrongful act will cause a serious injustice, and the public's interest will not suffer undue damage by imposition of the liability").
Nevertheless, estoppel has been applied against the government to lift the bar of the statute of limitations when the government has made misrepresentations that have induced taxpayers to act to their detriment. For instance, the Commissioner was estopped from claiming the protection of the statutory bar when he inadvertently misrepresented the amount of time remaining under the statute to file a claim for refund where the taxpayer, relying on the Commissioner's assertions that the statute was open, filed its claim after the statute had run. Similarly, where the misrepresentations of an IRS agent caused a taxpayer to rely to its detriment on the integrity of a refund claim, the government was subsequently estopped to raise the ground of failure to perfect a claim as a basis to deny the refund.

Quasi-estoppel has, of course, also been applied against the taxpayer in a variety of circumstances. The most common case arises when the taxpayer attempts to renege on a formal agreement with the government. Moreover, if a taxpayer maintains that a tax liability is

53. See, e.g., Bosley, 1990 U.S. Dist. LEXIS 19810, at *7 (estopping government from asserting validity of federal tax lien where taxpayer purchased property upon assurances from government that underlying tax liability had been satisfied); United States v. Borg-Warner Corp., 39-2 U.S. Tax Cas. (CCH) ¶ 9794, at 10,949 (7th Cir. 1939) (estopping government from claiming that statute of limitations precluded taxpayer's refund suit). Conversely, quasi-estoppel has also been applied against the government to impose such a bar. See Stockstrom v. Commissioner, 190 F.2d 283, 289 (D.C. Cir. 1951) (precluding government from asserting that statute of limitations never ran when taxpayer's failure to file a gift tax return was due to government's actions).

54. See Staten Island Hygeia Ice & Cold Storage Co. v. United States, 85 F.2d 68, 70-71 (2d Cir. 1936) (holding that closing agreement did not lift the bar of the statute of limitations, where government argued that statute did not apply because taxpayer had executed closing agreement, because the government had made misrepresentations on which the taxpayer had relied to its detriment). But cf. United States v. Garbutt Oil Co., 302 U.S. 528, 535 (1938) (holding that refund claim filed after expiration of statute of limitations did not constitute amendment of original, timely filed claim).

55. See Smale & Robinson, Inc. v. United States, 123 F. Supp. 457, 466-67 (S.D. Cal. 1954) (considering case of taxpayer who relied on IRS agent's assertions that a credit carryback would be allowed to generate a refund in a year in which the taxpayer was being audited but who had not otherwise filed a refund claim).

56. See, e.g., Elbo Coals, Inc. v. United States, 588 F. Supp. 745, 749 (E.D. Ky. 1984) ("The bottom line is that both parties made mutual concessions, and both parties agreed to be bound by those concessions."). aff'd, 763 F.2d 818 (6th Cir. 1985); Kretchmar v. United States, 9 Cl. Ct. 191, 196-98 (1985) (imposing quasi-estoppel against taxpayer who signed a Form 870-AD and discussing elements of a binding closing agreement). There is a conflict among some of the lower federal courts and the Court of Claims as to whether quasi-estoppel may apply in the absence of a formal agreement. Compare Stair v. United States, 516 F.2d 560, 565 (2d Cir. 1975) (holding that taxpayer could not renege on informal settlement agreement to detriment of government; otherwise "outcome would arm the taxpayer with both a shield and a sword," and he would have "no chance of losing"); McGraw-Hill, Inc. v. United States, 623 F.2d 700, 706 (Cl. Ct. 1980) (noting that under its liberal view of estoppel, the doctrine will apply whenever the government cannot be placed in the same position it was in when the agreement was executed), and Guggenheim v. United States, 77 F. Supp. 186, 196-97 (Cl. Ct. 1948) (applying estoppel to prevent taxpayer from reneging on informal agreement to detriment of the government after statute of limi-
attributable to a particular taxable year, or to a particular person, and
the government acquiesces, the taxpayer should not be allowed to
change that position by maintaining that the tax liability is attributable
to an earlier, closed year after the statute of limitations has run.57
Apart from an honest mistake, if the taxpayer was acting in good
faith, she would have made arrangements to pay the tax liability
before the statute of limitations expired.58 If the taxpayer was not
acting in good faith, estoppel might apply.

Because estoppel is an equitable remedy, it cannot override a direct
statutory provision. Thus, it does not open an otherwise closed taxa-
ble year in order to adjust inequities or inconsistencies. It also does
not correct any earlier mistakes nor, in fact, is it very concerned with
the existence of those mistakes.59 It merely prevents a change of posi-
tion by one party when such a change could prejudice an innocent
party. Strict interpretation of tax statutes is of secondary importance.
Instead, the focus of estoppel is primarily on issues of fairness and the
protection of reasonable reliance.60

57. See, e.g., Swartz v. Commissioner, 69 F.2d 633, 635 (5th Cir. 1934) (estopping
taxpayer from asserting, after statute of limitations had run against assessment, that
he, not third party, was the real owner of income and should have been taxed accord-
ingly); Commissioner v. Garber, 50 F.2d 588, 591 (9th Cir. 1931) (holding that tax-
payer could not change position and claim that income was actually taxable in an
earlier year, the assessment of which was then barred by the statute of limitations).

58. This is the clear implication of Garber. 50 F.2d at 590-91.

59. The question has arisen, however, whether estoppel is an appropriate remedy
if equitable recoupment applies. See Morris White Fashions, Inc. v. United States, 176
F. Supp. 760, 765 (S.D.N.Y. 1959) (holding that estoppel is inappropriate if govern-
ment can use recoupment to sufficiently offset taxpayer’s claim). But see D.D.I., Inc.
v. United States, 467 F.2d 497, 500 (Ct. Cl. 1972) (stating that recoupment will not
override estoppel where compromise agreement is a “package deal” because there
would be no full right of setoff), cert. denied, 414 U.S. 830 (1973).

60. See, e.g., R.H. Stearns Co. v. United States, 291 U.S. 54, 61-62 (1934). The
Court stated:

Sometimes the resulting disability has been characterized as an estoppel,
sometimes as a waiver. The label counts for little. Enough for present pur-
poses that the disability has its roots in a principle more nearly ultimate than
either waiver or estoppel, the principle that no one shall be permitted to
found any claim upon his own inequity or take advantage of his own wrong.
Id.; see also Smale & Robinson, Inc. v. United States, 123 F. Supp. 457, 463 (S.D. Cal.
1954) (“Justification for equitable estoppel is found in equity, common honesty and
good conscience.”).
B. Equitable Tolling

A similar remedy is equitable tolling, which tolls the statute of limitations in certain exceptional circumstances. Unlike estoppel, however, the elements of equitable tolling have never been defined, although the Supreme Court has stated that the rebuttable presumption of equitable tolling applicable to suits between private litigants should be extended in the same manner to suits against the government. There is presently a conflict among the courts as to whether equitable tolling applies at all in federal tax cases, and if so, under what conditions it applies. These issues are currently pending before the U.S. Supreme Court, however, so a resolution should be forthcoming. An interesting issue to watch is whether the Supreme Court will follow the mistakes of some of the lower courts and confuse equitable tolling with equitable recoupment.

C. Election

The doctrine of election applies to prevent a change of position where there was initially a choice between two legitimate, alternative

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62. Id. at 95-96. The doctrine has been applied only in narrow circumstances such as in cases of senility, mental incompetence, and where the law in a circuit is unclear. Barker v. United States, [U.S. Tax Cases Advance Sheets] Stand. Fed. Tax Rep. (96-2 U.S. Tax Cas.) (CCH) ¶ 50,421, at 85,406 (S.D. Cal. June 17, 1996).
63. Compare Brockamp v. United States, 67 F.3d 260, 263 (9th Cir. 1995) (extending the principle to tax refund cases “where ‘extraordinary circumstances beyond the plaintiffs’ control [make] it impossible to file the claims on time” (quoting Seattle Audubon Soc’y v. Robertson, 931 F.2d 590, 595 (9th Cir. 1991)),” cert. granted, 116 S. Ct. 1875 (1996) with Webb v. United States, 66 F.3d 691, 698-99 (4th Cir. 1995) (holding that equitable tolling is not applicable in tax cases), petition for cert. filed, 64 U.S.L.W. 3593 (U.S. Feb. 23, 1996) (No. 95-1360) and Oropallo v. United States, 994 F.2d 25, 28 n.3 (1st Cir. 1993) (“[T]ax laws have been viewed as technical laws which are not subject to general principles of equity,” (citing Lewyt Corp. v. Commissioner, 349 U.S. 237, 249 (1955)), cert. denied, 510 U.S. 1050 (1994).
64. Compare Irwin, 498 U.S. at 96 (holding that principle should be applied “where the claimant has actively pursued his judicial remedies by filing a defective pleading during the statutory period, or where complainant has been induced or tricked by his adversary’s misconduct into allowing the filing deadline to pass”) and Medellin v. Shalala, 23 F.3d 199, 204 (8th Cir. 1994) (“[M]isconduct on the part of the agency or gross, but good-faith, error on the part of the claimant should justify [equitable tolling].”) with Brockamp, 67 F.3d at 262-63 (applying equitable tolling to permit recovery for mental incompetence) and Dillard v. Runyon, 928 F. Supp. 1316, 1326 (S.D.N.Y. 1996) (noting that equitable tolling should be available when a failure to meet a deadline is someone else’s fault but not when claimant fails to use due diligence).
66. See, e.g., Webb, 66 F.3d at 698 (relying on Dalm to hold equitable tolling inapplicable); Vintilla v. United States, 931 F.2d 1444, 1447 n.1 (11th Cir. 1991) (noting that Irwin and Dalm are seemingly contradictory). But see Schwartz v. United States, 67 F.3d 838, 841 (9th Cir. 1995) (distinguishing the two principles correctly).
The concept has been applied against the government to prevent a subsequent reassessment of a tax liability on the same item or transaction under a different theory from the initial assessment after the statute of limitations has run, preventing the taxpayer from filing a claim for refund with respect to the initial assessment. For instance, in *Vestal v. Commissioner*, shareholders of a liquidating corporation formed a partnership to receive corporate assets. The partnership later sold the assets, with the individual partners paying an income tax on the gain. The IRS subsequently characterized the partnership as an association, taxable as a corporation, and issued a notice of deficiency under that assumption. The taxpayers then appealed to the Board of Tax Appeals, which held in their favor.

In the meantime, some of the taxpayers filed a protective claim for refund of the tax liability they had paid earlier. These claims were denied. After the statute of limitations had run against any further refund claim, the IRS assessed a second tax on the sale against the same individuals, this time classifying the asset sale as a sale by the corporation, with the taxpayers holding the proceeds as transferees. The taxpayers brought suit in the Tax Court, which held in favor of the government. On appeal, the court held that the government had made a binding election. It had collected a tax under one theory, and it could not subsequently reassess another tax liability under an alternative theory after the statute of limitations barred recovery by the taxpayers.

While election may be viewed as a form of estoppel, technically, the difference between the two remedies is that election involves a choice between two or more valid alternatives, while estoppel does not. According to the appellate court, the government's alternatives in *Vestal* were threefold: (1) to assert that the sale was made by the corporation and to assess a tax against the individuals as transferees; (2) to assert that the sale was made by the partnership and to assess a tax against the individual partners; or (3) to place the issue before the Tax Court by issuing notices of deficiency in the alternative.

The Commissioner initially assessed a tax liability under the second alternative.

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67. *See*, e.g., *Radiant Glass Co. v. Burnet*, 54 F.2d 718, 719 (D.C. Cir. 1931) (noting that once the taxpayer files a return he executes his choice of status and cannot switch to another whenever it appears advantageous to do so); *Buttolph v. Commissioner*, 29 F.2d 695, 696 (7th Cir. 1928) (holding that taxpayer, having filed a joint return, could not subsequently file separate returns). It has been said that the choice must be based on a Code provision, a regulation, or a U.S. Supreme Court case. *See* Manning, *supra* note 35, at 377.

68. 152 F.2d 132 (D.C. Cir. 1945).

69. *Id.* at 133.

70. The statute of limitations at that time provided that the statutory period was extended one year for assessment against transferees, thus the government's claim was timely if the sale was, in fact, a sale by the corporation. *Id.* at 134.

71. *Id.* at 136.

72. *Id.* at 135.
and denied the taxpayers' protective refund claims. When the Commissioner subsequently changed the theory of liability from the second alternative to the first, it was too late for the taxpayers to refile their claims for refund.

Vestal clarifies that election is a limited remedy. But where the government is cognizant of the facts and aware of the problem involved, an election to collect a tax under one theory will be binding unless there is both an erroneous interpretation of a statute and the amount of tax liability initially collected can be refunded to the taxpayer. Presumably, it is the latter factor that is more important. Because the government, in this case, made the initial decision and later changed its position, it must treat the taxpayers fairly in order to act on that change of position.

Another important difference between election and estoppel is that taxpayers are generally more successful with election than with estoppel. This is probably because election, unlike estoppel, does not involve an affirmative misrepresentation. Thus, the evidentiary burden is not as great. Instead, for the doctrine of election to apply against the government, by definition, the government must have chosen one of two or more legitimate alternatives and must subsequently have attempted to gain an advantage by changing its position to the detriment of the taxpayer. Thus the equities of the taxpayer's position in an election case are usually more compelling than in an estoppel case.

D. Duty of Consistency

A concept related to estoppel, quasi-estoppel, and election is the duty of consistency. The concept has often been confused with estoppel. The duty of consistency and estoppel differ, however, in that the latter involves a more holistic approach, concerned primarily with detriment and the conduct of the parties, whereas the former focuses more on the actual prior choices and the effect that a subsequent

73. Id. at 136-37.
74. Note that election has also been applied against the taxpayer. See Moran v. Commissioner, 67 F.2d 601, 602 (1st Cir. 1933) (considering case where taxpayer argued that, under the doctrine of constructive receipt, income was properly includable in earlier years currently barred by the statute of limitations, and holding that taxpayer had made a binding election in including income in later year).
75. Manning, supra note 35, at 376-77.
76. See, e.g., Robbins v. United States, 21 F. Supp. 403, 407 (Ct. Cl. 1937) (referring to "quasi-estoppel" to prevent taxpayer from changing position to his advantage after statute of limitations barred correction of the effects of his earlier position); Hughes & Luce v. Commissioner, 68 T.C.M. (CCH) 1169, 1171 (1994) (stating that the doctrine of quasi-estoppel is the same as the duty of consistency), aff'd, 70 F.3d 16 (5th Cir. 1995), cert. denied, 116 S. Ct. 1824 (1996); see also Hess v. United States, 537 F.2d 457, 462 (Ct. Cl. 1976) ("[T]he evidence before the court here strongly indicates an estoppel . . .."); cert. denied, 430 U.S. 931 (1977).
Like estoppel, though, the duty of consistency is not primarily concerned with the technically correct tax treatment in the current year. For instance, in *Alamo National Bank v. Commissioner,* the taxpayers received a corporate liquidating distribution on which they paid a tax liability, but they mistakenly failed to include a franchise they received in the distribution. Thus, no tax liability was paid on the value of the franchise. The taxpayers operated the business under the franchise for ten years. After that time, they sold the business and maintained that the value of the franchise was properly includable in the year of the liquidating distribution, now barred by the statute of limitations, and that their basis should reflect the value of the franchise as of the date of the distribution, thus reducing their current gain. The Commissioner countered that the taxpayers were estopped from increasing their basis because, initially, they had not included the value of the franchise in income.

The Fifth Circuit upheld the decision of the Board of Tax Appeals in favor of the Commissioner, stating that "honesty, good faith, and consistency are due in tax accounting." The taxpayers were aware that they had received the franchise. They continued to operate their business under it, and only after the statute of limitations had run did

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77. The duty of consistency has poorly defined elements that have been linked to estoppel. See *Johnson, Duty of Consistency,* *supra* note 9, at 549-69 (discussing development of the doctrine). Its most commonly accepted elements are as follows: (1) the taxpayer has made a representation of fact or reported an item for tax purposes in one taxable year; (2) the Service acquiesced in or relied on that fact for that year; and (3) the taxpayer desires to change the representation, previously made, in a later taxable year after the first year has been closed by the statute of limitations. *McMillan v. United States,* 64-2 U.S. Tax Cas. (CCH) ¶ 9720, at 93,838 (S.D.W.V. 1964); *see also Beltzer v. United States,* 495 F.2d 211, 212-13 (8th Cir. 1974) (upholding *McMillan*); *Johnson, Duty of Consistency,* *supra* note 9, at 549-69 (discussing the various elements).

There is not as much confusion between election and the duty of consistency as there is between election and estoppel, because election involves a choice between two alternative legal theories in which the person making the choice is aware of the facts and the problems involved. The duty of consistency, on the other hand, involves a mistake in an earlier taxable year. Thus, election would not apply. Because election requires optional legal remedies, it is more limited in application and, therefore, applies less frequently than the duty of consistency.

A concept related to the duty of consistency is the tax benefit rule, in which a recovery of an amount deducted in a prior taxable year will result in an income inclusion in the year of recovery attributable to the previous tax benefit. Although the tax benefit rule is a judicially created doctrine, a portion of it is now codified in I.R.C. § 111 (1994), providing for the exclusion from gross income of an amount of recovery that did not result in an earlier tax benefit. For exceptions to the tax benefit rule, see *Canelo v. Commissioner,* 53 T.C. 217, 223-30 (1969), acq., 1971-1 C.B. 2, *aff’d,* 447 F.2d 484 (9th Cir. 1971); *Streckfus Steamers, Inc. v. Commissioner,* 19 T.C. 1, 8-9 (1952). For a discussion of the relationship between the duty of consistency and the tax benefit rule, see *Johnson, Duty of Consistency,* *supra* note 9, at 543-44.

78. 95 F.2d 622 (5th Cir.), *cert. denied,* 304 U.S. 577 (1938).
79. *Id.* at 622.
80. *Id.* at 623.
they allege that it had value initially. The taxpayers were then estopped from changing their position after the statute of limitations had run and a sale had occurred. The court went on to state that "the value then fixed cannot be departed from unless on a general correction of all the results of the mistake, if mistake there was."\(^8\)

Although the court used the term "estoppel" throughout the opinion, the important aspect of the case was the focus on the correction of the earlier mistake. In this sense, the remedy was similar to election because the court focused on the earlier choice and the effect of a change in position.

The duty of consistency has been applied against the government as well, but such cases are rare.\(^8\) As a remedy, the duty of consistency has been criticized on the ground that equity is best served by allowing a correction of the earlier mistake.\(^8\) This objection, in turn, has been criticized on the ground that the duty of consistency should be viewed from the perspective of tax policy, rather than from the perspective of equity.\(^8\) If the earlier mistake is corrected after the statute of limitations has run, not only will the statute be circumvented, but the correction also will result in a distortion of income for the subsequent annual accounting period, which could have a detrimental effect on voluntary compliance.

On the other hand, the aggressive use by taxpayers of the statute of limitations in order to avoid tax liability victimizes those taxpayers who do pay their fair tax share. If these opposing policy considerations are balanced, the duty of consistency should apply in favor of the taxpayer only where the earlier, incorrect return is filed in good faith,\(^8\)

81. Id. at 624; accord Fabacher v. United States, 71-1 U.S. Tax Cas. (CCH) ¶ 9317, at 86,223 (S.D. Miss. 1971), aff'd in part, vacated in part per curiam, 454 F.2d 722 (5th Cir. 1972). Note that while the Fifth Circuit in Alamo National Bank referred to the remedy as "estoppel," it was neither a pure estoppel nor a quasi-estoppel principle that was applied because the court was not concerned with detriment nor, for that matter, with benefit, but rather, with consistency, i.e., with the earlier mistake. Cf. Orange Sec. Corp. v. Commissioner, 131 F.2d 662, 663 (5th Cir. 1942) ("[T]here is a duty of consistency on both the taxpayer and the Commissioner... whether or not there be present all the technical elements of an estoppel."). Note that in Orange Securities Corp., the court applied the duty of consistency to prevent the taxpayer from changing position with respect to the "same fact or transaction." Id.; see also Koppen v. Commissioner, 70 T.C.M. (CCH) 72, 76 (1995) (applying duty of consistency to prevent taxpayer from reelecting the one-time exclusion of gain on the sale of a personal residence when previous election occurred before taxpayer reached age 55).

82. See IBM Corp. v. United States, 343 F.2d 914, 923 (Cl. Ct. 1965) (holding, narrowly limited to its facts, that similarly situated taxpayers must be treated similarly), cert. denied, 382 U.S. 1028 (1966).

83. See Manning, supra note 35, at 378. Such a correction would be similar to the corrective treatment under the Internal Revenue Code for the receipt of a tax benefit, see I.R.C. § 111 (1994); supra note 77, or for the return of property held under a claim of right. See I.R.C. § 1341 (1994).

84. See Johnson, Duty of Consistency, supra note 9, at 544-49.
and where such return includes enough information to place the government on reasonable notice of the error.  

III. Recoupment and Setoff

Recoupment originated as a limited equitable remedy allowing a defendant to mitigate or defeat a plaintiff's claim for damages when there was no statute that directly prevented its application, and when the defendant affirmatively claimed that damages should be reduced, in whole or in part, because of an earlier payment or recovery. Recoupment, like other equitable remedies, is regarded as a fairness doctrine designed to "promote justice, and to prevent useless litigation." It allows the court to examine the transaction as a whole and to determine whether the facts warrant the application of an equitable remedy. If the opposing claims arise out of the same subject matter and can be resolved in one action, the character of the claims is inconsequential.

Recoupment, as an equitable remedy in federal tax cases, has been confused with other equitable remedies, such as estoppel. It has also been confused with the remedy of setoff, which arose in the tax context in the case of Lewis v. Reynolds, which in turn, paved the way for the application of recoupment.

85. This has been suggested with respect to estoppel. See Yale Note, supra note 39, at 179. This premise should apply, though, whenever the statute of limitations is circumvented through the use of an equitable remedy.
86. See Waterman, supra note 31, at 476-77. In England, recoupment was originally a defense to a charge of fraud. Later, it was used as a defense to charges of breach of contract, assumpsit, and negligence. Id. at 481-581. For a novel recoupment argument, see United States v. Stutsman County Implement Co., 274 F.2d 733, 735 (8th Cir. 1960), where plaintiff argued that equitable recoupment should apply to lift federal tax liens from property it had purchased.
87. Waterman, supra note 31, at 481.
88. That is, a tort claim may be set up against a contract claim and vice versa. Id.; McConnell, supra note 7, at 376.
89. See Bull v. United States, 295 U.S. 247, 261 (1935) (citing United States v. McDaniel, 32 U.S. (7 Pet.) 1 (1833) as a recoupment case; however, a careful reading reveals that estoppel was applied). Recoupment and estoppel may be pleaded in the alternative. See Stone v. White, 301 U.S. 532, 534 (1937) (discussing case where government pleaded both recoupment and estoppel); see also McEachern v. Rose, 302 U.S. 56, 58 (1937) (discussing case as a recoupment case, but the pleadings were based on estoppel). If recoupment and estoppel are pleaded in the alternative, recoupment may apply even if the elements of estoppel are not met because, with recoupment, the claimant does not have to prove reliance on his part or misrepresentation on the part of the opposing party.
91. See, e.g., First Nat'l Bank v. United States, 365 F.2d 507, 512 (8th Cir. 1977) (noting that the Supreme Court first addressed equitable recoupment in the Lewis case); Springfield St. Ry. v. United States, 312 F.2d 754, 758 (Cl. Ct. 1963) ("The doctrine of equitable recoupment was first set forth in Lewis v. Reynolds . . . "); Routzahn v. Brown, 95 F.2d 766, 770 (6th Cir. 1938) (citing stone v. White, 301 U.S. 532 (1937) for the proposition that although a "suit is one at law for the recovery of an overpayment of taxes," it is controlled by equitable principles).
A. Setoff

In *Lewis v. Reynolds*, an estate brought suit in federal district court to recover an alleged overpayment of income taxes. In its income tax return for the taxable year 1920, the estate had claimed several deductions, including attorney’s fees and state inheritance taxes. After audit, the Commissioner disallowed all deductions except the attorney’s fees. The estate paid the resulting deficiency then shortly afterward filed a claim for refund. At the time the refund claim was filed, the statute of limitations for assessment of the 1920 taxable year had expired. The Commissioner disallowed the refund claim on the ground that there was no overpayment for the 1920 taxable year, and thus the taxpayer was not entitled to a refund. The Commissioner based his conclusion on the finding that the deduction for attorney’s fees had been improperly allowed and the deduction for state inheritance taxes had been improperly disallowed. The proper deduction for the state inheritance taxes was less than the amount of the attorney’s fees the estate had claimed. This resulted in a deficiency for the 1920 taxable year, from which the Commissioner was barred from assessing because of the expiration of the statute of limitations.

The estate argued that the Commissioner was also barred from redetermining the total tax liability for 1920 because of the expiration of the statutory period. The Commissioner countered that while he was barred from assessing and collecting any further tax attributable to the 1920 taxable year, he could nevertheless redetermine the total tax liability for that year in order to ascertain whether there had been an overpayment with respect to that taxable year, as the taxpayer had alleged.

The Supreme Court affirmed the lower courts in holding for the Commissioner. The opinion quoted the appellate decision: “The action to recover on a claim for refund is in the nature of an action for

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93. At the time, the statute of limitations was five years from the date the return was filed. *Lewis*, 284 U.S. at 282 n.1 (citing Revenue Act of 1926, ch. 27, § 277, 44 Stat. 9).

94. *Collinson*, 43 F.2d at 395.

95. *Id.* at 396.

96. *Id.*

97. *Lewis*, 284 U.S. at 283. Note that while *Lewis v. Reynolds* represents a victory for the government, it is also available to the taxpayer in limited circumstances. The most useful example is its role as a defense to the government’s use of a setoff against the taxpayer’s refund claim. Thus, a taxpayer may use *Lewis* to raise offsetting defenses to counter the government’s use of *Lewis*, even though such issues were not originally raised in the timely filed refund claim. *See* Union Pac. R.R. v. United States, 389 F.2d 437, 447 (Ct. Cl. 1968). But a taxpayer may not increase her refund if the government fails to prove a legitimate offset. *Id.*
money had and received, and it is incumbent upon the claimant to show that the United States has money which belongs to him.\textsuperscript{998}

It is important to note that the Supreme Court allowed the Commissioner to offset only the amount of the alleged overpayment by the amount of the deficiency. No excess deficiency attributable to the 1920 taxable year could be assessed. It is also important to note that the overpayment at issue in \textit{Lewis} was an overpayment on the merits. Any overpayment made after the expiration of the statute of limitations would constitute a statutory overpayment to which \textit{Lewis} would not apply.\textsuperscript{99}

There appears to be some confusion as to whether setoff is an equitable remedy.\textsuperscript{100} The issue is important in determining whether the Tax Court has incidental refund jurisdiction over setoff claims, because the issue of whether or not the Tax Court has equity jurisdiction remains unresolved.\textsuperscript{101} Because \textit{Lewis v. Reynolds} appears to be a case of statutory interpretation, it follows that setoff is not an equitable remedy in the tax context, and hence it is not subject to the equitable defenses such as laches and unclean hands.\textsuperscript{102} Nor should the application of setoff be subject to judicial discretion after weighing the equities of the individual case.\textsuperscript{103}

98. \textit{Lewis}, 284 U.S. at 283 (quoting \textit{Lewis v. Reynolds}, 48 F.2d 515, 516 (10th Cir. 1931)).


100. Some courts have stated that setoff is not subject to equitable considerations. See, e.g., \textit{Fisher v. United States}, 80 F.3d 1576, 1581 (Fed. Cir. 1996) ("The IRS's right to . . . interest cannot be defeated by reference to the alleged 'equities' of the taxpayer's case."); \textit{Dysart v. United States}, 340 F.2d 624, 627 (Ct. Cl. 1965) ("Although the origin of these defenses may be traced to equitable principles, the right to raise a setoff is not subject to equitable considerations as the taxpayers contend."); \textit{Missouri Pub. Serv. Co. v. United States}, 245 F. Supp. 954, 961 (W.D. Mo. 1965) (same), \textit{aff'd}, 370 F.2d 971 (8th Cir. 1967). Other courts and commentators have regarded it as a general equitable defense akin to estoppel. See, e.g., \textit{Pacific Mills v. Nichols}, 31 F. Supp. 43, 44-45 (D. Mass. 1939) (noting several times that \textit{Lewis v. Reynolds} is an equitable doctrine); Jones, \textit{supra} note 36, at 868 (noting that the Supreme Court has pointed out that "in the absence of true estoppel, the use of a general equitable defense in refund cases must be limited to a relatively narrow class of cases, typified, perhaps, by \textit{Lewis v. Reynolds}"); Note, \textit{Equitable Recoupment in Tax Law}, 42 N.Y.U. L. Rev. 537, 542 (1967) [hereinafter NYU Note] (stating that setoff is an equitable adjustment of tax liability justified by statutory interpretation sanctioned both by \textit{Lewis} and by an equitable policy against unjust enrichment).

Setoff, on occasion, has also been confused with recoupment. See \textit{supra} text accompanying note 90.

101. See \textit{infra} part VLB (discussing Tax Court jurisdiction).


103. See \textit{Dysart}, 340 F.2d at 628-29 ("The Supreme Court has never suggested that—in a refund suit in which the setoff involves the same tax, the same year, and the same taxpayer—the court may, or should, weigh 'equities' to decide whether it would
Further, the elements of estoppel were lacking in *Lewis* because there was no misrepresentation or concealment of a material fact by the taxpayer, nor was there detrimental reliance by the Commissioner. Instead, there was a mistake by the Commissioner in the determination of the tax liability. At first blush, the Commissioner's position appears unreasonable from a fairness perspective because his error created the situation for which he now requests relief. From a tax policy perspective, however, if the estate's claim for refund had been allowed, the estate would have been unjustly enriched because it would have been able to hide behind the statute of limitations and thereby avoid its fair share of the tax burden.\footnote{104. See Bull v. United States, 295 U.S. 247, 259 (1935) ("[T]axes are the life-blood of government, and their prompt and certain availability an imperious need.").}

A taxpayer is entitled to a refund only in the event of an overpayment. An overpayment or underpayment usually must be determined on the basis of an annual tax accounting period.\footnote{105. See I.R.C. § 441 (1994) (setting out the statutory period). An annual accounting period may either be a calendar year or a fiscal year. Under some circumstances, an accounting period may be less than a year, but this is not the usual situation. See I.R.C. § 443 (1994) (authorizing short period returns).} Setoff, as exemplified by *Lewis*, is a narrow doctrine defining an overpayment.\footnote{106. See I.R.C. § 6511 (1994) (pertaining to refunds for overpayments of tax liability); cf. I.R.C. § 6514(a) (1994) (prohibiting refund after expiration of statute of limitations and further prohibiting the crediting of a barred refund against an open deficiency); I.R.C. § 6514(b) (1994) (prohibiting the credit of an open refund against a barred deficiency).}

Under *Lewis*, the determination involves a single taxpayer, a single taxpayer is entitled to a refund only in the event of an overpayment. An overpayment or underpayment usually must be determined on the basis of an annual tax accounting period. Setoff, as exemplified by *Lewis*, is a narrow doctrine defining an overpayment.

The rationale behind *Lewis* is that I.R.C. § 6514(b) is designed to prohibit the crediting of an open refund claim of one taxable year against a barred deficiency of a different taxable year. It does not prevent the court or the IRS from offsetting an open refund against a barred deficiency if both arise in the same taxable year, because such an offset merely determines the amount of the overpayment for that taxable year. See Missouri Pub. Serv. Co. v. United States, 245 F. Supp. 954, 961 (W.D. Mo. 1965) ("[T]he right of the government is based on the broader principle that a taxpayer is not entitled to a refund unless he has in fact overpaid the particular tax . . . ."), aff'd, 370 F.2d 971 (8th Cir. 1967); see also Allen v. United States, 51 F.3d 1012, 1015 (11th Cir. 1995) (permitting the government to offset an improper fraud penalty against unassessed negligence and delinquency penalties).

Procedurally, a question arises as to whether a taxpayer may claim a setoff without first complying with the statute and filing a refund claim. See I.R.C. § 7422(a) (1994); Jones v. Fox, 162 F. Supp. 449, 464-65 (D. Md. 1958) (stating that taxpayer must first file claim for refund, but there taxpayer was requesting refund attributable to different taxable years). Because the use of setoff by the taxpayer would be defensive, the first issue should be whether the taxpayer owes an additional amount. Thus, setoff should be appropriate in order to determine the correct amount of tax due without the necessity of filing a refund claim.

It has been held that the IRS is not required to issue a notice of deficiency before raising a setoff defense against a taxpayer's refund claim. Walt Disney Prods. v. United States, 549 F.2d 576, 582 (9th Cir. 1977).
taxable year,\textsuperscript{107} and a single tax.\textsuperscript{108} That different transactions may be involved is of no consequence.

B. \textit{The Equitable Recoupment Decisions of the Supreme Court}

\textit{Lewis v. Reynolds} reveals that the statute of limitations is not always an absolute bar and that, under limited circumstances, items in closed years can affect open claims. Similarly, recoupment allows consideration of the effect of a barred claim on an open claim. But unlike setoff, which involves a single taxpayer, a single taxable year, a single tax, and could involve more than one transaction, recoupment involves a single taxpayer (or two or more taxpayers with an identity of interest), two or more taxable years, generally more than one type of tax, and a single transaction.

\textit{Lewis} set the stage for an extension of the offset remedy under equitable principles. Three years after the Supreme Court decided \textit{Lewis}, it confronted the issue of whether equity would permit an examination of items in a barred year in order to determine the tax consequences in an open year.

1. \textit{Bull v. United States}\textsuperscript{109}

Archibald H. Bull died in 1920 holding a partnership interest that entitled him and consequently, his estate, to participate in the profits and losses of the partnership.\textsuperscript{110} Partnership profits that accrued to the date of the decedent's death were included in the estate tax return, as part of the gross estate. The Commissioner valued the decedent's partnership interest much higher, however, after including the additional amount of profits that had accrued from the date of the dece-

\textsuperscript{107} But see Blansett v. United States, 181 F. Supp. 637, 644 (W.D. Mo. 1960) (allowing the government to offset a refund claim attributable to a credit carryback).
\textsuperscript{108} Cf. Fisher v. United States, 80 F.3d 1576, 1580 (Fed. Cir. 1996) (allowing government to offset previously unassessed interest against valid refund on the ground that the Internal Revenue Code treats interest as "an integral part of the liability itself"); Allen, 51 F.3d at 1015 (allowing offset of fraud penalty refund that had been improperly assessed, with newly assessed negligence and delinquency penalties for same taxable year after expiration of statute of limitations); Loftin & Woodward, Inc. v. United States, 577 F.2d 1206, 1247 (5th Cir. 1978) (allowing government to offset refund claim with increased delinquency penalty). \textit{But see} Morristown Trust Co. v. Manning, 104 F. Supp. 621, 628 (D.N.J. 1951) (applying \textit{Lewis} to bar estate tax refund). \textit{aff'd}, 200 F.2d 194 (3d Cir. 1952), \textit{cert. denied}, 345 U.S. 939 (1953).
\textsuperscript{109} 295 U.S. 247 (1935).
\textsuperscript{110} Under the partnership agreement, if a partner were to die, the remaining partners would continue the business for one year. The estate of the deceased partner would have the right to share in profits and losses to the same extent as the decedent, unless the estate exercised its option under the agreement to opt out of the partnership within thirty days of the probate of the will. The Bull estate did not exercise this option, thus it was entitled to share in the partnership profits and losses to the same extent Bull would have if he had lived. Because there was no capital contribution of any kind by any of the partners, there was no capital interest. \textit{id.} at 251.
dent’s death to the end of the partnership period one year later. The estate then paid the additional estate tax assessment.

The amount of partnership profits that had been included in the gross estate were not included in the decedent’s final income tax return. The Commissioner subsequently determined, however, that the amount of profits earned during the decedent’s last taxable year was income taxable without reduction for the estate tax already paid on that same amount.\textsuperscript{111}

The estate appealed the deficiency to the Board of Tax Appeals, which sustained the Commissioner’s determination.\textsuperscript{112} In 1928, the estate paid the income tax deficiency, with interest. Shortly thereafter, the estate filed a claim for refund on the ground that the partnership profits represented corpus of the estate, which was not subject to an income tax. The estate’s claim was rejected in 1929. The following year, the estate brought suit in the Court of Claims, requesting a refund of the income tax paid in 1928, or in the alternative, a credit against the income tax liability for the amount of the estate tax paid in 1921 on the partnership profits earned after the decedent's death.\textsuperscript{113}

The Court of Claims held in favor of the Commissioner, opining that the profits earned before the decedent’s death constituted both corpus and income to the estate and thus were properly taxable as such in 1921.\textsuperscript{114} According to the court, the income tax attributable to the post-death profits should have reduced the gross estate. Because it had not, the estate tax was overpaid. The court nonetheless refused to consider the credit issue because the statute of limitations for filing an estate tax refund claim had expired.\textsuperscript{115}

The estate then appealed to the Supreme Court, which concurred with the Court of Claims on the characterization of the pre- and post-death profits.\textsuperscript{116} The government argued that it was entitled to both the estate tax and the income tax, on the ground that the decedent’s right to receive future profits constituted an asset taxable to the estate as corpus, while the profits themselves represented taxable income. Indeed, this had been the case with the pre-death profits.\textsuperscript{117}

The Court decided, however, that the Commissioner had subjected the actual profits, rather than the right to receive the profits, to both

\begin{itemize}
  \item \textsuperscript{111} Id. at 252-53.
  \item \textsuperscript{112} Bull v. Commissioner, 7 B.T.A. 993, 1002 (1927).
  \item \textsuperscript{113} Bull v. United States, 6 F. Supp. 141, 143 (Ct. Cl. 1934), rev’d, 295 U.S. 247 (1935). Procedurally, the Bull situation cannot arise today because of the finality of Tax Court jurisdiction. See Estate of Ming v. Commissioner, 62 T.C. 519, 521 (1974) (“[M]ere filing of the petition in the Tax Court is enough to deprive a U.S. District Court of jurisdiction.” (citing Dorl v. Commissioner, 57 T.C. 720, 721-22 (1972))). For a further explanation of the procedural technicalities involved, see Andrews, supra note 13, at 599 n.20.
  \item \textsuperscript{114} Bull, 6 F. Supp. at 143-44.
  \item \textsuperscript{115} Id. at 143.
  \item \textsuperscript{116} Bull v. United States, 295 U.S. 247, 254 (1935).
  \item \textsuperscript{117} Id. at 255.
\end{itemize}
the estate tax and the income tax. Because the decedent had no capital interest in the partnership, there was no taxable corpus in the post-death profits. Thus, the post-death profits could not be subject to an estate tax liability.\textsuperscript{118}

The government further argued that if a mistake had been made in 1921, it was too late to correct it because the statute of limitations had expired.\textsuperscript{119} The Court, in response, stressed the fundamental importance of the revenue raising function of the tax system\textsuperscript{120} and noted that while a tax liability results in a debt owed by the taxpayer to the government, the usual procedural formalities associated with debt recoveries are reversed when federal taxes are involved.\textsuperscript{121} The Court went on to explain that, despite the reversal of procedure, the ultimate issue in a deficiency action is the "recovery of a just debt owed the sovereign."\textsuperscript{122} When the sovereign extracts more than its due, however, the recovery is not just. Recovery under such circumstances offends "morality and conscience" and amounts to a "fraud on the taxpayer's rights."\textsuperscript{123} The Court, in holding for the taxpayer, concluded: "[R]ecoupment is in the nature of a defense arising out of some feature of the transaction upon which the plaintiff's action is grounded. Such a defense is never barred by the statute of limitations so long as the main action itself is timely."\textsuperscript{124} Because the partnership profits had already been subject to the estate tax, they could not be further subject to the income tax.\textsuperscript{125}

\textbf{a. The Nature of the Remedy}

The Court equated the government's actions to a fraud on the taxpayer's rights.\textsuperscript{126} If this analogy is taken at face value, the government

\begin{enumerate}
\item[118.] Id. at 255-57.
\item[119.] Id. at 258.
\item[120.] The Court stated: "[T]axes are the life-blood of government, and their prompt and certain availability an imperious need." Id. at 259.
\item[121.] Because of the overriding need for an efficient functioning of the revenue raising process:
\begin{quote}
[T]he usual procedure for the recovery of debts is reversed in the field of taxation. Payment precedes defense, and the burden of proof, normally on the claimant, is shifted to the taxpayer. The assessment supersedes the pleading, proof and judgment necessary in an action at law, and has the force of such a judgment. The ordinary defendant stands in judgment only after a hearing. The taxpayer often is afforded his hearing after judgment and after payment, and his only redress for unjust administrative action is the right to claim restitution.
\end{quote}
Id. at 260.
\item[122.] Id.
\item[123.] Id. at 260-61.
\item[124.] Id. at 262.
\item[125.] Cf. Duffield v. United States, 136 F. Supp. 944, 945-46 (E.D. Pa. 1955) (holding that equitable recoupment did not apply where estate assessed on value of contracts decedent held at death).
\end{enumerate}
would then be compelled to refund the taxpayer's money under a constructive trust theory.\footnote{127} The Court did not take this approach, however. Instead, it appeared to be admonishing the government to use due diligence in its dealings with taxpayers. In other words, when the government takes a proactive position, fails to use due diligence, and then tries to hide behind the statute of limitations to avoid correcting its mistake, there is a fraud on the taxpayer's rights, which, in turn, should entitle the taxpayer to relief.

Note that it would have been far easier for the Court to have held that the Commissioner had made a previous binding election in treating the partnership income as corpus of the estate, thus precluding the subsequent characterization of the same money as income after the statute of limitations prohibited the taxpayer from recovering the overpayment. There are, perhaps, two reasons that the Court did not choose this path. First, given the integrity of the taxable year, some commentators believe it is more desirable to maintain the correct tax treatment in each year, even though it may occasionally produce inequitable results.\footnote{128} A mistake in one taxable year may have collateral consequences that may affect several taxable years. Perhaps the Court thought it more desirable to require the correct treatment in the later year because of the implications for other transactions, as well as the implications for other pending cases. Furthermore, both the Board of Tax Appeals and the Court of Claims had stressed that the income tax treatment was the proper treatment by the estate.\footnote{129}

Moreover, the integrity of the tax system is better served by imposing a tax on the proper amount of income in a particular taxable year, rather than by imposing a tax on an incorrect amount. This leads to a further possible reason: the remedy of election should apply only when the taxpayer or the Commissioner has a clear choice between two legitimate, alternative courses of action.\footnote{130} In Bull, the Commissioner initially made a mistake in characterizing income of an estate as corpus. Thus, there was only one technically correct way to treat this item: as income, not as corpus. This meant that there was no alternative to elect. Moreover, estoppel was an equally unsatisfactory remedy because there was no misrepresentation of fact.

That the Court mentioned the procedural aspect of the taxing system is significant. The Court implied that the overriding public policy interest in the efficient functioning of the federal government justifies the reversal of the normal procedural rules for debt collection in the

\footnote{127} Indeed, this appeared to be the case in United States v. State Bank, 96 U.S. 30 (1877), cited in Bull, 295 U.S. at 261.  
\footnote{128} See Manning, supra note 35, at 378.  
\footnote{129} Bull, 295 U.S. at 253-54.  
\footnote{130} See Maguire & Zimet, supra note 38, at 1289 ("The view does seem to be indicated that if the taxpayer's choice was actuated by a material and non-culpable mistake, it may not finally bind him, and he may seize a later occasion for really fair choice.").
case of federal taxes. What the Court did not mention is the fact that there was a one-month period after the executor was notified of the asserted income tax deficiency in which the estate could have filed a claim for refund of the estate taxes. Thus, the estate sat on its rights in not asserting a timely refund claim. That the Court did not consider this important indicates that primary emphasis was placed on balancing the equities of the case as a whole. The government's lack of due diligence resulted in an initial error in the examination of the estate tax return. Because the additional estate tax liability, attributable to the post-death profits interest, had been paid nearly four years before the Commissioner decided to subject the same interest to an income tax liability, it was reasonable for the taxpayer to focus on the income tax liability at hand, rather than on the previous estate tax liability.

In sum, the government's lack of diligence potentially produced a windfall while causing the taxpayer to suffer substantial detriment. Because the facts were so egregious, the Court decided the taxpayer was morally entitled to recoup the barred overpayment against the open deficiency.

b. Bull Contrasted with Lewis

There is a similarity between Lewis and Bull: both cases authorized a credit of a barred claim against an open claim. There are, however, important differences between the two cases. Lewis defined an overpayment, on the merits, of a single tax by a single taxpayer in a single taxable year. The government may scrutinize any transaction during a single taxable year to determine whether there has been an overpayment within the definition of the statute. That the statute of limitations bars further assessment with respect to the particular taxable year is inconsequential because the underlying policy rationale of the statute (i.e., preventing stale claims with its inherent problems such as memory lapse and lost records) is not violated when the person whom the statute was designed to protect (in this case the taxpayer) raises the issue. In that event, the taxpayer should not be heard to complain that all transactions in that year are beyond scrutiny in determining the amount of the refund.

In Bull, the Court, while considering the equities, viewed the transaction as a whole in determining the overpayment. Because Bull involved two taxable entities, two different taxes, and two taxable years, it did not present a Lewis situation. Thus, there was the further re-

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131. See Andrews, supra note 13, at 601 n.27.
132. Other minor technicalities apparently unimportant to the Court were the fact that there were two different taxes involved and that the taxpayer technically was required to file a claim for refund, rather than to offset the income tax by the estate tax. The complexity of the federal tax laws may also have been considered sub rosa by the Court.
requirement of a single transaction in order to avoid the bar of the statute of limitations and to allow an offset of the open claim by the barred claim. The single transaction requirement of *Bull* could be regarded as equivalent to the single taxable year requirement in *Lewis*. Both allowed an examination of an otherwise barred claim because the person the statute was designed to protect had demonstrated that such protection was unnecessary based on the claim. The issue was, however, a much narrower one in *Bull* than in *Lewis*. Under *Lewis*, all transactions in the taxable year in question may be scrutinized. With equitable recoupment, only the transaction that is the subject of the claim is open to scrutiny. Moreover, recoupment does not apply when both taxes are imposed in a single taxable year, nor does it apply when the inconsistent taxes are income taxes, because that issue has been preempted by the statutory mitigation provisions. Questions have arisen, however, as to whether mitigation is an exclusive remedy that preempts the application of recoupment.

*Lewis* is purely a case of statutory interpretation. As such, it is not primarily concerned with issues of fairness and equity. With recoupment, however, as with all equitable remedies, fairness should be a paramount consideration.

2. *Stone v. White*\(^{136}\)

Two years after *Bull*, the Supreme Court granted certiorari in *Stone v. White*, a case involving a testamentary trust with the surviving wife as the sole beneficiary. The wife elected to take her interest under the will in lieu of a dower or statutory interest. Under applicable case law, trust income paid in periodic installments to the wife was considered an annuity purchased by the surrender of her dower interest, which was not taxable to her until she had recovered the value of that interest.\(^{137}\) In reliance on these cases, the wife did not pay any income tax on the trust income distributed to her.

In 1931, after the statute of limitations had run against assessment of an income tax deficiency against the wife, the Commissioner assessed a deficiency against the trust. Such assessment was attributable

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133. This situation is covered under either the *Lewis* doctrine or under the statutory mitigation provisions. See I.R.C. §§ 1311-1314 (1994).
134. See *infra* text accompanying notes 262-85.
135. See, e.g., United States v. Dalm, 494 U.S. 596, 610 (1990) ("It is undisputed that Dalm's action does not come within these [statutory mitigation] provisions; were we to allow her to maintain a suit for refund on the basis of equitable recoupment, we would be . . . overriding Congress' judgment as to when equity requires that there be an exception to the limitations bar."); O'Brien v. United States, 766 F.2d 1038, 1050 n.14 (7th Cir. 1985) (reserving ruling on government's argument that mitigation provides the exclusive remedy); see also *infra* note 281 (stating that mitigation provisions only apply in limited situations, but when they do apply, it is unlikely that Congress intended the situation to be remedied exclusively under these provisions).
136. 301 U.S. 532 (1937).
137. *Id.* at 533.
to the periodic income payments to the wife. The trust paid the assessment under protest. In 1933, the Supreme Court decided the case of Helvering v. Butterworth, which held such trust income was properly taxable to the beneficiary.

In reliance on Butterworth, the trust then brought suit for a refund of the income tax wrongfully collected. The Commissioner argued that the trust was not entitled to a refund because the income tax that should have been paid by the beneficiary (now barred by the statute of limitations) was greater than the tax collected from the trust. Because any refund to the trust would inure solely to the wife's benefit, the wife would then be unjustly enriched to the detriment of the government.

a. The Balance of Equities

The Supreme Court, in holding for the government, discussed the equitable nature of the refund action. The Court again appeared to be considering the holistic situation. Although the tax code regards the trust and the beneficiary as two separate and discrete taxable entities, the Court, in applying equitable recoupment, stated that the trust and beneficiary are discrete entities only for purposes of assessment and collection of the tax liability. Because a court of equity can consider the realities of the situation as a whole, the identity of interest of the trust and beneficiary may be acknowledged. The Court stated: "[E]quity does not countenance the idle ceremony of allowing recovery by the trustee only to compel him to account to the beneficiary who would then have to pay the proceeds to the original defendant."

138. Id.
139. 290 U.S. 365 (1933).
140. Id. at 370.
142. Stone, 301 U.S. at 534.
143. The Court acknowledged that the action was an action at law, but went on to state: "It is the lineal successor of the common count indebitatus assumpsit for money had and received." Id. "The statutes authorizing tax refunds and suits for their recovery are predicated upon the same equitable principles that underlie an action in assumpsit for money had and received." Id. at 535.
144. The Court stated:
Since, in this type of action, the plaintiff must recover by virtue of a right measured by equitable standards, it follows that it is open to the defendant to show any state of facts which, according to those standards, would deny the right, even without resort to the modern statutory authority for pleading equitable defenses in actions which are more strictly legal.

Id. (citations omitted).
145. Id. at 537.
146. Id.
The Stone Court appears to have been weighing three considerations: (1) compelling public policy; (2) the actions of the party seeking the equitable remedy; and (3) the actions of the opposing party in light of any compelling facts that speak for or against the application of the remedy.

1) Public Policy

If the trust had prevailed, the result would have been the avoidance of the beneficiary's just share of tax liability. This would be contrary to the public interest.\(^{147}\) The Court reasoned that the tax burden on neither the trust nor the beneficiary was increased by denying the trust's claim for refund, because the trust was merely a conduit, or fund, for the beneficiary.\(^{148}\) Thus, the equitable result was reached—that is, the beneficiary ultimately footed at least some portion of her fair tax bill.\(^{149}\) The ultimate result was that the integrity of the federal tax system was preserved, and the federal fisc was protected.

2) The Actions of the Party Seeking Recoupment

Because the government was the party requesting recoupment in Stone, the actions of the government must be carefully scrutinized. The first question should be whether the government used due diligence, or whether its actions or inactions contributed to its dilemma. The Supreme Court did not address this issue as clearly as the appellate court did. Because of the then prevailing lower court opinions holding that payments from a trust to a beneficiary in lieu of a dower interest constituted a nontaxable return of capital to the extent of the value of the dower interest, the government could not assess the beneficiary. Therefore, it took the only available course of action and assessed the trust. When the Supreme Court later clarified that the beneficiary was the proper taxable entity, it was then statutorily too late for the government to assess the beneficiary. Thus, neither the defense of laches nor the defense of unclean hands could be applied against the government.

The second question should be whether the government would be unjustly enriched if it prevailed in its request for recoupment. Under the reasoning of the Supreme Court, the answer was no. The government was clearly entitled to a tax on the income distributed to the beneficiary, and but for the statute of limitations, the government would have been able to assess this liability.\(^{150}\) According to the

\(^{147}\) Id.

\(^{148}\) Id. at 537-38.

\(^{149}\) The Court stated: "Since in equity the one taxpayer represents and acts for the other, it is not for either to complain that the government has taken from one with its right hand, when it has, because of the same error, given to the other with its left." Id. at 538.

\(^{150}\) Id. at 537-38.
Court, the underassessment of the beneficiary and the overassessment of the trust were the result of "excusable" error on the part of the government because of the "persistent judicial declarations." Thus, the Court found no facts upon which to deny the government the right to recoup from the trust the tax that the beneficiary was obligated to pay.

3) The Actions of the Opposing Party: Are There Factors for or Against the Use of Recoupment?

The next question should be whether it is fair to the opposing party, the trust in this case, to allow the government to use equitable recoupment. Because of the identity of interest between the trust and the beneficiary in Stone, the logical conclusion was that the beneficiary would be unjustly enriched if the trust prevailed. This conclusion brings us back full circle to the public policy argument because the parties cannot be considered in isolation. If the beneficiary is unjustly enriched by avoiding her fair share of tax liability, such a result could ultimately have a detrimental effect on the taxpaying public.

b. Elements Applied in Stone

There are two further interesting aspects of the Stone decision. First, while the Court did not hesitate to apply an equitable remedy and to reach an equitable result, it struggled with the label to be applied to the remedy. In one instance the label was estoppel. In another, it was a defense "comparable to an equitable recoupment or diminution of petitioners' right to recover." Thus, it becomes difficult to articulate clearly the elements of the remedy when even the Court was not certain what the remedy was.

The other interesting aspect of Stone is what the Court did not say. Nowhere did it directly mention the single transaction issue which predominated the opinion in Bull, although a single transaction was also clearly at issue in Stone. One rationale is that the Court did not...
consider itself confined to this element. Nevertheless, it is odd that the Court did not mention the issue for two reasons. First, it had taken such pains to stress the issue in Bull, a case decided only the previous year by the same court. Second, it would appear that in Stone the single transaction element would be even more crucial than in Bull, because in Stone the Court had to come to grips with the fact that there were two separate taxpayers involved, with the transaction as the unifying theme. Instead, the Stone Court appeared to be more concerned with viewing the case as a whole and applying the remedy in a manner designed to achieve the greatest equity. The significance of this broad-spectrum remedy is that it provides great flexibility while furthering both the revenue-raising function of the tax laws and the public perception of fairness.

3. McEachern v. Rose

A few months after the Stone decision, the Supreme Court again addressed the issue of equitable recoupment in McEachern v. Rose. In McEachern, an estate filed income tax returns and paid an income tax attributable to taxable years 1928 through 1931, on amounts received in those years under an installment obligation of the decedent, treating each year’s receipt as a sale. This treatment was, in fact, erroneous. Instead, the administrator should have included in income the difference between the fair market value of the obligation on the date of the decedent’s death in 1928, less the basis of the obligation. An income tax was due on this difference in 1928, the year of the decedent’s death, but no tax was due on the obligation after that time.

The estate filed a claim for refund of the amount of income taxes paid in taxable years 1929 through 1931. At the time the refund claim was filed, the assessment and collection of the 1928 income tax were barred by the statute of limitations. The Commissioner denied the estate’s claim on the ground that the estate was not entitled to a refund as a matter of equity because the barred deficiency exceeded the amount of the overpayment.

The estate then brought suit against the Commissioner in the federal district court. The court held in favor of the taxpayer, but its decision was reversed by the Fifth Circuit. The Fifth Circuit reasoned that the taxpayer owed the tax liability and “ought not in good conscience . . . have [it] back.” The Supreme Court reversed, up-

156. The basis of the obligation was defined as the excess of the face amount of the obligation over the amount returnable as income if the obligation is satisfied in full. Id. at 58 n.1.
157. Id. at 57, 60.
158. Id. at 58.
160. Id.
holding the integrity of the statute of limitations. The Court distinguished Stone by characterizing the McEachern income tax overpayments as statutory overpayments, ascertained and credited after the expiration of the 1928 statute of limitations.

Most commentators view the McEachern decision as severely restricting the application of recoupment because the Court did not apply the remedy, nor did the opinion even mention recoupment. Consequently, the decision has created much confusion, emanating primarily from a strained interpretation of the term "single transaction." The Supreme Court, however, did not mention the single transaction element, nor did it appear to take such a narrow view of the limitations of recoupment.

2. Id.; see also Lyeth v. Hoey, 112 F.2d 4, 7 (2d Cir. 1940) (citing McEachern in holding that the government was not entitled to recoup a barred estate tax deficiency against an open refund claim arising from an illegal assessment).
3. See, e.g., Andrews, supra note 13, at 606 ("McEachern left almost the entire viability of equitable recoupment in federal taxation in grave doubt."); NYU Note, supra note 100, at 545 ("The pall cast on recoupment by McEachern was reflected in the lower federal courts, which subsequently denied recoupment to both taxpayer and Commissioner."). But see McConnell, supra note 7, at 594-600 (arguing that McEachern was not a recoupment case).

4. Consider for instance, Professor Andrews's statement:
   Although the overall transaction—the sale and use of the installment method—might be broadly viewed as a single transaction, nonetheless the death of the decedent can reasonably be treated as a separate event, even though it triggered the acceleration. So also can the administrator's continuing to report on the installment method for each of the post-death years be reasonably construed as events distinct from the decedent's death. Andrews, supra note 13, at 611. He then adds that McEachern is "at least potentially reconcilable on the basis that the failure of the same or single transaction element . . . resulted in the inapplicability of equitable recoupment." Id.

   Such a construction strains the bounds of logic, however. Both the overpayment and the subsequent refund claim relate to a single event—the transfer of the installment obligation to the estate. This event should have triggered an estate tax liability, but the administrator instead treated the payments as income. Under Andrews's theory, a decedent's death will usually be considered a separate event, which would mean that recoupment would rarely be considered an appropriate remedy when an estate tax is involved. Yet Andrews uses the estate tax/financial model as an example of the modern application of recoupment. Id. at 598; see also Estate of Vitt v. United States, 706 F.2d 871, 875 (8th Cir. 1983) (describing government's argument that initial events were the deaths of husband and wife but holding that single transaction was transfer of property by the estate to the children).

5. Instead, in both Stone and McEachern the Court focused on the timing of the payment of the tax liability. In Stone, the assessment and payment of the income tax by the trust were made within the statutory period, in accordance with then applicable case law. It was not until Butterworth v. Helvering, 290 U.S. 365 (1933), two years later, that the proper taxable entity was identified. Stone thus begs the question of what constitutes a statutory overpayment.

   In McEachern, on the other hand, the issue was more complex. The estate had made payments of income tax from 1928 through 1931. The statute of limitations for assessment of the 1928 income tax liability expired after the estate made the 1929 income tax payment. Thus, the payments made in 1930 and 1931 were clearly statutory overpayments, made after the collection of the 1928 tax was barred. The 1928
On the other hand, the Court did give significant weight to the fact that the open claim was a refund claim and the refund at issue was attributable to a statutory overpayment, rather than an overpayment on the merits.\(^6\) According to the statute, such an overpayment must be “credited or refunded to the taxpayer if claim therefor is filed within the period of limitation for filing such claim.”\(^6\) Recoupment, as an equitable remedy, cannot override a statute that is directly applicable. Thus, it was appropriate under this theory that recoupment was not applied in \textit{McEachern}.

The failure of the Supreme Court to apply recoupment in \textit{McEachern} raises the issue of whether \textit{Bull} and \textit{Stone} are inconsistent with \textit{McEachern}. If so, are \textit{Bull} and \textit{Stone} still valid decisions? If not, why did the reasoning of \textit{McEachern} not apply in \textit{Stone} where the deficiency against the trust was paid after the statute of limitations had run against further assessment of the beneficiary?

If the Court had employed the same strict statutory rationale in \textit{Stone} that it had in \textit{McEachern}, recoupment would not have applied because the income tax payment of the trust was made after the expiration of the statute of limitations against further assessment of the beneficiary. Thus, the income tax payment in \textit{Stone}, under the rationale of \textit{McEachern}, should also have constituted a statutory overpayment to which recoupment would not apply. But although a different result was reached in \textit{Stone}, \textit{McEachern} did not explicitly overrule \textit{Stone}. Perhaps this is because \textit{Stone} and \textit{McEachern} are not necessarily inconsistent. The \textit{Stone} Court engaged in a legal fiction to conclude that the trust and the beneficiary were one taxable entity. This effectively transformed what would have been a statutory overpayment into no overpayment at all.\(^8\) Because of this legal fiction, the statute remained open for assessment against the trustees; thus the open refund could be timely credited against the otherwise barred deficiency in the manner of \textit{Lewis v. Reynolds}.

This raises the question of why a similar legal fiction was not employed in \textit{McEachern}. The answer to that question is that \textit{Stone} involved a trust and a single beneficiary, while \textit{McEachern} involved a decedent and an estate. The tax against the trust in \textit{Stone} affected only the single beneficiary. In \textit{McEachern}, a tax against the estate

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\(^{166}\) Id. at 60.

\(^{167}\) Id. (quoting Revenue Act of 1928, ch. 852, § 607, 45 Stat. 791, 874).

\(^{168}\) Instead, the overpayment arose later, in 1933, after the Supreme Court decided that such trusts were not the proper taxpayers. The \textit{Stone} Court apparently decided that its 1933 decision did not have sufficient retroactive effect to transform the payment by the trust into a statutory overpayment.
would affect the residual beneficiaries. The identity of interest element of Stone has been strictly construed by the courts to apply only when no third parties would be adversely affected by the recoupment.\textsuperscript{169}

On the other hand, the equities in Stone favored the application of recoupment because the government had raised questions about the deficiency prior to the lapse of the statute of limitations (i.e., it had exhibited some degree of diligence). This was not the case in McEachern.

It is strange that the McEachern Court did not mention the Bull decision. This suggests either that Bull was tacitly approved or that the facts of Bull were substantially different from those of McEachern.\textsuperscript{170} It has been postulated that McEachern is reconcilable with Bull because McEachern did not involve two different, inconsistent taxes imposed on a single transaction; therefore, recoupment was not an appropriate remedy in McEachern.\textsuperscript{171} But the Supreme Court has neither stated nor implied that recoupment applies only to cases involving two different taxes, although admittedly, the majority of the subsequent lower court cases seem to support the two tax theory.

On the equities alone, however, McEachern is distinguishable from Bull and Stone. In McEachern, the government requested recoupment because the taxpayer's actions were inconsistent—the taxpayer initially admitted that it owed an income tax liability, then later requested a refund. But the taxpayer's inconsistency was the result of an honest mistake. The estate was not trying to avoid its fair share of tax liability. This was evident because it had flagged the existence of the installment sale income on multiple income tax returns.\textsuperscript{172}

\textsuperscript{169} See supra note 152.

\textsuperscript{170} See Boyle v. United States, 355 F.2d 233, 237 (3d Cir. 1965) (concluding, on facts similar to Bull, that McEachern did not apply because it presented a different situation from Bull, which was verified by McEachern's failure to mention Bull); see also McConnell, supra note 7, at 594-95 (postulating that McEachern was not a recoupment case because recoupment was neither pleaded by the parties nor mentioned by the Court). But see American Light & Traction Co. v. Harrison, 142 F.2d 639, 642 (7th Cir. 1944) (noting that the Court did address the substance of the defense of recoupment, regardless of the label).

\textsuperscript{171} See McConnell, supra note 7, at 597-98 (stating that McEachern did not involve a single transaction because there were two tax claims with different bases; nor was recoupment at issue because it was not pleaded); Legatzke, supra note 20, at 872 ("Because McEachern did not involve the subjection of a single taxable event to two inconsistent theories of taxation, a requirement of the equitable recoupment doctrine, the case failed to qualify under that doctrine."). But see Andrews, supra note 13, at 611 (suggesting that the death of the decedent, the sale of stock, and use of the installment method for each of the post-death years all constituted separate transactions).

\textsuperscript{172} The Court noted the fact that the taxpayer/estate had not made erroneous statements that caused the government to fail to assess the income tax deficiency. McEachern v. Rose, 302 U.S. 56, 59 (1937); cf. Lofquist Realty Co. v. Commissioner, 102 F.2d 945, 948 (7th Cir. 1939) (denying recoupment to taxpayer and distinguishing McEachern on ground that in case at bar, government's failure to assess was attributable to taxpayer's wrongful omissions).
On the other hand, the government missed two opportunities to assess the deficiency in a timely manner: once when the estate filed the initial income tax return, including only a partial gain from the installment sale, and a second time when the estate filed an income tax return for the taxable year 1929, again including only the partial gain. Thus, the government was not diligent in McEachern, as it had been in Stone, nor was there any fundamental unfairness which offended the sensibilities in McEachern, as there had been in Bull.

Another factor in McEachern which distinguishes it from Bull and Stone is that McEachern involved multiple tax years. Clearly, the estate owed an income tax liability in 1928, part of which it paid. The taxpayer was not entitled to a refund of that amount. The 1930 and 1931 payments, however, constituted statutory overpayments, remitted by the estate and credited by the government after the statute of limitations had lapsed against assessment of the 1928 income tax liability. Both Bull and Stone involved overpayments on the merits. This is a significant distinction because an equitable remedy cannot override a statutory provision on point.\(^{173}\) To allow the government to use recoupment to defeat the taxpayer's refund attributable to those years would be tantamount to using recoupment as an independent action, rather than as a defense, as it was intended.

The 1929 payment, however, did not constitute a statutory overpayment at the time it was remitted by the estate. Nevertheless, the Court characterized the payment as such because the government did not attempt to ascertain the amount of the deficiency and to credit the income tax overpayment against it until the statute of limitations for assessment against the estate had lapsed.\(^{174}\)

\(^{173}\) See G.W. Keeton, An Introduction to Equity 96 (6th ed. 1965) ("If equity was free to accept or reject the common law rules according to whether these rules fitted in with the more progressive policy of the Court of Chancery or not, equity was not similarly free to accept or reject the provisions of a statute.").

\(^{174}\) See McEachern, 302 U.S. at 61-62; cf. Elbert v. Commissioner, 2 T.C. 892, 896 (1943) (citing McEachern and its reasoning and refusing to allow taxpayer to recoup barred refund against open deficiency). Note that the point at which an overpayment was deemed credited was not defined or explained under the Revenue Act of 1928. Instead, the courts looked to the administrative practice of the IRS to determine when this point was reached. See, e.g., United States v. Swift & Co., 282 U.S. 468, 475-76 (1931) (stating that date of allowance for overpayment of taxes was date on which the Commissioner approved the certified schedule); United States v. Boston Buick Co., 282 U.S. 476, 478 (1931) (same with respect to allowance of credit for interest). The problem this raises, though, is that a case can be overruled and an administrative practice can be changed, thereby effectively amending the statutory interpretation. Compare Weinroth v. Commissioner, 74 T.C. 430, 434-40 (1980) (strictly interpreting I.R.C. § 6212, which provides that a notice of deficiency must be sent to taxpayer's last known address) with Looper v. Commissioner, 73 T.C. 690, 696-97 (1980) (holding a notice of deficiency valid, despite that it was not sent to taxpayer's last known address, because taxpayer received notice in time to file a Tax Court petition, and thus, was not prejudiced), acq., 1984-2 C.B. 1.

Moreover, there is currently a split in the circuits as to whether a payment or a deposit has been made if the taxpayer has paid an admitted liability in advance of a
This raises the interesting question of why a similar characterization was not employed in *Bull*, where the statute of limitations on the estate tax refund had lapsed when the estate tax overpayment was credited against the open income tax deficiency. A strict construction of the statute in *Bull* would have produced the same result as in *McEachern*; however, *McEachern* did not present the compelling equities of *Bull*.

If one focuses on the equities and assumes that the application of recoupment depends upon compelling facts, *McEachern* then becomes a case of statutory construction to which recoupment does not apply. This is borne out by the fact that the Court does not mention recoupment in the *McEachern* decision, even though *McEachern* was decided shortly after *Bull* and *Stone* by roughly the same court. Further proof of the importance of the equities lies in the Court's distinction of *Stone* on the ground that “[e]quitable considerations not within the reach of the statutes denied a recovery” to the taxpayer.


The Electric Storage Battery Co. had paid excise taxes on the sale of its storage batteries from 1919 to 1926 under the mistaken belief that such taxes were owed. In 1926, it filed a claim for refund of the taxes paid between 1922 and 1926, the prior years being barred by the statute of limitations. After successfully litigating the issue, the taxpayer received a refund in 1935 of the excise taxes paid for the years in question. Because the excise tax payments had been deducted by the taxpayer in calculating its income tax liability, the refund represented a return of a tax benefit. Thus, the taxpayer had taxable in-

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175. *Bull*, *Stone*, and *McEachern* were all decided within a two-and-a-half year period, with *Stone* and *McEachern* decided just months apart. The composition of the Court was identical in the *Bull* and *Stone* cases, and the composition of the *McEachern* court was not substantially different. In *Bull* and *Stone*, Charles Evans Hughes was Chief Justice with Associate Justices Louis Brandeis, Harlan Stone, Owen Roberts, Willis Van Devanter, James McReynolds, Benjamin Cardozo, Pierce Butler, and George Sutherland. There was one change in the *McEachern* court: Hugo Black had replaced Willis Van Devanter.

176. *McEachern*, 302 U.S. at 63. The Court added: “It was enough, in the peculiar facts of the case, that the trustees had suffered no burden and that the Government was not unjustly enriched.” *Id.*

177. 329 U.S. 296 (1946).

178. The ultimate amount of the refund was $1,395,515.35. Of this amount, $852,151.52 represented tax, and the balance represented interest. *Id.* at 298.
come attributable to the refund. The government then assessed an additional amount of income and excess profits taxes, with interest, on this income. The taxpayer sought to recoup the barred excise tax it had previously paid against the current income and excess profits tax deficiency, but its claim was denied.

The Supreme Court, citing Bull and Stone and emphasizing the single transaction aspect, opined:

[Recoupment] has never been thought to allow one transaction to be offset against another, but only to permit a transaction which is made the subject of suit by a plaintiff to be examined in all its aspects, and judgment to be rendered that does justice in view of the one transaction as a whole.

The Court also rejected the conclusion of the appellate court that recoupment was a fairness doctrine, to be broadly applied and not to be limited to the narrow confines of a single transaction. Instead, the Court stressed the importance of the integrity of the statute of limitations, concluding that the statute itself was a fairness doctrine based on compelling public policy that should not be undermined.

The Court further noted that many cases involve either hardships to the taxpayer or loss of revenue to the government. The fact that such considerations are involved does not necessarily mean that recoupment is an appropriate remedy. In fact, it is only in extraordinary cases, in which a strict application of the law would so offend the sensibilities, that recoupment is appropriate. In Rothensies, for example, if one were looking solely to factual fairness, a case could be made for both parties. The taxpayer had overpaid its tax liability for the three taxable years in question and clearly would have been entitled to a refund if a claim had been timely filed. The taxpayer's income tax deficiency arose because of the recovery of the earlier tax benefit—the deductions of excise tax payments against its income tax liability

179. The additional income and excess profits taxes plus interest totaled $229,805.34, which the Commissioner attributed to the 1935 taxable year because that was the year the refund was received by the taxpayer. Id.

180. Id.

181. Id. at 299.

182. Id. at 300-01.

183. The Court reasoned:

It probably would be all but intolerable, at least Congress has regarded it as ill-advised, to have an income tax system under which there never would come a day of final settlement and which required both the taxpayer and the Government to stand ready forever and a day to produce vouchers, prove events, establish values and recall details of all that goes into an income tax contest. Hence, a statute of limitation is an almost indispensable element of fairness as well as of practical administration of an income tax policy.

Id. at 301.

184. Id. at 302.

185. The Court stated: "If there are to be exceptions to the statute of limitations, it is for Congress rather than for the courts to create and limit them." Id. at 303.
for the taxable years 1922 through 26.\footnote{186} The taxpayer argued that the amount of excise tax it had erroneously overpaid for the now barred taxable years 1919 through 1922, which the taxpayer could not otherwise recoup, should offset the amount of the current income tax deficiency because the deficiency was triggered by an excise tax refund.\footnote{187} Solely from the taxpayer's perspective, the government had received more net revenue from the taxpayer than it was entitled to receive. Therefore, the government should be estopped from arguing that the taxpayer now owes more.

From the government's perspective, while the taxpayer would clearly have been entitled to a refund of the excise taxes for the taxable years in question if the claim had been timely filed, nevertheless, the fact was that the taxpayer never filed such a claim. Instead, the taxpayer sought recoupment of the overpaid taxes sixteen years after their recovery was precluded by the statute of limitations.\footnote{188}

The statute of limitations was designed to prevent such a consideration of stale claims. The Court pointed out that occasionally the limitations bar will result in unfairness, but the greater good is served by maintaining the integrity of both the statute and the fisc.\footnote{189} Thus, recoupment is an extraordinary remedy.

In determining whether recoupment should apply, a court must not only weigh the equities, but it must also consider tax policy. A problem for the Electric Storage Battery Co. was that there were multiple tax years involved. The excise tax payment and its corresponding income tax deduction in each year constituted a single transaction. When the taxpayer received a refund of excise taxes paid in taxable years 1922 through 1926, the refund with respect to each taxable year represented a separate return of a tax benefit, giving rise to a discrete income tax deficiency in each of those years. The earlier excise tax payments in taxable years 1919 to 1922 had generated their own income tax deductions. Thus, the earlier tax years involved separate considerations. The excise tax overpayments from these earlier years and the income tax deficiency attributable to the later taxable years did not constitute a single transaction.\footnote{190} Therefore, the earlier overpayments could not offset the later deficiency. The shortcoming of the

\footnote{186} \textit{Id.} at 298.

\footnote{187} \textit{Id.}

\footnote{188} Although the Supreme Court did not characterize the case directly as a laches case, preferring instead to decide the issue under the single transaction element, \textit{Rothensies} is characterized as a laches case in Boyle v. United States, 355 F.2d 233, 236 (3d Cir. 1965). Moreover, the \textit{Rothensies} Court implied the laches argument: "That claims dead so long can be resurrected under this doctrine, is enough to show its menace to the statute of limitations . . . ." \textit{Rothensies} v. Electric Storage Battery Co., 329 U.S. 296, 303 (1946).

\footnote{189} \textit{Rothensies}, 329 U.S. at 302.

\footnote{190} Note, however, that three justices, Murphy, Black, and Rutledge, dissented in \textit{Rothensies} on the ground that they believed the claim for refund attributable to the taxable years 1919-22 was part of the same transaction as the government's assess-
Rothensies decision is that the Court did not discuss the single transaction issue, nor did it elaborate on why the equities compelled the result.

Many commentators regard McEachern and Rothensies as a retreat by the Supreme Court from its earlier view that recoupment might be accorded a broad scope. But the equities in Bull and Stone were so heavily weighted in favor of the prevailing party that they compelled the application of an equitable remedy. It was under these factual circumstances that the equitable remedy overrode the statutory bar.

In Rothensies, on the other hand, the equities were not weighted in favor of either party. The excise tax overpayments in the earlier years were the result of an honest mistake on the part of both the taxpayer and the government. The taxpayer requested recoupment, yet the taxpayer’s honest error and lack of diligence had caused its dilemma. The government, on the other hand, was not attempting to hide its own mistake (i.e., lack of diligence) behind the statutory bar. Neither of the parties would be unjustly enriched if the remedy were not applied. On the contrary, if equitable recoupment had applied, it would have had the effect of lifting the statute of limitations to cure the taxpayer’s own inadvertence and lack of diligence. Moreover, the taxpayer’s overpayments were tempered somewhat by the tax benefit the taxpayer obtained with respect to those overpayments.

Under purely equitable considerations, the primary inquiry should be whether public policy concerns demand application of the remedy or, stated differently, whether the integrity of the federal tax system would be injured if the remedy were not applied. Because the purpose of the statute of limitations is to prevent the litigation of stale claims, this purpose would have been thwarted in Rothensies if the taxpayer had prevailed.

III. Subsequent Cases and the Resulting Elements

Based on the four Supreme Court cases, two important elements determine the applicability of equitable recoupment: (1) an inconsistency based on a single transaction and (2) a single taxpayer or an identity of interest sufficient to consider two taxpayers as a single unit.

A third element has emerged from the subsequent lower court cases—

191. See, e.g., Wood v. United States, 213 F.2d 660, 661 (2d Cir. 1954) (“The gap in statutes of limitation created by the recoupment doctrine in tax cases seemed at one time to be fairly wide. But the gap has been narrowed markedly by McEachern v. Rose and Rothensies v. Electric Storage Battery Co.” (citations omitted)); Babcock & Wilcox Co. v. Pedrick, 212 F.2d 645, 648-49 n.1 (2d Cir. 1954) (“Rothensies ... shows that novel extensions of the doctrine thus applicable in the instance of the barred claim will not be tolerated in tax litigation.”), cert. denied, 348 U.S. 936 (1955); see also Gindes v. United States, 661 F.2d 194, 200 n.18 (Ct. Cl. 1981) (attributing this retreat to the enactment of the mitigation provisions).
two different taxes—because these cases have largely involved precisely this situation. In addition, the Supreme Court has recently stressed that recoupment is a defense, not an affirmative remedy. Further, there is apparently a growing trend requiring the party requesting recoupment to have engaged in self-help before bringing suit.

While these three elements are easily articulated, they are not as easily applied, primarily because they have been inconsistently interpreted by the lower courts. The most important element, albeit the most problematic, is the single transaction.

A. Single Transaction

If inconsistent tax treatment arises out of a single transaction, the claimant should not require the protection of the statute of limitations in seeking relief. Because of the single transaction, the claimant, by definition, has the necessary records and witnesses. The recoupment defense can be addressed adequately without resort to stale records or different proof. Therefore, the remedy should be available only in cases in which "both the plaintiff's course of action and the defendant's claim in reduction thereof [are] susceptible of adjustment in one adjudication." The problem, however, is that the term "single transaction" is susceptible to inconsistent interpretations. The result is an inadequate


193. See, e.g., Estate of Mann v. United States, 731 F.2d 267, 279 (5th Cir. 1984) (holding that government could not recoup barred income tax deficiency against open estate tax overpayment because it failed to protect itself against the statute of limitations on bad debts); Kellogg-Citizens Nat'l Bank v. United States, 330 F.2d 635, 639 (Ct. Cl. 1964) (denying taxpayer relief because taxpayer failed to act for 10 months and allowed statute to run without filing protective refund claim); Holzer v. United States, 250 F. Supp. 875 (E.D. Wis.) (denying taxpayer recoupment because taxpayer failed to file timely protective claim which would have preserved right to refund), aff'd per curiam, 367 F.2d 822 (7th Cir. 1966).

194. McConnell, supra note 7, at 584 (citing Wheat v. Dotson, 12 Ark. 699, 703 (1852)); accord Mills v. United States, 35 F. Supp. 738, 739 (N.D.N.Y. 1940) (finding that doctrine of recoupment is appropriate if the claims arise out of the same subject matter). But see United States v. Cummins Distilleries Corp., 166 F.2d 17, 22-23 (6th Cir. 1948) (disregarding single transaction element and instead concentrating on unjust retention in holding that taxpayer is entitled to offset a barred refund against an unrelated tax liability).

195. The U.S. Supreme Court itself has admitted the difficulty of defining the term: "'Transaction' is a word of flexible meaning. It may comprehend a series of many occurrences, depending not so much upon the immediateness of their connection as upon their logical relationship." Moore v. New York Cotton Exch., 270 U.S. 593, 610 (1926), quoted in McConnell, supra note 7, at 584; see also supra note 190 (discussing Rothensies dissent).

Part of the problem with the single transaction element is that many courts interpret the Rothensies decision as strictly limiting equitable recoupment in general, and the single transaction element in particular. See, e.g., Estate of Mitchell v. United States, 645 F. Supp. 274, 277 (S.D. Fla. 1986) ("Rothensies [sic] thus established that
remedy. Thus, while the single transaction is considered the most important element, it also has caused the most confusion among the lower courts.

Much of this confusion has been attributed to the Supreme Court’s indications in Rothensies that recoupment is a narrow remedy.\(^{196}\) The depth of the confusion is illustrated by two decisions of the Court of Claims.

1. \textit{Ford v. United States}\(^{197}\)

In \textit{Ford v. United States}, the plaintiffs were brother and sister who, as minors, had inherited stock in a Brazilian corporation from their father. This stock was included in the gross estate at a value of $11,857.50. Shortly before the estate tax statute of limitations expired, the IRS sent plaintiffs a statutory notice of deficiency. In this notice, the IRS proposed a significant increase in estate tax liability,\(^{198}\) attributable primarily to the inclusion in the estate of the proceeds of certain life insurance policies. There was also a proposed increase in the valuation of the Brazilian stock to $23,715.\(^{199}\)

The plaintiffs filed suit in the Tax Court, complaining of the inclusion of the insurance proceeds. They did not complain about the increase in the stock valuation or the resulting estate tax deficiency.\(^{200}\) The Tax Court ultimately held in favor of the plaintiffs on the exclusion of the insurance proceeds, and the plaintiffs paid the resulting deficiency attributable to the increased stock valuation.

In 1947, the plaintiffs sold the stock in question, filing an income tax return, using as their basis $13,809.02.\(^{201}\) Subsequently, the plaintiffs filed a claim for refund alleging that they had miscalculated their basis. They maintained that the basis had been miscalculated originally, ar-

\(^{196}\) Rothensies v. Electric Storage Battery Co., 329 U.S. 296, 301 (1946) (opining that the lower court misconstrued the limitations of recoupment); see also Wood v. United States, 213 F.2d 660, 661 (2d Cir. 1954) (“[W]e think [the remedy] lacks all vitality unless there has occurred a ‘single taxable event.’”); Wood v. United States, 121 F. Supp. 769, 770 (S.D.N.Y. 1953) (holding that government mischaracterized bond premium deduction as two transactions—purchase and sale—and citing Rothensies), aff’d, 213 F.2d 660 (2d Cir. 1954).

\(^{197}\) 276 F.2d 17 (Cl. Ct. 1960).

\(^{198}\) The original estate tax liability was calculated to be $439.61. The deficiency notice proposed increasing the liability to $52,221.61. \textit{Id.} at 19.

\(^{199}\) This proposed increase was attributable to a discrepancy in the conversion factor used by the estate for converting Brazilian currency into U.S. dollars. \textit{Id.}

\(^{200}\) In fact, the executors, in briefs filed before the court, affirmatively approved the new valuation. \textit{Id.}

\(^{201}\) \textit{Id.} at 20. It is unclear how plaintiffs derived this figure.
guing that the true basis was greater than both that determined in the earlier Tax Court proceeding and the amount realized on the sale of the stock. Their refund claim was denied by the IRS, and the plaintiffs filed suit in the Court of Claims.

The government argued first that the doctrines of estoppel, release, waiver, or res judicata should apply to deny the plaintiffs the right to change the basis which they had effectively misrepresented and which had already been determined by the Tax Court. In holding for the plaintiffs, however, the Court of Claims emphasized the true value of the stock and the correct tax treatment.

On its own motion, the court further considered the issue of whether recoupment applied to credit the open refund attributable to the overpayment of income tax against the resulting barred underpayment of estate tax. The court reasoned that the remedy would have been appropriate if not for Rothensies, because Rothensies had indicated that the scope of recoupment was a narrow one. Therefore, it concluded, recoupment was not available to the government in this case. Beyond this limited reasoning, however, the court did not give any further indication of why recoupment should not apply.

But the established elements for the application of recoupment were all met. The subsequent increase in the basis of the stock directly caused an automatic estate tax deficiency, the collection of which was barred by the statute of limitations. Thus the single transaction element appeared to have been met; yet, the court summarily dismissed any further consideration of recoupment.

Another factor favoring the application of recoupment is that the main claim, the refund claim, was timely filed. Thus, there was neither a statutory overpayment as in McEachern nor an initial statute of limitations problem to prevent the consideration of recoupment. If the statute of limitations were not a bar to a consideration of all the issues, the taxpayers should clearly have lost. In that event, there would

202. Id. at 21.
203. Id. at 21.
204. The Ford decision is inconsistent with the decision of the Court of Claims in Robbins v. United States, 21 F. Supp. 403 (Cl. Ct. 1937), in which the court considered the issue of basis where the taxpayer had improperly failed to report a gain upon receipt of stock. After the statute of limitations had run, the taxpayer sold the stock and attempted to use the higher market value at the time of receipt as the true basis. The court, holding in favor of the government, concluded that "in good conscience and honest dealing a party ought not to be permitted to repudiate his previous statements, declarations, or actions." Id. at 407 (paraphrasing Rothschild v. Title Guar. & Trust Co., 97 N.E. 879, 881 (N.Y. 1912)).
205. Ford v. United States, 276 F.2d 17, 23 (Cl. Ct. 1960).
206. Id. Admittedly, the court did not go so far as to state that the single transaction element had been met, although that clearly seems to be the direction in which it was heading. The reasoning, however, is obscured by the discussion of Rothensies. Note that two of the dissenting judges thought that recoupment should apply. Id. at 23-24 (Jones, J., concurring in part, dissenting in part); id at 24-25 (Littleton, J., dissenting).
have been an estate tax underpayment which would have inured to the benefit of the taxpayers, much as the exclusion of income by the trust inured to the benefit of the beneficiary in *Stone*.

The court apparently attached significance to the fact that the government had in its possession data from which to make a correct determination of the value, and thus the basis of the stock. The court correctly concluded, however, that it was incumbent upon the executors to report the stock’s true value and to pay the correct amount of estate tax. Not only did the executors not do this, but they also acquiesced in the recalculated valuation in the Tax Court proceeding. It was only later, after further estate tax assessment was barred, that the taxpayers contested the Tax Court determination. Because the basis of the stock had a direct bearing on both the income tax overpayment and the estate tax deficiency, the court should have concluded that the single transaction element was satisfied. Therefore, it should have applied recoupment in favor of the government because the elements were met and the equities weighed more heavily in the government’s favor. The court did not see it this way, however. As a result, the taxpayers were unjustly enriched at the expense of the government.

From a public policy perspective, both the revenue raising function and the integrity of the tax system are undermined if taxpayers can avoid their fair share of tax liability by hiding behind the statute of limitations. The plaintiffs in *Ford* raised the main claim as a refund action. In essence, the plaintiffs were conceding that they did not need the benefit of the statute of limitations because they had their records in support of the main claim. Thus, with the threshold requirements met, and the equities balanced against the taxpayers, the government should have prevailed.

It is interesting to note that other equitable remedies might have applied in *Ford*, and indeed, their application was urged by the government. But the court chose to disregard these remedies, reasoning that the plaintiffs were minors at the time the estate tax return was filed, and thus they had no knowledge of what was filed in the return. Such reasoning is odd, because the plaintiffs were represented by competent executors—a relative and a corporate fiduciary—chosen by their father to represent their interests. In addition, they may have had guardians appointed for them.

207. *Id.* at 22.
208. *Id.* at 19.
209. See supra text accompanying note 203. In addition, laches might have been applied against the taxpayers because the government was prejudiced in its position by the taxpayers’ failure to act. Moreover, the taxpayers’ inaction was not merely passive because they had, in effect, conceded the basis determination in the earlier Tax Court proceeding.
The Court of Claims' implication that the plaintiffs should be viewed as distinct from the executors is contrary to the identity of interest rationale in *Stone*. Indeed, in *Ford* as in *Stone*, the plaintiffs benefitted directly and improperly from the valuation error.

The court also implied that the government sat on its rights by not acting on information within its possession, and by not assessing an additional estate tax on the higher stock valuation. But this argument would have been based on a passive lack of diligence. In such cases, the government should not be charged with constructive knowledge of the estate tax return because of the administrative difficulty of examining every return.

Finally, it should be noted that the facts of this case are similar to those of *Alamo National Bank*. But unlike the Fifth Circuit, the Court of Claims summarily dismissed the argument that the taxpayers had a duty of consistency in dealing with the government.

2. *Wilmington Trust Co. v. United States*

The lower court decision that has caused the most confusion is *Wilmington Trust Co. v. United States*, in which the government sought to recoup a barred estate tax deficiency against an open income tax refund. The first issue presented in the consolidated cases of *Wilmington Trust* was whether certain expenses incurred in connection with timber sales were ordinary or capital in nature. The taxpayer in each case had treated the expenses as ordinary and had deducted them against ordinary income. After the deaths of these taxpayers, the government assessed an income tax deficiency against the estates on the ground that the expenses represented capital expenditures. The estates paid the deficiencies, deducted the amounts from the respective gross estates, and subsequently sued for a refund of the income taxes paid. The lower courts rendered conflicting decisions, and an appeal was made to the Court of Claims.

The Court of Claims decided the expenses were ordinary in nature, thereby entitling the taxpayers to an income tax refund attributable to

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213. 610 F.2d 703 (Ct. Cl. 1979).

214. *Id. at 705-07*. In the cases of *Wilmington Trust* and *Schutt*, the court held the expenses were capital, while in the case of *McMullan*, the court held the expenses were ordinary. *Id.*
the foregone corresponding deduction. This raised a problem for the government: A refund of the entire amount of the income tax overpayment would create an estate tax deficiency because the income tax payment initially had been deducted from the gross estate. Further assessment and collection of the estate tax, however, was precluded under the statute of limitations.

The government then sought to recoup the barred estate tax deficiency against the open refund claim. The court refused to permit recoupment, allowing the taxpayers to collect their full refund without any estate tax offset and summarily dismissing the government’s claim under the rationale that the single transaction element was not met. The court based its decision on Rothensies which, it opined, narrowed the concept of the single transaction.

Professor Andrews correctly criticizes the Wilmington Trust decision as too narrow a construction of Rothensies. Andrews argues that the direct effect of one tax on another is sufficient to constitute a single transaction. On this issue, Andrews is correct, and the reasoning of the Court of Claims is wrong. There was only one set of expenditures involved in Wilmington Trust. The determination that these expenditures represented expenses deductible against ordinary income automatically resulted in the estate tax deficiency. Further, the statute of limitations was not a direct bar to recoupment in either case.

It is difficult to fathom how the court could conclude that such a direct connection did not constitute a single transaction. The flaw in the court’s reasoning is apparent from its struggle with the concept of the single transaction. The court acknowledged that under its view there are areas in which it is difficult to categorize two events as a single transaction. The court based its decision on Rothensies which, it opined, narrowed the concept of the single transaction.

Professor Andrews regards the Wilmington Trust decision as inconsistent with the Supreme Court’s equitable recoupment cases. But while the conclusion of the Court of Claims is inconsistent with the

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216. Wilmington Trust, 610 F.2d at 713-15; accord Mann v. United States, 552 F. Supp. 1132, 1141 (N.D. Tex. 1982) ("[T]he fact that a single tax determination may affect the taxes on two transactions does not convert the two transactions into a single one." If it did, the doctrine of equitable recoupment would be drastically expanded beyond the ‘limited scope’ dictated by Rothensies . . . ." (citation omitted) (quoting Wilmington Trust, 610 F.2d at 714)), aff'd, 731 F.2d 267 (5th Cir. 1984).

217. See Andrews, supra note 13, at 641-43.

218. See Wilmington Trust, 610 F.2d at 714 (stating that some cases are easy to determine, others are not, and there is a wide range in between; when a case falls in between, the policy considerations must be examined).

219. See Andrews, supra note 13, at 641-47.
underlying theory of those cases, the ultimate result in *Wilmington Trust* is not necessarily inconsistent.

The Court of Claims indicated in dicta that even if the single transaction element had been met, laches might apply against the government. In fact, the government had sat on its rights in each of the consolidated cases without acting, and had allowed the statute of limitations to run to its detriment. Moreover, this was not a case of ignorance in which the government did not have adequate notice or knowledge of the claim, as in *Ford*. Instead, in *Wilmington Trust* the expense issues had been litigated; thus, the government was familiar with the cases, and knew or should have known that the statute would expire shortly and that its interests were best served by a timely protective assessment. Because the government failed to protect itself, laches could properly have been applied to prevent the application of equitable recoupment in its favor.

One might at this juncture question the application of laches against the government in *Wilmington Trust* when it clearly did not apply against the taxpayer in *Bull*. But *Bull* can be distinguished in several respects. First, the period of delay in *Bull* was one month, whereas, in *Wilmington Trust*, the period was longer—more than eight months in one case, and more than one year in the other. This distinction alone, however, may not be very significant because there is no definite time period to determine the application of laches. Instead, courts must consider each case on its merits. In *Bull*, the taxpayer requested recoupment, so the equities initially should be construed against the taxpayer. But the government had mistakenly made the initial determination that there was an estate tax underpayment attributable to the decedent's partnership interest, and subsequently an income tax deficiency was assessed against this same interest.

The equities were clearly weighted in favor of the taxpayer because the government had assessed a double tax liability without crediting

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220. *Wilmington Trust*, 610 F.2d at 714.
221. See *McMullan v. United States*, 686 F.2d 915, 924 (Ct. Cl. 1982) (discussing protective assessment by the government); see also *United States v. Boyle*, 469 U.S. 241, 251-52 (1985) (opining that even laymen are held to knowledge of statutory deadlines).

In informal conferences with the IRS, as well as in the Tax Court, the district court, or the U.S. Court of Federal Claims, the taxpayer has the burden of proof. The exception is that the IRS bears the burden in a fraud case, or where new matters or an additional amount of deficiency are raised after the case has been docketed. Arthur H. Boelter, Representation Before the Appeals Division of the IRS § 7-5.90 (1993). Moreover, the choice of forum determines the degree of proof. In the Tax Court, the taxpayer must prove that the IRS is incorrect in its deficiency determination. In refund actions in the district court and the Court of Claims, the taxpayer must prove that she overpaid her tax liability, that she is entitled to a specific amount of refund under an appropriate and correct theory for relief, and that her claim for refund was wrongfully denied. Michael Mulroney, Federal Tax Examinations Manual § 12.3(b)(2) (1985).

the earlier tax that had been paid by the taxpayer, and without any consideration of the fact that it was the government’s error that had caused the estate tax overpayment. It is thus likely that an even longer delay by the taxpayer would not have prevented the application of recoupment. After all, the government has a duty to deal fairly with its citizens and vice versa.\textsuperscript{223}

In \textit{Wilmington Trust} the equities were not as compelling as they were in \textit{Bull}. It is unfortunate that the \textit{Wilmington Trust} court only obliquely addressed the issue of lack of diligence before dismissing it. Because recoupment is an extraordinary remedy, it should apply only to promote fundamental fairness and only when the parties otherwise have acted diligently and in good faith. It should not be used to cure a lack of diligence. This reasoning is consistent with the public policy considerations underlying both the statute of limitations and the federal tax system.

Professor Andrews notes that the Court of Claims in \textit{Wilmington Trust} wisely did not rely upon the government’s lack of diligence.\textsuperscript{224} He further notes that in the Supreme Court cases, “some lack of diligence on the part of either the taxpayer or the government in the timely pursuit of its claim does not foreclose the application of equitable recoupment.”\textsuperscript{225} But this issue was not significant in any of the four Supreme Court cases. Moreover, the Supreme Court has never stated or even implied that the issue has no significance. But under the current recoupment elements, neither lack of diligence nor any of the other equitable defenses are relevant.\textsuperscript{226} In the application of most other equitable remedies, however, laches is an important defense.\textsuperscript{227} Perhaps the complexity of the tax laws is the reason that laches does not appear to have significance in the recoupment cases. The average taxpayer should not be held to a high standard of diligence with respect to substantive tax provisions, particularly when the equities are otherwise in the taxpayer’s favor. Thus, where the government attempts to extract a double tax by hiding behind the statute of limitations, the taxpayer’s case should not be thwarted by mere passive inaction. Indeed, equity allows all considerations to be weighed.

\textsuperscript{223} See, e.g., Rock Island Ark. & La. R.R. v. United States, 254 U.S. 141, 143 (1920) (“Men must turn square corners when they deal with the Government.”); Stockstrom v. Commissioner, 190 F.2d 283, 289 (D.C. Cir. 1951) (“Taxpayers expect, and are entitled to receive, ordinary fair play from tax officials.”).

\textsuperscript{224} Andrews, \textit{supra} note 13, at 640.

\textsuperscript{225} Id. at 618. This opinion is echoed by Tierney, \textit{supra} note 28, at 127-29.

\textsuperscript{226} See, e.g., Holzer v. United States, 250 F. Supp. 875, 878 (E.D. Wis.) (“[L]aches is not a defense to a claim for equitable recoupment . . . .”), \textit{aff’d per curiam}, 367 F.2d 822 (7th Cir. 1966); United States v. Bowcut, 287 F.2d 654, 657 (9th Cir. 1961) (providing equitable relief to executor even though he did not take advantage of one-month period to file protective claim for refund after Commissioner asserted an income tax deficiency).

\textsuperscript{227} See McClintock, \textit{supra} note 31, at 71-76.
B. Single Taxpayer or Identity of Interest

Under Stone, it may be inferred that the single taxpayer element is defined to include an identity of interest.\textsuperscript{228} Such an interpretation is consistent with an examination of the whole situation in light of equitable considerations. When presented with separate taxpayers with an identity of interest, however, courts have very strictly construed the Stone definition,\textsuperscript{229} displaying none of the flexibility and creativity of the earlier Supreme Court decisions.

For instance, in \textit{Kramer v. United States},\textsuperscript{230} the Court of Claims held there was no identity of interest between an estate and a single beneficiary. In \textit{Kramer}, executors of an estate brought suit against the government alleging that the value of a widow's right to receive weekly payments from the decedent's employer was wrongfully included in the gross estate. After the estate paid the estate tax on this inclusion, the widow filed a claim for refund of the income taxes she had paid on this amount, alleging that she was entitled to an offset of the estate taxes attributable to the receipt of income in respect of a decedent.\textsuperscript{231} The widow's claim was granted.

The Court of Claims subsequently determined that the value of the widow's right to receive the payments had been improperly included in the gross estate and that the estate was entitled to a refund of the estate tax attributable to this amount.\textsuperscript{232} This produced a corresponding deficiency in the income tax liability, which the government was barred from assessing at the time of the suit because the statute of limitations had run. The government then sought to recoup the barred income tax deficiency against the open estate tax overpayment. The court held for the estate, concluding that there was insufficient identity of interest between the estate and the widow because there were several beneficiaries who, potentially, would be affected by the recoupment.\textsuperscript{233}

But while Mrs. Kramer held only a life estate in the corpus with her children as remaindermen, her interest was actuarially determinable. As a result of the Court of Claims' decision, Mrs. Kramer was unjustly enriched at the expense of the government. It was clear that the single transaction element had been met. What was not clear was why

\textsuperscript{228} See supra text accompanying notes 145-46.

\textsuperscript{229} See, e.g., Smith v. United States, 373 F.2d 419, 422 (4th Cir. 1966) (refusing to apply recoupment because remainderman was not represented and would be affected if recoupment were permitted against income beneficiary); Sewell v. United States, 19 F. Supp. 657, 663 (Ct. Cl. 1937) (refusing, on facts similar to Stone, to allow government to recoup barred deficiency of income beneficiary against open overpayment of trust because there was a remainderman, in addition to the income beneficiary, who would have been injured if recoupment were applied).

\textsuperscript{230} 406 F.2d 1363 (Ct. Cl. 1969).

\textsuperscript{231} \textit{Kramer}, 406 F.2d at 1364-65; see I.R.C. § 691(c) (1994).

\textsuperscript{232} \textit{Kramer}, 406 F.2d at 1371.

\textsuperscript{233} Id.
the court did not give more serious consideration to the offset of the widow's portion of the overpayment.

Unfortunately, some courts view McEachern and Rothensies as restricting the application of recoupment.\(^\text{234}\) The reason is that the boundaries of equitable recoupment have not been clearly delineated by the Supreme Court. Consequently, many lower courts have attempted to fit the remedy into narrowly defined elements and, as a result, recoupment has become an inflexible, quasi-legal remedy.

C. Two Different Taxes

In his article, Professor Andrews postulates that recoupment, by definition, most commonly applies when two different types of taxes are involved in a single transaction.\(^\text{235}\) According to Professor Andrews, there are two different situations in which recoupment is generally warranted. The first, exemplified by Bull, is where two different taxes are imposed upon a single item of income that is subject to only one tax,\(^\text{236}\) which Andrews refers to as the "two tax effect."\(^\text{237}\) The second situation, not yet addressed by the Supreme Court, is where the imposition of one tax produces an automatic inequity with respect to another tax on the same item of income or expenditure. Because the Supreme Court addressed only the issue of the two tax effect in Bull, Professor Andrews proposes, with considerable acumen, that the Bull result should be extended to cases involving two different, inconsistent taxes which automatically produce an inequitable result.\(^\text{238}\)

The cases he uses to exemplify this theory are United States v. Herring\(^\text{239}\) and United States v. Bowcut,\(^\text{240}\) both of which involved income tax deficiencies and additions to tax attributable to fraud, which in turn, caused a corresponding estate tax deficiency. In both cases, the courts allowed the estates to recoup the barred estate tax overpayments against the open income tax deficiencies. Professor Andrews

\(^{234}\) See, e.g., Gindes v. United States, 661 F.2d 194, 200 (Cl. Ct. 1981) ("Nine years after Stone... the Supreme Court held in Rothensies v. Electric Storage Battery Co. that the doctrine had a far more circumspect application to tax cases." (citation omitted)); Wood v. United States, 213 F.2d 660, 661 (2d Cir. 1954) (noting that the gap in statutes of limitations had been "narrowed markedly by McEachern v. Rose and Rothensies" (citations omitted)).

In Gindes, the Court of Claims theorized that the statutory mitigation provisions, I.R.C. §§ 1311-1314, enacted in 1938, account for the Supreme Court's seeming shift in direction in Rothensies. Gindes, 661 F.2d at 200 n.18. The problem with this theory, however, is that the shift occurred in McEachern, which the Court decided before the enactment of the mitigation provisions.


\(^{236}\) Id. This situation may also arise through the denial of an appropriate deduction.

\(^{237}\) Id. at 630.

\(^{238}\) Id. at 645-47.

\(^{239}\) 240 F.2d 225 (4th Cir. 1957).

\(^{240}\) 287 F.2d 654 (9th Cir. 1961).
notes that these decisions are correct because "if the estate had been able to file the estate tax refund claim in timely fashion, the existence of fraud with respect to the decedent's income taxes would not have precluded the estate tax recovery."\(^{241}\)

There are many situations under the income tax laws in which tax consequences would be different but for the statute of limitations. While Professor Andrews's statement is technically true, it must be noted that recoupment is an extraordinary remedy. Thus, it should apply only to prevent a fundamental unfairness. As Professor Andrews points out, the statutes of limitations on the income tax deficiency and the estate tax refund are coterminous.\(^{242}\) Therefore, the *Herring* and *Bowcut* issues could arise procedurally only when the statute of limitations on the income tax deficiency is extended for some reason.\(^{243}\)

In both *Herring* and *Bowcut*, the statute of limitations for assessment of the income tax deficiency was extended because of fraud. Fraud, by definition, arises from intentional wrongdoing.\(^{244}\) In both of these cases, the fiduciary/surviving spouse was also charged with the fraud. Yet the *Bowcut* court rejected the government's argument that the doctrine of unclean hands should constitute a defense to recoupment.\(^{245}\) There, the court noted that the spouse was charged with fraud only because she signed the joint income tax return, stating: "[C]onsidering the limited extent to which a wife normally is an active and knowing participant in the representations contained in a joint tax return, we doubt that any rational inference of knowledge or fraudulent intent can be drawn from this fact."\(^{246}\)

The court's statement is correct because fraud cannot be imputed, but must be proved by clear and convincing evidence.\(^{247}\) Thus, the decedent's fraud would not be imputed to the survivor. Nevertheless, under statutory law both spouses are jointly and severally liable for an understatement of tax liability, including penalties (except fraud) and


\(^{242}\) Id. at 633.

\(^{243}\) Id. at 633-34.

\(^{244}\) See *Estate of Spruill v. Commissioner*, 88 T.C. 1197, 1241-42 (1987) ("[F]raud is the intentional commission of an act or acts for the specific purpose of evading a tax believed to be owing."). For the criminal fraud offense, the elements are the existence of a deficiency, an attempt to evade or defeat a tax in any manner, an affirmative act of fraud, and willfulness. See *Michael I. Saltzman, IRS Practice and Procedure* ¶ 7A.02 (2d ed. 1991).

\(^{245}\) United States v. Bowcut, 287 F.2d 654, 657 (9th Cir. 1961) (holding that the facts did not warrant a finding of unclean hands, and thus unclean hands could not serve as a defense to recoupment).

\(^{246}\) Id.

\(^{247}\) Saltzman, *supra* note 244, ¶ 7B.01[1] (stating that the standard of proof is "clear and convincing evidence"); see also I.R.C. § 7454 (1994) (providing that the burden of proof is on the IRS).
interest, even though the results of such a provision are sometimes harsh. Unfortunately, the *Herring* court did not discuss the full effect of the civil fraud, and in *Bowcut* the fraud issue was only cursorily considered and dismissed. Thus, it is not clear from the facts how involved in or knowledgeable about the fraud the surviving spouses actually were. But because the *Bowcut* decision predated the enactment of the innocent spouse provision, it made no difference legally whether Mrs. Bowcut participated in or had actual or constructive knowledge of the fraud. Because she had signed the joint return, the effect of the fraud was statutorily imputed to her, and she should have been held liable for the understatement of tax liability attributable to the fraud. It is doubtful that the *Bowcut* court would reach the same result today if the spouse/fiduciary were to fail to qualify for relief as an innocent spouse.

248. See Revenue Act of 1938, ch. 289, § 51(b), 52 Stat. 447, 476 (enacting I.R.C. § 6013 (1994)). There were some limited exceptions for a joint return filed under duress or mistake, or where the joint signature was obtained by fraud. Huelsman v. Commissioner, 416 F.2d 477, 479 (6th Cir. 1969). Even where the spouse failed to sign the return, joint and several liability could be imposed if the return was intended to be a joint return. Kann v. Commissioner, 18 T.C. 1032, 1045 (1952), aff'd, 210 F.2d 247 (3d Cir. 1953), cert. denied, 347 U.S. 967 (1954).

While the innocent spouse provision, see I.R.C. § 6013(e) (1994), provides some limited relief from joint and several liability, that provision had not been enacted at the time of the *Bowcut* decision. See Act of Jan. 12, 1971, Pub. L. No. 91-679, § 1, 84 Stat. 2063 (codified as amended at I.R.C. § 6013(e) (1994)).

Ironically, the Ninth Circuit had held, prior to the enactment of the joint and several liability provision, that the government could not impose joint and several liability on an innocent spouse. Cole v. Commissioner, 81 F.2d 485, 489 (9th Cir. 1935), rev’d 29 B.T.A. 602 (1933). The *Cole* decision had been voided by the statutory joint and several liability provision, however. For a discussion of I.R.C. § 6013, see Richard C.E. Beck, *The Innocent Spouse Problem: Joint and Several Liability for Income Taxes Should Be Repealed*, 43 Vand. L. Rev. 317, 349-64 (1990); Note, *Innocent Spouses’ Liability for Fraudulent Understatement of Taxable Income on Joint Returns*, 56 Va. L. Rev. 1268, 1281-87 (1970).

249. See Beck, supra note 248, at 323-31, 348-64; see also Huelsman v. Commissioner, 27 T.C.M. (CCH) 436, 437 (1968) (stating that it has “no equitable power to grant relief to petitioner, however distasteful the result”); Joan Pryde, “*Innocent Spouse* Rule Is Too Narrow To Be Workable, Treasury Official Says,” 107 Daily Tax Rep., June 4, 1996, at G-3 (discussing Treasury official’s comments on the problems inherent in the innocent spouse provision and noting that the IRS and the Treasury Department plan to address the issue in a joint internal study on the tax treatment of divorced or separated taxpayers). But see Wiksell v. Commissioner, 90 F.3d 1459, 1463 (9th Cir. 1996) (affirming tax court’s finding that taxpayer had reason to know of substantial understatement of tax, but apportioning relief on grounds that an inequitable result would be produced otherwise because a spouse would be denied relief altogether “if culpability can be shown even as to a minute portion of the understatement”); Huelsman, 416 F.2d at 480-81 (“We are not convinced . . . that the statute is so inflexible that an innocent wife who has been victimized by a dishonest husband must be subjected to an additional appallingly harsh penalty by the United States Government.”).

250. To qualify for such relief, the spouse must prove (1) that there was a joint return filed for the taxable year in question, (2) that there was a substantial understatement of tax (greater than $500) attributable to grossly erroneous items of one spouse, (3) that the other spouse, in signing the return, did not know or have reason
A further complicating factor in *Bowcut* should have been the issue of diligence, which, again, the court raised but summarily dismissed. What the court did not discuss was the fact that for more than two years prior to the expiration of the estate tax statute of limitations, the surviving spouse/fiduciary had been dealing directly with the IRS on the issues of the income tax deficiency, the fraud, and the additions to tax.\(^2\)\(^5\)\(^1\) Thus, the five-week window period, that the court considered unimportant to the application of recoupment,\(^2\)\(^5\)\(^2\) should not have been the reference period for the consideration of the taxpayer's lack of diligence. Indeed, the revenue agent handling the case had advised both the taxpayer's attorney and her accountant to file a protective claim for refund of the estate tax overpayment before the estate tax statute of limitations expired.\(^2\)\(^5\)\(^3\) The taxpayer failed to heed this advice, however.

Given the fact that *McEachern* was probably not a recoupment case at all, because the remedy did not apply and was never mentioned by the Court, Professor Andrews is correct in noting that recoupment seems to apply only in cases of two different types of taxes imposed under inconsistent theories. But the established elements raise several general problems for the application of the remedy. First, while the two tax theory provides a neat, concise test, it obscures what should be the main thrust of the remedy—a consideration of the equities. Recoupment is, after all, an equitable remedy. Second, it delegates recoupment to the status of a legal or quasi-legal remedy if it applies automatically without a consideration of the equities. Third, it allows no consideration of the effect of equitable defenses such as laches and unclean hands. Thus, this author is of the opinion that the two tax effect should not be considered a leading indicator of the application of recoupment, but rather, a relatively inconsequential element of the recoupment cases.

IV. EQUITABLE RECOUPMENT UNDER PROPOSED NEW ELEMENTS

*Butl* was a cutting-edge decision, providing a flexible equitable remedy to alleviate the inequity that would result from a strict adherence to the law. Indeed, the hallmarks of equity are flexibility and fair-

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251. The taxpayer and her accountant first met with the revenue agent on May 21, 1954 to discuss the proposed income tax deficiency. *Bowcut v. United States*, 175 F. Supp. 218, 218 (D. Mont. 1959), aff'd, 287 F.2d 654 (9th Cir. 1961). Throughout the next two years the taxpayer had dealings with the IRS on this issue. *Id.* at 218-19.


ness.254 Since the Bull decision, however, lower courts have focused more on artificial elements than on either flexibility or fairness. The true purpose of an equitable remedy is to grant relief when there is no satisfactory legal remedy.255

Historically, statutes of limitation have been overridden by the equitable plea of concealed fraud, which included any “wilful wrongdoing . . . unknown to the plaintiff when it [was] committed.”256 Thus, equity shifted the point at which the statute normally began to run (i.e., when the underlying cause of action arose) to the point at which the plaintiff discovered the wrongdoing. In this manner, equity “sought to make the parties conform to a standard of social conduct prescribed by itself. It operated upon the ‘conscience of the wrongdoer.’”257

A. Is There an Adequate Legal Remedy?

In determining whether the statute of limitations applies directly, the initial inquiry should focus on the point at which the main claim arises. If, at that point, the statute applies, recoupment is not an appropriate remedy.258 This was the case in McEachern. On the other hand, the Supreme Court has clearly stated that as long as the main claim is timely and a single transaction is involved, the defense of recoupment is never barred by the statute of limitations.259

This statement does not mean that recoupment should always be applied when a single transaction is at issue and the main claim is timely. It merely means that the statute of limitations is not a bar to such a remedy. Whether the remedy should apply is a matter of equity and, thus, the facts as a whole must be considered from an equitable perspective.

254. “The essence of equity jurisdiction has been the power of the Chancellor to do equity and to mould each decree to the necessities of the particular case. Flexibility rather than rigidity has distinguished it.” Hecht Co. v. Bowles, 321 U.S. 321, 329 (1944).

255. See George W. Keeton & L.A. Sheridan, Equity 41 (3d ed. 1987) (“Where the rule of law was satisfactory, equity would apply it. Where the rule was defective, or operated harshly, equity would evolve another solution.”).

256. Id. at 107. Ordinarily, the statute of limitations could be tolled by fraudulent concealment at law, but the concealment itself had to have constituted an actionable fraud. The equitable plea of concealed fraud was more flexible. Id.

257. Keeton, supra note 173, at 22.

258. See, e.g., United States v. Tomar Hills, Inc., 783 F.2d 753, 754-55 (8th Cir. 1986) (holding that recoupment does not apply to permit a taxpayer to retain an overpayment mistakenly refunded after the statute of limitations has run); United States v. Gulf Oil Corp., 485 F.2d 331, 333 (3d Cir. 1973) (same). Recoupment should not apply to lift the statutory bar in order to grant relief where the requesting party was remiss. See Rushlight v. United States, 259 F.2d 658, 659 (9th Cir. 1958) (holding that the court is powerless to allow recoupment to taxpayer because contracts at issue were subject to Renegotiation Act), cert. denied, 359 U.S. 952 (1959).

In *McEachern*, the main claim was a refund claim attributable to a statutory overpayment. Recoupment, as an equitable remedy, can apply only to an overpayment on the merits, never to a statutory overpayment. Thus, in *McEachern*, recoupment was barred by direct application of the statute of limitations. This was not the case in *Stone*. In *Stone*, the main claim was a refund action filed by the trustees to recover an amount that had been timely assessed by the IRS. There was no statutory overpayment in *Stone*. Thus, the threshold requirement for the application of recoupment was met.

In *Bull*, the statute of limitations was open when the government initially assessed the estate tax, as well as later when the income tax was assessed. Thus, the statute did not apply directly to bar either assessment. Moreover, in *Bull*, the government, in both instances, was the aggressor. It was attempting to collect a second tax on the same item of income with no consideration either of its earlier mistake or of the fact that, cumulatively, the estate had overpaid its tax liability. Thus, no revenue would be lost if recoupment were allowed.

One of the maxims of equity is that "equity will not suffer a wrong without a remedy." In *Bull*, the government had erred, yet it was attempting to hide behind the statute of limitations and collect a double tax. But for the statute of limitations, the taxpayer would clearly have prevailed. It was also clear that the taxpayer had no other legal remedy. In applying recoupment, the Court stated: "While here the money was taken through mistake without any element of fraud, the unjust retention is immoral and amounts in law to a fraud on the taxpayer's rights."261 Because the estate had clearly been victimized by the government, the Court fashioned a remedy to provide relief to the taxpayer; otherwise, strict adherence to the applicable law would have produced an unfair result.

The application of recoupment has been further complicated by the statutory mitigation provisions.262 These provisions, enacted in 1938 to "supplement the equitable principles" and to take "the profit out of inconsistency,"263 represented a congressional nod to the issues of inequities caused by the operation of the statute of limitations and the inadequacy of the common law remedies.

Mitigation is not a panacea to these problems, nor was it intended to be. The mitigation provisions are cumbersome,264 narrowly con-
strued provisions that apparently apply only to income taxes.265 While an in-depth discussion of the mitigation provisions is beyond the scope of this Article,266 there are some similarities and differences between mitigation and recoupment worth noting. For instance, they both require a single or closely related taxpayer, a single transaction, and an inconsistency arising from a closed taxable year. They differ in two very important respects. First, if mitigation applies, it opens the statute of limitations with respect to the error or item in issue, and provides for an adjustment attributable to that item.267 Thus, mitigation is an independent action, rather than a defense, and it provides a more exact adjustment than recoupment.268 Second, the mitigation provisions are intended to provide more objective criteria to alleviate inequities caused by an operation or rule of law. This does not mean, however, that the mitigation provisions themselves have not fostered some inconsistencies in application.269

For mitigation to apply, a determination270 must be made which requires tax treatment that is inconsistent with that of a previous year.271 Correction of the error in the previous year must be barred by an operation or rule of law.272 In addition, the facts must fit one of the seven circumstances of adjustment described under the Internal Revenue Code.273 Generally, the mitigation provisions are not concerned with the existence of a single transaction; nevertheless, the circum-

mination proceeding. See Esterbrook Pen Co. v. United States, 60-2 U.S. Tax Cas. (CCH) ¶ 9609, at 77,608 (D.N.J. 1960) (holding that refund claim, filed before determination proceeding and pending at the time of the determination, provided adequate notice to the IRS of the grounds for adjustment).

265. There is some disagreement on this point. See Chertkof v. United States, 676 F.2d 984, 993-94 (4th Cir. 1982) (holding that an erroneous stock basis determined as a result of an estate tax misvaluation produced an income tax inconsistency to which the mitigation provisions applied); cf. Hall v. United States, 975 F.2d 722, 726-27 (10th Cir. 1992) (reversing Tax Court's application of mitigation provisions to windfall profit taxes). But it has been persuasively argued that the mitigation provisions apply only to income taxes. See Willis, Limits, supra note 13, at 651-52. But see Hoffman F. Fuller, Finality and Equity in Tax Litigation, 10 Am. J. Tax Pol'y 51, 59-61 (1992) (suggesting that Willis's view is too restrictive).

266. For a discussion of mitigation, see Saltzman, supra note 244, ¶ 5.07.

267. The statute of limitations is treated as remaining open for one year from the date of the determination. Recoupment, on the other hand, "causes a later matter to be equally wrong in the opposite direction;" thus two wrongs make a right. Willis, Limits, supra note 13, at 633.

268. Because of differing tax rates, differing filing status, and the time value of money, recoupment could result in a very imprecise adjustment.

269. See generally Willis, Limits, supra note 13 (discussing the misapplication of mitigation in Chertkof).

270. I.R.C. § 1313(a) (1994). A "determination" is defined as follows: (1) a final decision by the Tax Court or a final judgment, decree, or other order by any court of competent jurisdiction; (2) a § 7121 closing agreement; (3) a final disposition of a claim for refund; or (4) an agreement between the IRS and the taxpayer. Id.


272. Id.

stances of adjustment must necessarily arise from a single transac-

This requirement is more clearly defined under the mitigation
provisions than under the recoupment elements, thus resulting in
fewer inconsistencies with mitigation in determining whether a single
transaction exists.

Regardless of whether the adjustment results in a refund or credit,
on the one hand, or an additional assessment, on the other, an in-
consistent position by the party prevailing in the determination is
required. If the adjustment would produce a refund or credit in the
closed year, the determination must establish that the government
maintained a position inconsistent with the position it maintained in
the closed year. If the adjustment would produce an additional assess-
ment, the determination must establish that the taxpayer maintained
the inconsistent position.

There is currently a conflict among the lower courts as to whether
the inconsistency must be active or whether it may be passive. For
instance, assume a taxpayer erroneously omits an item of income in a
closed year, and the IRS accepts the return. Is this a sufficient incon-
sistency for the IRS to invoke the mitigation provisions if the taxpayer
later files a claim for refund in an open year in which the item was
erroneously included and the refund claim is granted? The better
view, based on the legislative history and the policy rationale behind
the mitigation provisions, is that an active inconsistency is not re-
quired. Thus, in the above example, the taxpayer's passive inconsis-
tency (good faith omission of income) should not prevent the IRS
from using the mitigation provisions to assess a deficiency in the ear-
lier, closed year.

The mitigation adjustment also may be applied to a party other than
the taxpayer who sought the determination if the requisite relation-
ship exists between the two taxpayers. The delineated relationships

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274. See id. Only § 1312(7) refers directly to a transaction, but considering the na-
ture of the other circumstances, they must all involve a single transaction.
276. Compare Chertkof v. Commissioner, 649 F.2d 264, 267 (4th Cir. 1981) (con-
cluding that inconsistency could be established passively through the determination
position urged by party who benefitted) with Brigham v. United States, 470 F.2d 571,
574 (Ct. Cl. 1972) (requiring active inconsistency of Commissioner, based on reading
277. The statute requires only that the position maintained and adopted in the de-
termination must be inconsistent with the erroneous treatment in the closed year, and
that the person in whose favor the determination operates must have derived the
benefit of the erroneous treatment in the closed year. Saltzman, supra note 244, ¶
5.07[2][a][i]. Also, according to Saltzman, the active-inconsistency view fails to con-
sider the purpose of the statute of limitations, which is to bar the litigation of stale
claims. The party who successfully maintained the position adopted in the determina-
tion does not need the protection of the statute, for the evidence should be available,
and not stale, because it has been successfully used in the determination proceeding.
Thus, the normal justification for the statutory bar is removed. Id.
278. I.R.C. § 1313(c) (1994).
are those in which issues of income allocation and determination of the proper taxable party are likely to arise.\textsuperscript{279} The relationship must also have been in existence at certain designated times.\textsuperscript{280}

Because the mitigation provisions apply only in limited situations, they do not supplant recoupment. It is generally agreed, however, that they do preempt the application of recoupment where the facts fit one of the seven circumstances of adjustment, even if mitigation does not otherwise apply.\textsuperscript{281}

Although several commentators have suggested that the solution to the problem is for Congress to extend the mitigation provisions to cover some of the recoupment scenarios,\textsuperscript{282} this is easier said than done. First, the mitigation provisions are very complex—so complex that mitigation opportunities are frequently missed.\textsuperscript{283} Second, the provisions are sometimes very narrowly construed, thus resulting in inconsistencies.\textsuperscript{284} Third, there is a benefit to having a more flexible remedy in which the equities (or inequities) of the situation may be considered. Particularly if the Tax Court changes its view with respect to its equity jurisdiction,\textsuperscript{285} many of the recoupment problems may be alleviated without resorting to legislation that ultimately may lead to a more rigid, inflexible remedy.

\begin{footnotesize}
\begin{enumerate}
\item Saltzman, \textit{supra} note 244, § 5.07[4].
\item See I.R.C. § 1313(c) (1994) (providing that, when the government requests mitigation for erroneous tax treatment, the relationship must have been in existence during the time the taxpayer's inconsistent position was first maintained).
\item See, \textit{e.g.}, Brigham v. United States, 470 F.2d 571, 577 (Ct. Cl. 1972) (holding that recoupment could not apply because the case fell within § 1312, although mitigation did not apply either because the Commissioner had failed to maintain an inconsistent position), \textit{cert. denied}, 414 U.S. 831 (1973); Benenson v. United States, 385 F.2d 26, 34 (2d Cir. 1967) (acknowledging that the mitigation procedure would be long and costly and noting that "once a situation is arguably covered by the mitigation provisions it is likely that Congress intended that the situation be remedied exclusively under those provisions"); Gooding v. United States, 326 F.2d 988, 995-96 (Ct. Cl.) (stating that mitigation provisions supersede any common law recoupment remedies, including those issues which mitigation technically does not cover), \textit{cert. denied}, 379 U.S. 834 (1964). Because § 1314(c) provides that the mitigation adjustment shall not be diminished by any setoff other than "the one which was the subject of the adjustment," any \textit{Lewis v. Reynolds} offset is also preempted by the mitigation provisions. First Nat'l Bank v. United States, 565 F.2d 507, 518 (8th Cir. 1977).
\item See, \textit{e.g.}, Fuller, \textit{supra} note 265, at 70 ("[T]he statutory mitigation provisions . . . should be expanded to cover inconsistencies other than those of income tax determinations alone."); Willis, \textit{Limitis, supra} note 13, at 661 ("Congress should either amend the present mitigation provisions or write new ones to allow reopening of barred returns affected by inconsistent estate tax and income tax treatment.").
\item See Steven J. Willis, \textit{The Tax Benefit Rule: A Different View and a Unified Theory of Error Correction}, 42 Fla. L. Rev. 575, 615-18 (1990) (postulating that the mitigation provisions should have applied in some cases decided under a tax benefit theory).
\item See \textit{id.}; \textit{see also supra} text accompanying note 269 (stating that the mitigation provisions have fostered some inconsistencies in application).
\item See \textit{infra} part VI.B.
\end{enumerate}
\end{footnotesize}
B. Is There an Inconsistent Theory of Taxation, as a Matter of Law, by the Opposing Party on a Single Transaction Producing a Double Tax, or a Double Benefit, on the Same Dollars?

If the statute of limitations does not preclude the application of recoupment, the next inquiry should be whether there is an inconsistency, as a matter of law (as opposed to fact), relating to a single transaction involving the same elements of proof. The purpose of this element is twofold: (1) to avoid multiplicity of action by ensuring that the matter is capable of resolution without raising new issues of proof (i.e., because recoupment is a defense to the main claim, the party raising the main claim cannot be prejudiced by lapse of memory or lack of records from the earlier year) and (2) to further preserve the integrity of the statute of limitations by ensuring that mistakes of fact fall outside recoupment (as should fraud).

1. Inconsistency

The purpose of recoupment is not to provide a means to correct all mistakes or inconsistencies that arise after the expiration of the statutory period. That would denigrate the statute of limitations. Instead, its purpose is to provide protection against an offensive use of the statute of limitations that would produce an inequity tantamount to a fraud. Thus, where the opposing party asserts an inconsistent position and then seeks to use the statute of limitations to prevent any correction of the inconsistency, as in Bull, recoupment is an appropriate remedy. The remedy is not appropriate, however, where there is no inconsistency or where the inconsistency arises from a defensive use

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286. See, e.g., Gindes v. United States, 661 F.2d 194, 202 (Ct. Cl. 1981) (holding that recoupment was not available to taxpayer because there was no inconsistency, merely bad choice by the taxpayer); Minskoff v. United States, 349 F. Supp. 1146, 1149 (S.D.N.Y. 1972) (holding that the “doctrine of equitable recoupment is available only when a litigant seeks to take advantage of inconsistent legal theories,” not to correct erroneous factual matters), affd, 490 F.2d 1283 (2d Cir. 1974).

287. It further ensures good faith by the requesting party, which is more difficult to monitor when dealing with a mistake of fact.

288. See Kolom v. United States, 791 F.2d 762, 766-67 (9th Cir. 1986) (“The doctrine of equitable recoupment prevents unjust enrichment—it is invoked either by the taxpayer to recover a twice paid tax or by the Government to prohibit tax avoidance.”).

289. See, e.g., United States v. Tomar Hills, Inc., 783 F.2d 753, 755 (8th Cir. 1986) (holding that refund granted in error after expiration of statute of limitations is not an appropriate case for recoupment); Gindes, 661 F.2d at 202 (concluding that there was no inconsistency between the failure to make an election and inclusion of income in the estate); Minskoff, 490 F.2d at 1285 (holding that income tax deficiency was properly attributable to pre-death income and did not produce estate tax overpayment). But see Priv. Ltr. Rul. 82-10-004 (Apr. 28, 1980) (ruling that the major purpose of recoupment is to avoid inequitable results and stating that it has “never been thought that equitable recoupment applies only in situations in which the opposing party has taken inconsistent positions”); cf. Priv. Ltr. Rul. 90-36-002 (May 18, 1990) (holding
of the statute of limitations, such as where the party requesting recoupment asserted or otherwise brought about the inconsistent position. Similarly, where the party requesting recoupment fails to take steps to protect itself, recoupment is not an appropriate remedy.

The test should be whether the case would have been an appropriate one for the application of estoppel, if estoppel applied to inconsistencies as a matter of law. If the answer is yes, then recoupment should apply.

2. Single Transaction

By definition, the inconsistency must arise from a single transaction. If not, there is no ground for asserting that the opposing party has taken an inconsistent position. Thus, the focus of the single transaction requirement should be on whether the taxpayer is double taxed, or has received a double benefit on the same dollars. In practice, however, the single transaction element has caused the most confusion. In some instances, the determination of whether two events constitute a single transaction may be a relatively easy one, but in other instances it is not so simple. One problem is that courts often apply very narrow, restrictive tests to determine the existence of a single transaction, rather than to examine the tax consequences from the

that, although double tax was imposed on a single transaction, the initial tax was attributable to taxpayer's error and therefore there was no inconsistency against which to recoup the overpayment.

290. See Kramer v. United States, 406 F.2d 1363, 1371 (Ct. Cl. 1969) (precluding government from offsetting estate tax overpayment with widow's barred income tax deficiency, although case was decided on basis of lack of identity of interest).

291. See, e.g., Estate of Mann v. United States, 731 F.2d 267, 279 (5th Cir. 1984) (stating that government failed to protect itself against seven-year statute of limitations on bad debts, thereby barring recoupment; nature and size of estate indicated that this was not a mere acceptance of a return by the government); Kellogg-Citizens Nat'l Bank v. United States, 330 F.2d 635, 640 (Ct. Cl. 1964) (holding that there was no reason to extend the normal limitations period because plaintiff failed to file a protective refund claim within the statutory period). Note that Mann was decided on the basis of the failure of the single transaction element.

292. The mere relation of items has been determined to be insufficient to support a claim of recoupment. See, e.g., Mills v. United States, 35 F. Supp. 738, 739 (N.D.N.Y. 1940) ("The doctrine of recoupment is not limited to a claim arising directly from the particular contract sued upon. It is sufficient if it arises out of the same subject matter, and that the claims are susceptible of adjustment in one action."); Priv. Ltr. Rul. 93-11-002 (Oct. 28, 1992) (ruling that, despite the disallowance of depreciation deductions that caused corresponding overpayment of income tax on sale of property, the deficiency and overpayment did not arise from the same transaction).

293. See, e.g., Wilmington Trust Co. v. United States, 610 F.2d 703, 714 (Ct. Cl. 1979) ("As the decided cases show, there is no litmus paper test for determining whether two tax claims arose out of the same transaction. Some cases clearly are within that category, and some cases clearly are without it."); Pond's Extract Co. v. United States, 134 F. Supp. 476, 479 (Ct. Cl. 1955) (stating that the "task of distinguishing between factual situations that warrant the application of equitable recoupment in tax cases is admittedly a difficult one, and the distinction when made in some cases will be a tenuous one").
standpoint of double tax or double benefit. When the important initial determination rests on a technical issue upon which reasonable minds may differ, inconsistency is likely to result.294

Much of the confusion has been generated by the Supreme Court because in discussing the single transaction element, the Court has used the terms “transaction” and “taxable event” interchangeably.295 In addition, commentators have used the term “item.”296 But there has been no attempt to define these specific terms. An examination of the various situations in which the issue of recoupment has arisen reveals that the definition of the applied term may have a bearing on the outcome. For instance, the term “transaction” includes the act of conducting business, which encompasses sales, leases, mortgages, lending, and borrowing.297 A “taxable event” is a realization of taxable income, a severance of income from capital.298 Usually the precipitating event is a disposition of property, such as a sale or exchange.299 The term “item” implies a part of a whole.300 Because of the understandable confusion generated over the use of these terms, some courts have interpreted them very narrowly,301 while others have misunderstood them entirely. For instance, there are some situations that do not fall within the scope of the element, such as a depreciation

294. Compare United States v. Herring, 240 F.2d 225, 228 (4th Cir. 1957) (granting the taxpayer’s request for recoupment of income tax against barred estate tax, noting that government made two claims against monies held by the estate and that it is impossible to determine the amount of the estate tax without adjusting the deduction caused by the income tax) with Kojes v. United States, 241 F. Supp. 762, 765 n.11 (E.D.N.Y. 1965) (reaching a result opposite to Herring, concluding that it is not obligated to follow it).

295. See Rothensies v. Electric Storage Battery Co., 329 U.S. 296, 300 (1946) (discussing “single transaction or taxable event”). In addition, the Court has used the term “single error.” Stone v. White, 301 U.S. 532, 537 (1937).

296. See, e.g., Andrews, supra note 13, at 613.


299. See id. (holding that mere appreciation in value of property is not taxable).

300. The term is defined as “[o]ne of the portions, equal or unequal, into which anything is divided, or regarded as divided. . . . A separate entry in an account or a schedule, or a separate particular in an enumeration of a total.” Black’s Law Dictionary, supra note 297, at 832.

The definition was addressed in the mitigation case of Gardiner v. United States, 536 F.2d 903 (10th Cir. 1976), where the Tenth Circuit stated:

The meaning of an item of gross income is, under Section 61 of the 1954 Code, limited to specific items and does not include everything that results in an increase in tax. It is restricted to positive items and does not include negative elements such as deductions (like depreciation), the omission of which results in increased taxes.

Id. at 906.

301. See, e.g., Estate of Mann v. United States, 552 F. Supp. 1132, 1141-42 (N.D. Tex. 1982) (holding that income tax refund and corresponding estate tax deficiency were not part of same transaction), aff’d, 731 F.2d 267 (5th Cir. 1984); Twitchco, Inc. v. United States, 348 F. Supp. 330, 337 (M.D. Ala. 1972) (holding that, despite double tax benefit on single piece of property, the sale was not the same transaction as the purchase).
miscalculation, or an inventory misvaluation. While a mistake in deprecation deductions and inventory valuation may have a direct and automatic effect on another taxable year, the question is whether such mistakes amount to “transactions” or “taxable events.”

Both terms imply a single, discrete event, rather than an event that is spread out over an entire taxable year or beyond. Events that affect an entire taxable year should be confined to that taxable year. Thus, one year’s depreciation deductions cannot be offset by another year’s depreciation deductions. Moreover, depreciation deductions and inventory valuations do not, in themselves, constitute transactions. Rather, they are the by-products of transactions. While the ending value of inventory in one taxable year will directly determine the beginning value in the next taxable year, the valuation itself is not a transaction. Thus, the misvaluation of inventory should not be an appropriate circumstance for the application of recoupment.

According to Professor Andrews, the test should be whether two taxes operate interdependently such that if one tax is applicable the other is not, thereby automatically producing, or resulting in, the...

302. See Dixie Margarine Co. v. Commissioner, 115 F.2d 445, 447 (6th Cir. 1940), review dismissed, 127 F.2d 292 (6th Cir. 1942). In Dixie Margarine, a corporate taxpayer paid license and stamp taxes for taxable years 1923-31 under the Oleomargarine Act. Subsequent judicial decisions established that the taxpayer was not subject to this tax, so the taxpayer filed a claim for refund. The government granted refunds for the open years but disallowed the taxpayer’s claims for taxable years 1923-31 because these years were closed. The government then assessed a deficiency against the taxpayer in 1932, on the ground that the refund constituted income in the year received under the tax benefit doctrine. The taxpayer argued that it should be allowed to recoup the barred tax against the open deficiency. The court held for the taxpayer, noting that “[t]he same transaction does not necessarily mean occurring at the same time.” Id. (quoting United States v. National City Bank, 83 F.2d 236, 239 (2d Cir.), cert. denied, 299 U.S. 563 (1936)). The court went on to note that “the transaction may comprehend a series of many occurrences depending not so much upon the immediateness of their connection as upon their logical relationship.” Id. (quoting National City Bank, 83 F.2d at 239 (citing Moore v. New York Cotton Exch., 270 U.S. 593, 610 (1926))).

The court in Dixie Margarine was wrong in its analysis, however. The tax benefit rule produced a deficiency in the year the refund was received because the refund represented the return of a tax benefit attributable to the years of receipt. The earlier, barred years had nothing to do with the years attributable to the refund. The only logical connection was that the same type of tax was paid in each of those years. But because each taxable year stands alone, the earlier excise tax payments did not constitute a single transaction with respect to the later payments.


304. The Supreme Court disallowed recoupment in such a situation, but for jurisdictional reasons. The Court never addressed the issue of whether the single transaction requirement had been met. See Commissioner v. Gooch Milling & Elevator Co., 320 U.S. 418, 421 (1943). But see Crossett Lumber Co. v. United States, 87 F.2d 930, 933 (8th Cir. 1937) (allowing government to recoup erroneous refund credit for one taxable year against an overpayment for succeeding taxable year where both items arose from single erroneous inventory adjustment).
barred claim if both taxes apply.\textsuperscript{305} The beauty of such a test is that it is simple both to state and to apply. The problem with the test is that it has not alleviated the confusion generated over the single transaction element because courts continue to adhere to unreasonably strict definitions of the term "transaction."

Much of the problem lies in interpreting the single transaction requirement by focusing on the tax consequences, rather than on the actual transaction.\textsuperscript{306} This was a mistake made by the Court of Claims in Wilmington Trust.\textsuperscript{307} The court was not specific in its reasoning why the timber sale and the deductions generated from it did not constitute a single transaction. Clearly, the precipitating transaction for the first taxable event was the timber sale. This sale generated both taxable income and deductible expenses. The government’s disallowance of the expense deductions directly produced an income tax deficiency, the payment of which had a direct effect on the estate tax. Thus, the lowering of the estate tax liability was directly related to the income tax deficiency, which stemmed from the disallowance of the deductions attributable to the timber sale transaction.

When the court determined that the taxpayer was correct initially, the statute of limitations on the income tax refund claim was still open, but the estate tax deficiency was closed. While the result in Wilmington Trust is arguably correct,\textsuperscript{308} it is not because of the failure of the single transaction requirement.

Perhaps a complicating factor in Wilmington Trust was that there was more than one taxpayer involved: the decedent who made the sale and deducted the expenses against ordinary income, and the estate that was the beneficiary of the refund. But there was an identity of interest between the two, similar to that in Stone, so on this ground as well, the Wilmington Trust result is unwarranted under the established elements.

\textsuperscript{305} See Andrews, supra note 13, at 627, 630. Andrews’s view is inapposite to the position of the Court of Claims and the Northern District of Texas, affirmed by the Fifth Circuit. See Wilmington Trust Co. v. United States, 610 F.2d 703, 714 (Cl. Cl. 1979) (stating that the “fact that a single tax determination may affect the taxes on two transactions does not convert the two transactions into a single one”); Estate of Mann, 552 F. Supp. at 1141 (“[I]f the government were granted relief in this case [where a refund to plaintiff affected both the income tax and the estate tax], it would be entitled to equitable recoupment in every case in which the estate of a deceased taxpayer is successful in a tax refund suit.” (emphasis omitted)).

\textsuperscript{306} See Rev. Rul. 55-226, 1955-1 C.B. 469, 470 (determining that IRS lacked authority to apply equitable recoupment to open pre-death income tax liabilities of a decedent with closed federal estate tax overpayment because such a situation did not satisfy the single transaction requirement), revoked by Rev. Rul. 71-56, 1971-1 C.B. 404, 405.

\textsuperscript{307} For a full discussion of Wilmington Trust, see supra part III.A.2.

\textsuperscript{308} See supra text accompanying notes 219-27.
3. Identity of Interest

Since Stone, the courts have been relatively strict in requiring an absolute identity of interest between the parties against whom the inconsistent position was taken and those who stood to benefit from the recoupment. The degree to which the courts will delve into the facts in determining the absolute identity, however, is unclear. For instance, where the inconsistency is asserted against two related estates, and the recoupment will benefit the beneficiaries of those estates, it is unclear whether the courts will require absolute identity of interest, or whether they may permit some deviation attributable to changed circumstances, such as births, deaths, marriages, and divorces. At least one court has implied that an absolute identity of interest is not required.

The precise relationship that constitutes an identity of interest has never been defined. The government has argued that Stone should be interpreted as requiring a relationship of representative capacity. This argument has been rejected, however, in favor of a determination of whether a "benefit to one taxpayer inures to the benefit of the other taxpayer only." If so, there is an identity of interest.

C. Does a Consideration of the Equities Favor the Application of Recoupment?

Recoupment is based on principles of natural law, which require an examination of the facts as a whole in order to determine whether a claim should be "denounce[d] ... as unjust, immoral, and fraudulent when the claimant is at the same time wrongfully withholding money which in equity belongs to the other party." Thus, the position of

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309. See, e.g., Kramer v. United States, 406 F.2d 1363, 1371 (Ct. Cl. 1969) (finding insufficient identity of interest between widow and estate with multiple beneficiaries); Schlemmer v. United States, 94 F.2d 77, 78 (2d Cir. 1938) (finding no identity of interest between individual and closely held corporation); Sewell v. United States, 19 F. Supp. 657, 663 (Ct. Cl. 1937) (finding insufficient identity of interest between income beneficiaries and remainderman).
310. Estate of Vitt v. United States, 706 F.2d 871, 875 (8th Cir. 1983).
311. See id. at 875 n.3 ("W[e] believe sufficient identity of interest has been demonstrated. In substance, the same parties detrimentally affected by the overpayment will receive the proceeds from recoupment." (emphasis added)).
312. See Hufbauer v. United States, 297 F. Supp. 247, 250 (S.D. Cal. 1968) (considering government's argument that taxpayer was not entitled to recoupment because relationship of sole proprietor to sole shareholder of corporation was not representative relationship).
313. Id. at 251.
314. Crossett Lumber Co. v. United States, 87 F.2d 930, 932 (8th Cir. 1937). This opinion goes on to state: An action to recover taxes is in the nature of an action for money had and received. Although in form it is an action at law, it is governed by equitable principles. In such an action a plaintiff cannot recover unless he can show that in equity and good conscience he is entitled, as against the defendant, to the money. Such an action "aims at the abstract justice of the case, and
each party should be scrutinized from the perspective of equity and of what is moral, just, and nonfraudulent. In Bull, for example, the Supreme Court hinted that not every case involving a single transaction would give rise to recoupment, only those in which "the unjust retention is immoral and amounts in law to a fraud on the taxpayer's rights."\(^{315}\)

Recoupment is, thus, an extraordinary remedy that should be applied only in cases in which it is inequitable to allow the statute of limitations to be used as a shield.\(^{316}\) A careful examination of the important public policy considerations behind the statute of limitations reveals that the statute is defensive in nature. Where it is used as an offensive weapon, such use is inappropriate and should not be condoned by the courts. But where one party attempts to take advantage of the statute of limitations in order to obtain a double benefit on a single transaction under inconsistent legal theories, the result, almost by definition, is an immoral, unjust retention amounting to a fraud on the other party's rights.

The important issues in determining whether recoupment applies should be whether one party is unjustly enriched and whether the opposing party is overly burdened.\(^{317}\) For instance, there is generally a cost to inconsistent tax treatment. If the taxpayer is the inconsistent claimant, and recoupment is not applied in favor of the government, the taxpayer will be unjustly enriched at the expense of the government.\(^{318}\) The taxpaying public will have to bear the loss, even though the loss may be relatively small in an individual case. Conversely, if the government is the inconsistent claimant, and recoupment is not applied, the government will then be unjustly enriched at the expense of the taxpayer. On a more general level, the public may perceive the voluntary tax system as unfair.

In general, where there is a double tax liability or a double tax avoidance on the same item attributable to a single transaction, the

looks solely to the inquiry, whether the defendant holds money, which ex aequo et bono belongs to the plaintiff."

Id. (citations omitted) (quoting Claflin v. Godfrey, 38 Mass. (21 Pick.) 1, 6 (1838)).


316. In most of the recoupment cases, the courts refer to unjust enrichment. However, unjust enrichment alone should not be sufficient to avoid the statute of limitations. It has been suggested that the important factors to consider in determining whether recoupment should apply are "the avoidance of multiplicity of suits, the avoidance of circuity of action, and the doing of complete justice in one action." McConnell, supra note 7, at 597.

317. See Kolom v. United States, 791 F.2d 762, 766-67 (9th Cir. 1986) ("The doctrine of equitable recoupment prevents unjust enrichment....") (footnote omitted)).

318. Cf. Fisher v. Commissioner, 108 F.2d 707, 709 (6th Cir. 1939) (denying taxpayer remedy of recoupment on grounds that taxpayer took inconsistent positions and noting that recoupment is a claim in the nature of a refund which "should likewise not be allowed to create an unjust enrichment in favor of the taxpayer at the expense of the Government"), cert. denied, 310 U.S. 627 (1940).
potential for unjust enrichment is great. The equities are not as strong, however, where the double tax or double benefit is attributable to a mistake on the part of the requesting party.\footnote{319}{See Kolom, 791 F.2d at 768 (denying recoupment to government who had audited taxpayer's return for year in question and did not raise issue of inclusion); O'Brien v. United States, 766 F.2d 1038, 1049 (7th Cir. 1985) (denying recoupment to taxpayer who made mistake in valuing stock in gross estate and later made another mistake when the stock was sold and gain was taxed using the lower basis). \textit{But see} Mills v. United States, 35 F. Supp. 738, 740 (N.D.N.Y. 1940) (allowing taxpayer to recoup barred overpayment against open deficiency even though taxpayer's error caused the overpayment and noting also that government could not escape responsibility).} In other words, for the equities to favor recoupment, either the opposing (nonrequesting) party must be the aggressor, as was the case in \textit{Bull}, or the unjust enrichment element must be strong and the party requesting recoupment must have acted in good faith.\footnote{320}{See Hufbauer v. United States, 297 F. Supp. 247, 251-52 (S.D. Cal. 1968) (finding for taxpayer and noting that, although taxpayer's error created the situation, unlike in \textit{Bull} and \textit{Stone}, the equities favored the application of recoupment because otherwise the government would be unjustly enriched); \textit{see also} Priv. Ltr. Rul. 84-41-003 (June 6, 1984) (discussing elements of recoupment and noting that "the party seeking equitable relief from the statute of limitations must not be unjustly enriched").}

Because of the important policy rationale behind the statute of limitations, the remedy of recoupment should not be lightly applied. In considering the public interests, an examination of the facts as a whole should determine what is fair under all the circumstances. Furthermore, an equitable remedy should be individualized according to both the specific facts and the party seeking equitable relief.

But most of the cases in which recoupment has been denied have involved a failure of the single transaction element. The few reported cases in which the courts have held that the single transaction element was satisfied, but nevertheless denied the remedy, have usually involved a failure of the identity of interest requirement.\footnote{321}{See, \textit{e.g.}, Kramer v. United States, 406 F.2d 1363, 1370-71 (Ct. Cl. 1969) (denying recoupment to the government due to failure of identity of interest requirement); Smith v. United States, 373 F.2d 419, 422 (4th Cir. 1966) (denying recoupment to the government on facts similar to \textit{Stone} on ground that beneficiary had only a limited interest in the trust and to hold for the government would prejudice the remainderman).} In no reported cases in which these two elements have been met has an equitable defense prevented the application of the remedy.\footnote{322}{In fact, some courts have remarked on the failure of the equitable defenses. \textit{See, \textit{e.g.}}, Holzer v. United States, 250 F. Supp. 875, 878 (E.D. Wis.) (stating that laches is not a defense to a claim for equitable recoupment), \textit{aff'd per curiam}, 367 F.2d 822 (7th Cir. 1966); United States v. Bowcut, 287 F.2d 654, 657 (9th Cir. 1961) ("It is apparently not the diligence of the taxpayer as to his legal rights which controls . . . ."). In \textit{Dalm} the remedy was denied on jurisdictional grounds. \textit{See infra} part VI.A.} This is curious in light of the fact that recoupment is, after all, an equitable defense.
remedy. It is also curious in light of the fact that the Supreme Court appeared to decide *Rothensies* on the basis of laches. 323

1. Unjust Enrichment

Recoupment was not intended to cure inadvertence or to provide a second opportunity for either the taxpayer or the government to correct mistakes that would otherwise become permanent because of the lapse of time. Instead, it is anticipated that occasional injustices will occur because of the lapse of the statute of limitations. 324 Thus, recoupment was intended to be an extraordinary remedy to be applied only in extraordinary circumstances where the situation as a whole warrants its application.

Because of the public policy considerations behind the statute of limitations, the term "unjust enrichment," in the recoupment sense, should imply more than a mere passive retention by one party of money that, technically, does not belong to it. It should also require some egregious, affirmative misconduct by that party, such as an aggressive use of the statute of limitations to retain money that does not belong to it. It should also require that the party requesting recoupment have engaged in some self-help, rather than sitting by passively while the statute ran. 325 A good case on point, from the government's perspective, is *Stone*. There, a change in the case law resulted in the government's being whipsawed when the taxpayer attempted to take unfair advantage of the statute of limitations, even though the government had taken every conceivable step to protect itself. If the party seeking recoupment fails to do something it ought to have done, the equities do not lie with that party. 326 From the taxpayer's perspective,

323. See *Rothensies v. Electric Storage Battery Co.*, 329 U.S. 296, 303 (1946) ("We cannot approve such encroachments on the policy of the statute out of consideration for a taxpayer who for many years failed to file or prosecute its refund claim."); see also *Boyle v. United States*, 355 F.2d 233, 236-37 (3d Cir. 1965) (distinguishing *Rothensies* as a laches case).

324. The Supreme Court made note of this fact in *Rothensies*: "[Statutes of limitations] are by definition arbitrary, and their operation does not discriminate between the just and the unjust claim, or the voidable [avoidable] and unavoidable delay." 329 U.S. at 301 (quoting *Chase Sec. Corp. v. Donaldson*, 325 U.S. 304, 314 (1945)).

325. See, e.g., *Kellogg-Citizens Nat'l Bank v. United States*, 330 F.2d 635, 639 (Ct. Cl. 1964) (considering taxpayer's request for relief based on recoupment-like principle, but denying such relief because taxpayer failed to act for 10 months and allowed statute to run without filing protective refund claim), *Holzer*, 250 F. Supp. at 878 ("Refund of overpayment of estate tax was barred in the instant case because taxpayers, on learning of events which would likely occasion a decrease of estate tax liability, failed to file timely protective claim which would have preserved the right to refund."); *cf. Lyeth v. Hoey*, 112 F.2d 4, 8 (2d Cir. 1940) (rejecting government's argument that it should be allowed to recoup barred estate tax deficiency against open income tax overpayment under *McEachern* because the estate tax claim was open when the income tax refund claim was filed).

326. See *Minskoff v. United States*, 349 F. Supp. 1146, 1150 (S.D.N.Y. 1972) (stating that, in failing to report income which should have been reported, the "equities do not
a case on point is *Bull*, where the taxpayer challenged the government's characterization of includable income, but was whipsawed nonetheless by the statute of limitations.\(^\text{327}\)

To test these theories, reconsider *Wilmington Trust*. There, the government was the requesting party. There was no egregious conduct on the part of the taxpayer. Instead, the government initially erred in categorizing the taxpayer's expenses as nondeductible and in assessing an additional income tax. The taxpayer acted in complete good faith.

On the other hand, the government had ample opportunity to examine the facts and reach the correct conclusion. The fact that the government guessed wrong and allowed the statute of limitations to expire should not skew the equities in its favor, even though the single transaction element should technically have been met. Thus, *Wilmington Trust* is not analogous to *Bull* where the inequity compelled the remedy, for in *Wilmington Trust*, the government's own mistake did not constitute a "fraud on [its] rights."\(^\text{328}\) Therefore, the *Wilmington Trust* decision was a correct one, although the reasoning of the court was wrong.

Consider also the case of *Boyle v. United States*,\(^\text{329}\) in which an estate received poor advice from its accountant, resulting in the inclusion in the gross estate of an accumulated, undistributed dividend on which the estate paid an estate tax. Both the estate tax return and the tax were accepted by the government. Later, when the dividend was distributed to the beneficiaries, they excluded it from their taxable income in good faith because of the prior inclusion in the estate. After the expiration of the statute of limitations for filing a claim for refund of the estate tax, the government assessed an income tax deficiency against the beneficiaries. The beneficiaries then filed suit for refund in the district court alleging that they did not owe the income tax liability, or in the alternative, requesting recoupment of the estate tax overpayment.\(^\text{330}\)

The court held for the government on both the issues of liability and recoupment. The taxpayers then appealed. The appellate court upheld the district court's decision on the issue of liability, but it overruled the district court with respect to recoupment, holding that

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\(^{327}\) See also *Evans Trust v. United States*, 462 F.2d 521, 526 (Ct. Cl. 1972) (holding that equitable recoupment was not available to the taxpayer when no deficiency existed and taxpayer failed to raise the issue of recoupment during the settlement conference); *Dunigan v. United States*, 23 F. Supp. 467, 470-71 (Ct. Cl. 1938) (granting recoupment to taxpayer because taxpayer had reserved a right to an adjustment prior to the expiration of the statute, which amounted to a counterdemand by the taxpayer which the government did not honor).


\(^{329}\) 355 F.2d 233 (3d Cir. 1965).

recoupment was warranted because the facts of the case were similar to those of *Bull.*\(^3\) But in *Bull,* the government took an aggressive position which it later controverted to the detriment of the taxpayer, without considering the fact that its mistake caused the taxpayer to be double taxed. *Boyle* involved a good faith mistake by the estate, and a passive acceptance of the estate tax return by the government. In *Boyle,* the government did not take an aggressive position before the statute expired. Moreover, as the court noted, the taxpayers' conduct was "undeniably exemplary,"\(^3\) yet they were double taxed. The court further noted that the government's "insistence on form over substance" was "not in vindication of a basic principle that should be rigidly enforced."\(^3\) Nevertheless, the government's actions did not amount to a fraud upon the taxpayer's rights in the aggressive sense of *Bull,* although *Boyle* was similar to *Bull* in that the government was unwilling to consider the fact that the taxpayers had overpaid their tax liability with respect to this dividend.

2. **Is There a Defense to the Application of the Remedy?**

If the equities favor the application of recoupment, the final consideration should be whether there is any defense to that application. Because recoupment is an equitable remedy, the equitable defenses such as laches and unclean hands should be considered.

a. **Laches**

Statutes of limitations are creatures of law, not equity, although equity considers delay in determining whether the sought-after relief should be granted.\(^3\) While the statute of limitations considers the objective passage of time, equity is more flexible in that it also considers the effect of the delay as a whole and whether the delay was prejudicial.\(^3\) In equity, there are two important considerations in

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331. *Boyle,* 355 F.2d at 235.
332. *Id.* at 237.
333. *Id.*
334. See McClintock, *supra* note 31, at 74-75. In considering the effect vel non of a delay, courts often take the statute of limitations into account as a measuring point of unreasonable delay, *Id.* at 74 n.33; see also Pa. Note, *supra* note 44, at 346 (describing modern trend to defer to the statute of limitations). A delay could, however, also result in the inapplicability of an equitable remedy prior to the expiration of the statute of limitations. George L. Clark, *Equity* 46-47 (1954); de Funiak, *supra* note 31, at 47-48.
335. See, e.g., Jicarilla Apache Tribe v. Andrus, 687 F.2d 1324, 1337 (10th Cir. 1982) ("Laches will bar relief 'only where the enforcement of the asserted right would work injustice.'" (quoting Hoehn v. Crews, 144 F.2d 665, 671 (10th Cir. 1944), *affd* on other grounds, 324 U.S. 200 (1945))); Kellogg-Citizens Nat'l Bank v. United States, 330 F.2d 635, 640 (Cl. Cl. 1964) ("[S]ince the plaintiff-estate had adequate time, after receiving the deficiency notices (on the income taxes), in which to file a protective claim for refund of the estate tax before the normal limitations period ended, the estate is now precluded by its failure to take that step.").
determining the effect of a delay: its length\textsuperscript{336} and the conduct of the parties in the interim. With regard to the latter consideration, it must be determined whether this conduct “might affect either party and cause a balance of justice or injustice in taking the one course or the other, so far as relates to the remedy.”\textsuperscript{337} An examination of the conduct of the parties will involve a consideration of fault and whether one party purposely delayed in order to gain an unfair advantage over the other party. If there is no purposeful delay, the inquiry should focus on whether the party against whom laches is asserted, usually the plaintiff, was diligent in asserting her rights.\textsuperscript{338} If the party was diligent, the defense of laches should not apply against her.\textsuperscript{339} In \textit{Bull}, the executor had a one-month period in which to file a protective claim for refund before the statute of limitations expired.\textsuperscript{340} This delay was obviously not purposeful because the estate was thereby disadvantaged. The paramount question should be whether the executor was diligent in asserting the rights of the estate.

Lower courts and some commentators have interpreted the Supreme Court’s silence on this issue to mean that laches is not a defense to recoupment.\textsuperscript{341} Laches, however, involves more than a mere lapse of time. The reasonableness of the situation as a whole must be considered in light of the time lapse. Thus, “laches must be determined in light of the particular remedy fashioned.”\textsuperscript{342}

\textsuperscript{336} Mere lapse of time, however, does not amount to laches. \textit{Jicarilla Apache Tribe}, 687 F.2d at 1338.

\textsuperscript{337} Keeton, supra note 173, at 114 (quoting Lindsay Petroleum Co. v. Hurd, 5 L.R.-P.C. 221, 239-40 (1874)).

\textsuperscript{338} De Funiak, supra note 31, at 48.

\textsuperscript{339} Id. Thus, mere ignorance of one’s rights will not deprive a person of a remedy on the ground of laches. Also, if a party is under a disability, the defense may not be asserted against her. \textit{Id}.

\textsuperscript{340} See supra text accompanying note 131. The issue of timeliness also arises in the context of whether an equitable recoupment claim can be entertained if the claim is barred when the main claim is asserted. See \textit{Bull} v. United States, 295 U.S. 247, 263 (1935) (suggesting that the estate could proceed with its claim because, at the time the government raised its inconsistent position, the statute was open); Minskoff v. United States, 349 F. Supp. 1146, 1150 (S.D.N.Y. 1972) (“Another reason for denying plaintiff recovery on the theory of equitable recoupment is that, at the time of the income tax assessment, plaintiff had no timely and adequate estate tax refund claim outstanding nor could she have then brought one.”), aff’d, 490 F.2d 1283 (2d Cir. 1974); see also Tierney, supra note 28, at 127-31 (discussing the issues of diligence and timing, and posing arguments against it).

\textsuperscript{341} See, e.g., Holzer v. United States, 250 F. Supp. 875, 878 (E.D. Wis.) (“[L]aches is not a defense to a claim for equitable recoupment.”), aff’d per curiam, 367 F.2d 822 (7th Cir. 1966); Fuller, supra note 265, at 55-56 (stating that in many recoupment cases the passage of time may be attributable to the taxpayer’s contesting the subsequent liability, believing the earlier treatment to be correct). \textit{But see Journal Co. v. United States}, 195 F. Supp. 434, 440 (E.D. Wis. 1961) (denying recoupment to the government, noting that the government had a year in which to protect itself but failed to do so).

\textsuperscript{342} Jicarilla Apache Tribe v. Andrus, 687 F.2d 1324, 1337 (10th Cir. 1982).
One month is not a long period of time. Moreover, in the meantime, the executor in Bull was diligently pursuing other avenues, such as a contest of the income tax liability before the Board of Tax Appeals.\textsuperscript{343}

It is not clear from the Bull decision whether the Supreme Court ever seriously considered the effect of the executor's delay or whether it regarded the one-month window period as so outweighed by the inequity of the Commissioner's position as to be unworthy of mention. It is clear, however, that the Court strongly regarded the Commissioner's position as untenable.

Arguably, laches should be applied less readily against taxpayers than against the government. As a general rule, knowledge of substantive tax provisions should not be attributed to lay taxpayers due to the complexities of the federal tax laws.\textsuperscript{344} This logic does not apply to the government, however, which should be held to a higher standard of knowledge.

b. Unclean Hands

The extent to which the equitable defense of unclean hands applies to recoupment is not clear. Early cases indicated recoupment would not apply if the requesting party committed fraud.\textsuperscript{345} In the later cases of Herring and Bowcut, however, the taxpayer was permitted to recoup a barred estate tax overpayment against an open income tax deficiency,\textsuperscript{346} apparently without serious consideration of the government's defense of unclean hands.\textsuperscript{347}

\textsuperscript{343} Bull v. Commissioner, 7 B.T.A. 993 (1927).

\textsuperscript{344} See United States v. Boyle, 469 U.S. 241, 251 (1985) ("Most taxpayers are not competent to discern error in the substantive advice of an accountant or attorney.").

\textsuperscript{345} See, e.g., Elbert v. Johnson, 164 F.2d 421, 424-25 (2nd Cir. 1947) (Hand, J., concurring) (implying that recoupment should not apply if the taxpayers did not act in good faith); Minskoff v. United States, 349 F. Supp. 1146, 1150 (S.D.N.Y. 1972) ("The doctrine of equitable recoupment being in the nature of an equitable defense, it cannot be invoked by a party who lacks 'clean hands.'"), affd, 490 F.2d 1283 (2d Cir. 1974). It was also the early position of the IRS that unclean hands applied to defeat the application of recoupment. See E.M. Piper v. United States, Supp. Action on Decision, 1969-77 (Feb. 13, 1969) ("[E]quitable recoupment is an equity doctrine and here the taxpayer does not come with clean hands and refuses to do equity.").

\textsuperscript{346} See supra text accompanying notes 244-53.

\textsuperscript{347} A mitigating factor would be whether the government purposefully delayed in raising the fraud claim. If so, then this might eradicate the government's unclean hands defense.

In the taxpayer's brief in Bowcut, the taxpayer argued first that civil fraud, unlike criminal fraud, is compensatory in nature, rather than penal. Mrs. Bowcut's payment of the penalty should have absolved her of the fraud taint and rendered her hands clean. Second, the fraud penalty was a negotiated penalty, not a litigated penalty. In Mrs. Bowcut's brief she stated, "Sometimes it is advantageous for the taxpayer to accept a civil fraud penalty upon reduction of other deficiencies." Brief for the Appellee at 11, United States v. Bowcut, 287 F.2d 654 (9th Cir. 1961) (No. 16,837).

The government replied that Mrs. Bowcut had conceded the fraud issue in the settlement agreement. If she had intended to contest this issue, she could have argued
Fraud, by definition, involves knowledge and an intentional evasion of a tax liability. In both *Herring* and *Bowcut*, fraud was involved in the income tax return, which would have had a direct effect on the estate tax return. Although the surviving spouses/fiduciaries, who stood to benefit from the respective estates, were also accused of the fraud, the courts did not directly address this issue. If the survivors had participated in the fraud, then they would have caused their own dilemmas with full knowledge of their wrongdoing. Thus, this would not have been the proper circumstance for the application of recoupment, and the court should have given the government's argument greater consideration.

V. THE USE OF RECOUPMENT BY THE GOVERNMENT

While, in theory, recoupment is equally available to the taxpayer and the government, in practice, the government has been relatively unsuccessful with the remedy. One explanation is that, given the

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348. See supra text accompanying note 244; see also I.R.C. § 6663 (1994) (setting forth civil fraud penalty, although term "fraud" is not defined); I.R.C. § 7201 (1994) (criminal evasion); I.R.C. § 7454 (1994) (allocating burden of proof where taxpayer is suspected of "fraud with intent to evade tax").

349. The court in *Bowcut* recognized this fact and used it to the taxpayer's advantage. The court reasoned that the taxpayer had not doctored the estate tax return to cover up the fraud on the income tax return; therefore, she was innocent of the fraud and her hands were clean. *Bowcut*, 287 F.2d at 656-57. But see supra text accompanying notes 248-50 (discussing innocent spouse provision).

350. As the government stated in its brief in *Bowcut*: "The essence of the claim for recoupment lies in the fact that the party seeking it was unaware of some crucial fact or legality and his lack of knowledge rendered him unable to protect himself during the statutory period." Brief for the Appellant at 18, *Bowcut* (No. 16,837).

351. One potential weakness in this argument is that the fiduciary may not have been the sole beneficiary. If not, innocent parties would be disadvantaged if recoupment were not allowed. But if the fraud were attributable to an action of the fiduciary, the beneficiaries then could bring suit against the fiduciary for breach of duty.

352. See, e.g., Estate of Mann v. United States, 731 F.2d 267, 279 (5th Cir. 1984) (denying equitable recoupment to the government, arguably incorrectly, due to failure of the single transaction element), aff'd 552 F. Supp. 1132 (N.D. Tex. 1982); Lyeth v. Hoe, 112 F.2d 4, 7-8 (2d Cir. 1940) (denying equitable recoupment to the government under *McEachern*); Schlemmer v. United States, 94 F.2d 77, 78 (2d Cir. 1938) (denying recoupment to the government on ground of lack of identity of interest); Twitchco, Inc. v. United States, 348 F. Supp. 330, 337 (M.D. Ala. 1972) (holding that doctrine of equitable recoupment was inapplicable due to failure of single transaction requirement); see also Andrews, * supra* note 13, at 641 (discussing Wilmington Trust Co. v. United States, 610 F.2d 703 (Ct. Cl. 1979) and noting that the government was denied recoupment in a case which was "nothing more than the government's side of equitable recoupment in the same context as *Herring-Bowcut*"").

There have been a few cases, however, in which the government has sought and obtained recoupment. *See*, e.g., Crossett Lumber Co. v. United States, 87 F.2d 930,
important policy rationale behind the statute of limitations, recoupment is not appropriate where the failure to tax income before the expiration of the statutory period is the result of the government's own negligence, and is not attributable to any negligence or fraud on the part of the taxpayer. 353 For instance, the mere fact that the taxpayer is double taxed usually indicates some fault on the part of the government because it has custody and control over returns, and therefore has access to the facts. Thus, the mere passive acceptance of an erroneous return may, arguably, constitute fault. Under some circumstances, this type of fault may operate as a quasi-estoppel against the government. 354 There is also the issue of whether taxpayers and the government are similarly situated with respect to the application of laches. As mentioned earlier, laches should not apply against the taxpayer as readily as against the government, except in extreme cases, because the taxpayer "may in fact not have understood the precise implications of a particular event." 355 It is appropriate, though, to hold the government to a higher standard of cognizance and knowledge because the government has greater procedural advantages and far greater resources than are generally available to taxpayers.

Another problem for the government is that, logistically, the identity of interest requirement applies only when the government is the requesting party. Thus, a significant additional requirement is imposed against the government. 356 In combination, these problems make it more difficult for the government to prevail in a recoupment action. 357

931, 933-34 (8th Cir. 1937) (holding that government may set up the defense of recoupment where taxpayer made representations to government on which it sought to renge after the expiration of the statute of limitations); E.I. DuPont de Nemours & Co. v. United States, 147 F. Supp. 486, 494 (Ct. Cl. 1957) (upholding government's offset of interest on barred income tax deficiency against interest on open overpayment of excess profits tax); Lit v. United States, 18 F. Supp. 435, 439 (E.D. Pa. 1937) (permitting government to recoup barred gift tax against open estate tax overpayment).

354. See, e.g., Wilmington Trust, 610 F.2d at 714-15 (denying equitable recoupment where government had more than eight months in one case and more than a year in the other in which to assess); Estate of Mann v. United States, 552 F. Supp. 1132, 1135, 1140-41 (N.D. Tex. 1982) (denying government remedy of recoupment on ground of lack of single transaction, but also noting that government had three months to assess estate tax deficiency before expiration of statutory period and thus was not entitled to use recoupment against open overpayment where estate tax was barred due to its own failure to include plaintiff's income tax refund in gross estate), aff'd, 731 F.2d 267 (5th Cir. 1984).

355. See Grand Cent. Pub. Mkt., Inc. v. United States, 22 F. Supp. 119, 130 (S.D. Cal.) (stating that the Commissioner "may not blindly accept returns, or create estoppel by his own failure to perform"), appeal dismissed, 98 F.2d 1023 (9th Cir. 1938).

356. See Fuller, supra note 265, at 57 (noting that courts strive to avoid harm to innocent parties, and therefore will deny recoupment when anyone not involved in the earlier deficiency may be affected by the subsequent liability).

357. See Reeves v. United States, 154 F. Supp. 673, 677 (W.D. Pa. 1957) ("[W]here the knowledge is with the Internal Revenue Service, a liberal rule should be applied
On the other hand, the public policy considerations largely favor the government. But where the government is the aggressor and engages in conduct that could be considered egregious, such as intractability in failing to consider the unfairness of its own mistake, as in Bull, general public concerns about equity and fairness in the administration of the tax laws then tend to overshadow other public policy considerations.

For the government to prevail in the application of recoupment, it should demonstrate good faith and some degree of diligence. For instance, what measures did the government take while the statute was open? Given the overwhelming burden of examining every tax return, fairness requires that passive acceptance of an incorrect return count neither for nor against the government.\(^\text{358}\)

Generally, when the government seeks recoupment, it will do so as a defense to a taxpayer's claim for refund.\(^\text{359}\) Given that the govern-

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\(^{358}\) See Mayfair Minerals, Inc. v. Commissioner, 56 T.C. 82, 90 (1971), aff'd, 456 F.2d 622 (5th Cir. 1972). The Tax Court in Mayfair Minerals stated:

> The Commissioner of necessity does and must rely largely upon the representations of the taxpayer, and, in order to estop the taxpayer from assuming a contrary position, he is not compelled to look with suspicion upon all such representations and himself examine, or cause to be examined, the financial condition of all the taxpayer's debtors. It is the duty of the taxpayer to deal fairly and truthfully with the government.

\(^{359}\) But see Connecticut Nat'l Bank v. United States, 92-1 U.S. Tax Cas. (CCH) ¶ 50,265, at 84,034 (D. Conn. 1992) (denying government's request for recoupment in Tax Court which was raised in defense to taxpayer's argument that it was entitled to a stepped-up basis).
ment should be required to exert some degree of diligence in order to use recoupment, the cases favoring the government should be very narrowly confined to their facts. In Stone, for instance, the initial erroneous assessment against the trust had arisen out of an honest mistake on the part of both the government and the trust. Both parties had acted in good faith, in accordance with the prevailing law, and neither party was at fault. The government was diligent in assessing the trust before the expiration of the statute of limitations against the beneficiary. The government diligently protected its interest, but it was whipsawed by the subsequent change in the case law. Thus, no issue of laches or unclean hands applied against the government.

Because neither the taxpayer nor the government was at fault in Stone, the only further considerations were the public policy implications and the related issue of unjust enrichment. On the government's side of the public policy consideration was the fundamental importance of the federal tax system as a revenue raising system. If the statute of limitations were to apply strictly in this case, the government would lose revenue. But such a consideration is usually secondary to other public policy considerations underlying both the statute of limitations and the integrity of the federal tax system. In Stone, the integrity of the federal tax system inured to the benefit of the government. If recoupment had not applied, not only would the government have lost revenue, but the beneficiary would have been unjustly enriched as well. The beneficiary, with hindsight, would have been able to benefit directly by hiding behind the statute of limitations, thereby avoiding her just share of tax liability.

Because both parties in Stone acted in good faith and neither was at fault, it is curious that the Court did not apply the equity maxim, "The

360. Some commentators, however, have misstated this case. They assert that the statute had already run against the beneficiary and therefore argue that Stone is inconsistent with McEachern on this ground. See Andrews, supra note 13, at 602, 606.

361. A consideration which the Stone Court does not mention is the fact that there was potentially more at stake than the mere single claim of this particular taxpayer. Because of the subsequent change in the case law, there were likely to be a number of other similarly situated taxpayers who would be able to avoid their fair share of tax liability if the statute of limitations were strictly upheld. This is contrary to Bull, where only one particular taxpayer was involved.

A further issue which the Court does not mention is the prospectivity of Helvering v. Butterworth, 290 U.S. 365 (1933). Stone could have been decided on this ground, without reaching the recoupment issue. Although at that time the non-retroactive application of a Supreme Court decision was a relatively novel issue in the civil context, it could nevertheless have been raised. Under the elements of Chevron Oil Co. v. Huson, 404 U.S. 97 (1971), admittedly decided much later, the Court could have concluded that Butterworth did not apply retroactively. These elements under Chevron are: (1) whether the decision establishes a new principle of law, either by overruling clear precedent upon which the parties may have relied or by deciding a case of first impression the outcome of which may not have been reasonably foreseeable; (2) whether retroactivity would further or hinder the purpose of the underlying rule of law in light of its prior history; and (3) whether a retroactive application would produce hardships or inequities. Id. at 106-07.
law prevails where the equities are equal. Under a strict interpretation of this maxim, the taxpayer should have prevailed, because the government sought to assess the trust on behalf of the beneficiary after the statute of limitations had already expired. This maxim might be interpreted, however, to mean that where there is equal equity, public policy shall prevail. The public policy at stake in Stone was the integrity of the federal tax system as an important source of revenue, which the Bull Court referred to as “the life-blood of [the] government.”

Further, the decision did not undermine the intrinsic fairness of the system because no tax liability had ever been paid by the beneficiary. Moreover, because the income from the trust was distributable to the beneficiary, there was an identity of interest. Thus, the implication of Stone is that the equities will be construed in favor of the government when the conduct of the parties is equally balanced. The problem for the government is that the conduct of the parties is seldom equally balanced.

Consider further McEachern, which appears to be inconsistent with Stone under the established elements. While, initially, the taxpayer was mistaken as a matter of law with respect to the tax treatment of the item, the government was also mistaken in accepting the return as filed. But unlike in Stone, the government was not diligent in asserting its rights. Therefore, the taxpayer’s payments of income tax constituted statutory overpayments, made after the expiration of the statute of limitations, and accordingly, recoupment could not apply. Thus, because McEachern involved an honest mistake on the part of the taxpayer and a passive mistake on the part of the government in accepting the return as filed, recoupment was not an appropriate remedy, and in fact, this was precisely the type of situation for which the statute of limitations was designed.

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364. One commentator has maintained, however, that McEachern can be reconciled with Bull and Stone in that McEachern was not an equitable recoupment case at all, but was instead decided under estoppel principles. McConnell, supra note 7, at 594; see also Legatzke, supra note 20, at 871 (noting that recoupment was not specifically pleaded in Bull); supra text accompanying note 175 (arguing that McEachern was a case of statutory construction to which recoupment did not apply). This position has been dismissed as “hair splitting.” Kojes v. United States, 241 F. Supp. 762, 764 n.8 (E.D.N.Y. 1965).
365. From an equitable standpoint, delay defeats equities or, stated differently, “equity aids the vigilant” and not the indolent. McClintock, supra note 31, at 71-76.
Equitable Recoupment

VI. Procedural and Jurisdictional Problems

Recoupment raises several procedural and jurisdictional problems. Two of these problems coalesce in the relatively recent Supreme Court case of United States v. Dalm. Mrs. Dalm, the administratrix of an estate, received administration fees from the estate, plus two additional payments from a beneficiary. The beneficiary filed a gift tax return with respect to the first payment made in 1976, although Mrs. Dalm paid the gift taxes. The beneficiary filed no gift tax return and paid no gift taxes on the second payment made in 1977. The government subsequently determined that the two payments from the beneficiary constituted additional fees on which Mrs. Dalm owed an income tax. Mrs. Dalm then petitioned the Tax Court to contest these deficiencies, alleging that the payments were gifts. After two days of trial, Mrs. Dalm reached a settlement with the government by which she agreed to pay the income tax deficiency on the 1977 payment and to make a partial payment of the income tax on the 1976 payment. After remitting these amounts, Mrs. Dalm filed a claim for refund of the gift tax she had paid on the 1976 payment. When the government failed to act on this claim, Mrs. Dalm brought suit in the federal district court seeking a refund of the gift tax.

Although the statute of limitations on the 1976 taxable year had long since expired, Mrs. Dalm alleged that because the assessment of the income tax deficiency was timely, her suit for offset of that deficiency by the gift tax she had paid was also timely under the doctrine of equitable recoupment. The district court held for the government, however, in concluding that Mrs. Dalm’s suit constituted an independent suit for refund of the gift taxes which could be maintained only if the main claim, the refund claim, was timely. Because the statute of limitations for refund of the gift tax had expired, recoupment could not apply.

Mrs. Dalm then appealed to the Sixth Circuit, which reversed the lower court, holding that the district court had erred in its characterization of the main claim. According to the Sixth Circuit, the main claim was the initial income tax deficiency which was timely; therefore, recoupment did apply. The government then appealed to the U.S. Supreme Court, which reversed the Sixth Circuit, holding that

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367. Id. at 599.
369. Id. at 88,165-66.
370. Id.
recoupment did not apply because the statute of limitations barred the suit for refund.\footnote{372}

But the Supreme Court misapprehended the nature of recoupment. The 1976 payment by the beneficiary to Mrs. Dalm was taxed twice under inconsistent legal theories. Clearly, the 1976 payment to Mrs. Dalm could not have constituted both a gift and income. In considering the equities, Mrs. Dalm acted in good faith. Her gift tax payment, as well as the gift tax return on the 1976 transfer, were accepted by the government, yet the government subsequently changed the theory of taxation after the statute had run on the earlier gift tax payment.\footnote{373} The result was that Mrs. Dalm was double taxed, and the government was unjustly enriched. The government was the aggressor and took unfair advantage of the statute of limitations. This was clearly the type of situation for which equitable recoupment was designed. Indeed, the facts of \textit{Dalm} are reminiscent of those of \textit{Bull}, as Justice Stevens noted in his dissent.\footnote{374}

The problem for Mrs. Dalm, however, did not lie with the merits of the case, but rather with a technical procedural issue.


373. The Court appeared to attach significance to the fact that Mrs. Dalm had not taken full advantage of her opportunities to raise the equitable recoupment claim with the IRS in administrative proceedings. \textit{See Dalm}, 494 U.S. at 610. A case with similar reasoning is Kellogg-Citizens National Bank v. United States, 330 F.2d 635 (Ct. Cl. 1964), in which the IRS assessed income tax deficiencies against an estate on items of income which had previously been included in the estate and on which an estate tax had been paid, but refund of such tax was time-barred. The taxpayer contested the deficiencies in the Tax Court and ultimately settled with the IRS. Under the settlement agreement, the taxpayer agreed to pay an additional amount of income tax, plus penalties and interest attributable to this amount. Because of its relationship to the estate, the amount resulted in an overpayment of estate tax, for which a refund was time-barred at the time of the settlement. The taxpayer then brought suit in the Court of Claims seeking a refund of the estate tax overpayment. The Court of Claims held that the taxpayer had not been diligent in asserting its rights because there had been a period of ten months during which the taxpayer could have filed for a refund of the estate taxes but had failed to do so. The taxpayer argued that during this ten-month period the income tax liability was merely a contingent liability, because it was unclear at that time whether the taxpayer ultimately would be responsible for that tax and if so, in what amount. The Court of Claims, however, was not persuaded by this argument. It concluded that the taxpayer should have filed an open protective claim for refund when the IRS first sought to impose additional income taxes. \textit{Id.} at 640.

The interesting point is that the Court of Claims appeared to be arguing laches against the taxpayer. It never mentioned any jurisdictional problems other than expiration of the statute of limitations, although the situation was very similar to that of \textit{Dalm}. \textit{See also} Evans Trust v. United States, 462 F.2d 521, 526 (Ct. Cl. 1972) (holding that equitable recoupment did not apply where the result of settlement with IRS in Tax Court was that there never had been any deficiency).}

\footnote{374. \textit{Dalm}, 494 U.S. at 612 (Stevens, J., dissenting).}
A. Equitable Recoupment as a Defense

The *Bull* Court postulated that "recoupment is in the nature of a defense arising out of some feature of the transaction upon which the plaintiff's action is grounded. Such a defense is never barred by the statute of limitations so long as the main action itself is timely." Thus, recoupment may not be used as an independent jurisdictional ground for opening the statute of limitations. The modern technical use of recoupment is generally through a refund claim in which the taxpayer seeks to recoup a barred overpayment, or portion thereof, against an open deficiency. Procedurally, the taxpayer's claim must be a claim for offset of the open deficiency by the barred overpayment or, if the taxpayer has paid the deficiency, a timely claim for refund must be made requesting an offset of the barred amount. Such an offset would arise under the fiction that the barred overpayment would create a credit against the open deficiency. If the requirements for the application of recoupment are otherwise met, the statute of limitations will never bar such a suit.

Occasionally, taxpayers mistakenly file a claim for refund of the barred claim, rather than request an offset of the open deficiency by the barred overpayment. While, as Justice Stevens noted in his dissent in *Dalm*, such mistakes should generally be considered "meaningless

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376. See, e.g., *Brigham v. United States*, 470 F.2d 571, 577 (Ct. Cl. 1972) (noting that the "function of the doctrine is to allow the taxpayer to reduce the amount of a deficiency recoverable by the Government by the amount of an otherwise barred overpayment of the taxpayer" (emphasis omitted)), cert. denied, 414 U.S. 831 (1973); *Evans Trust*, 462 F.2d at 526 (holding that taxpayer could not use recoupment to recover barred estate tax when no deficiency existed and open refund claim requested recovery of amount agreed upon by taxpayer and government in settlement); *Ohlson v. United States*, 93-1 U.S. Tax Cas. (CCH) ¶ 50,266, at 88,006 (D. Colo. 1992) (noting that recoupment is a defense and may not be used to cure an untimely refund claim).

As succinctly stated by one court: "Attempts by taxpayers to utilize the doctrine to revive an untimely affirmative refund claim, as opposed to offset a timely government claim of deficiency with a barred claim of the taxpayer, have been uniformly rejected." *O'Brien v. United States*, 766 F.2d 1038, 1049 (7th Cir. 1985).

377. See, e.g., *Kolom v. United States*, 791 F.2d 762, 768-69 (9th Cir. 1986) (permitting taxpayer to recoup barred alternative minimum tax against open alternative minimum tax deficiency); *Boyle v. United States*, 355 F.2d 233, 234 (3d Cir. 1965) (describing action for refund of income tax on the ground that taxpayer should be able to recoup barred overpayment of estate tax attributable to the income tax).


379. *See Holzer v. United States*, 250 F. Supp. 875, 878 (E.D. Wis.), aff'd per curiam, 367 F.2d 822 (7th Cir. 1966) ("The doctrine of equitable recoupment utilizes the fiction of a tax credit or defense to liability for a year open to suit to avoid violation of the statutory scheme providing for finality of tax determinations.").

380. See supra text accompanying note 124 (quoting the Supreme Court's rationale for the application of recoupment in *Bull*). But see *Schenectady Trust Co. v. United States*, 88-1 U.S. Tax Cas. (CCH) ¶ 13,751, at 84,104-05 (N.D.N.Y. 1987) (misinterpreting *Bull* and requiring a timely refund claim to have been filed on the barred claim).
procedural distinctions," some courts, nevertheless, have strictly construed the jurisdictional requirements of recoupment in these situations, and have held that the claim is barred by the statute of limitations because recoupment cannot constitute the sole jurisdictional basis for the claim. Cases in which recoupment was properly denied because it was used as an independent jurisdictional ground, instead of a defense, have involved erroneous refunds made after the statute of limitations had run, situations in which there was no open deficiency, situations in which the party requesting recoupment was not the proper party, and where the court did not have jurisdiction because the

382. See, e.g., Fairley v. United States, 901 F.2d 691, 694 (8th Cir. 1990) (characterizing the recoupment claim as the main claim and holding that lower court was without jurisdiction because claim was filed after statute of limitations had run); Ellard v. United States, 81-2 U.S. Tax Cas. (CCH) ¶ 16,370, at 88,863-64 (Cl. Ct. 1981) (denying taxpayer use of recoupment to offset barred personal excise tax refund against open deficiency of 50% owned partnership); see also Epperson v. United States, 473 F. Supp. 1360, 1362 (E.D. Wis. 1979) (disallowing recoupment, erroneously, on ground that funds were not double taxed under inconsistent legal theories).
383. See, e.g., United States v. Gulf Oil Corp., 485 F.2d 331, 333 (3d Cir. 1973) (noting that taxpayer was trying to recoup "the very tax payment that the statute of limitations barred it from recovering").
384. See, e.g., Brigham v. United States, 470 F.2d 571, 577 (Cl. Ct. 1972) (holding that taxpayers were not entitled to recoup barred overpayment because there was no open deficiency to offset, and that taxpayers were attempting to expand recoupment to obtain a refund attributable to an otherwise barred year), cert. denied, 414 U.S. 831 (1973); Evans Trust v. United States, 462 F.2d 521, 526 (Cl. Ct. 1972) (holding that taxpayer was not entitled to recoupment because no deficiency existed by virtue of settlement, and statute had already run on overpayment).
385. See O'Brien v. United States, 766 F.2d 1038, 1046-48 (7th Cir. 1985) (considering beneficiary of estate who sought recoupment of barred income tax overpayment after estate had litigated issue of open estate tax liability). Technically, O'Brien was not decided on this ground, but rather was decided on the ground of improper tax and taxable year. See Steven J. Willis, Correction of Errors Via Mitigation and Equitable Recoupment: Some People Still Do Not Understand, 52 Tax Notes 1421, 1427 n.82 (1991) [hereinafter Willis, Correction of Errors] (discussing Justice Stevens's dissent in Dalm). Willis criticizes Justice Stevens's dissent in Dalm by noting that the Seventh Circuit did not decide O'Brien on the ground of improper party. Although Willis is technically correct, Justice Stevens's point is that the court could not have reached that conclusion without deciding that the beneficiary was not the proper party. If the Seventh Circuit had directly addressed the issue of whether the estate could recoup the barred income tax overpayment of the beneficiary against the open, litigated estate tax deficiency, it would probably have decided that res judicata would apply, precluding the estate from raising the issue. See Tierney, supra note 28, at 123-27 (discussing nature of claim and type of relief under recoupment).

The Seventh Circuit in O'Brien correctly noted that the beneficiary was not the proper party to whom the identity of interest inquiry should apply, because the open claim was not paid by the beneficiary but by the estate. Thus, only the estate could request a refund because nothing under the Internal Revenue Code would permit the beneficiary to do so. Therefore, the identity of interest test, if applied at all, must be applied to the estate. See O'Brien, 766 F.2d at 1050-51 n.16. Nevertheless, Justice Stevens was correct in noting that the Seventh Circuit's discussion of this issue was dicta. Cf. Hufbauer v. United States, 297 F. Supp. 247, 251-52 (S.D. Cal. 1968) (award-
main claim had been litigated. In the latter situation, an inequity may arise if the forum in which the main claim is litigated is the Tax Court.

B. The Tax Court and Equity Jurisdiction

The Tax Court originated from the Board of Tax Appeals, an independent agency of the Executive Branch, established under the Revenue Act of 1924. The Board was granted restricted jurisdiction over deficiencies and jeopardy assessments. During the 1924 congressional debates, it was proposed that the Board’s jurisdiction be expanded, in part to allow refund jurisdiction, but this proposal was defeated on the ground that it would increase the Board’s case load, and thus decrease its efficiency.

In E.J. Barry, one of its earliest decisions, the Board determined that it had jurisdiction to offset a proposed deficiency by an unrelated overpayment in a taxable year not before the court. This decision was rendered obsolete, however, by the Revenue Act of 1926, which forbade the Board from determining whether or not the tax for any

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387. Revenue Act of 1924, ch. 234, § 900, 43 Stat. 253, 336-38. For a discussion of the establishment of the Board, see Harold Dubroff, United States Tax Court—An Historical Analysis, 1-107 (1979). Although the Board was intended to be independent of the Treasury Department, the Department was heavily involved in the selection of the first Board members. Id. at 84-86. In fact, some of these members had previously served on the Committee on Appeals and Review, the forerunner of the Board which was under the auspices of the Internal Revenue Service. Id. at 43-45.
388. The Board’s jurisdiction was limited to income, excess profits, estate, and gift taxes. The term “deficiency” was, and is, defined as “the excess of tax due over the amount conceded as due by the taxpayer.” Dubroff, supra note 387, at 73; see also I.R.C. § 6211(a) (1994) (defining “deficiency” as the “amount by which the tax imposed . . . exceeds the excess of the sum of . . . the amount shown as the tax by the taxpayer upon his return . . . plus . . . the amounts previously assessed . . . over . . . the amount of rebates”). In order to appear before the Board, the taxpayer must first have received a notice of deficiency from the IRS and must have filed an appeal with the Board within 60 days of the date the notice was mailed. With respect to jeopardy assessments, a claim in abatement must have been filed with the Board within 60 days of receiving notice of the proposed assessment. Dubroff, supra note 387, at 73-74.

If a taxpayer lost an appeal before the Board, the taxpayer could file a claim for refund after paying the assessed amount. If such a claim was denied, the taxpayer could file a suit for refund in either federal district court or the Court of Claims because the 1924 Act had not provided for direct review of Board decisions. Id. at 77-78. This is how the estate in the Bull case managed to relitigate the recoupment issue. See Andrews, supra note 13, at 599 n.20.
389. Dubroff, supra note 387, at 74-77. It was also proposed that the Board be allowed to redetermine the tax in any case in which “fraud, favoritism, [or] gross error” was suspected. Id. at 74-75 (quoting 65 Cong. Rec. 2614 (1924) (statement of Rep. Jeffers)).
390. 1 B.T.A. 156 (1924).
391. Revenue Act of 1926, ch. 27, § 274(g), 44 Stat. 9 (codified at I.R.C. § 6214(b) (1994)).
other taxable year had been overpaid or underpaid, although it authorized a consideration of other taxable years in order to redetermine the deficiency at issue.\(^{392}\)

The rationale behind the 1926 Act was that Congress intended the Board to have deficiency jurisdiction restricted to the taxable year(s) at issue in the notice of deficiency.\(^{393}\) A consideration of other taxable years that were not procedurally before the Board would amount to an \textit{ultra vires} exercise of refund jurisdiction.\(^{394}\) After the 1926 Act, the Board took the position that it had no equity jurisdiction in general, and could not apply equitable recoupment, in particular.\(^{395}\) The Supreme Court upheld this position in \textit{Commissioner v. Gooch Milling \& Elevator Co.}\(^{396}\) \textit{Gooch} has been widely cited in support of the proposition that the jurisdiction of the Board/Tax Court to apply equitable recoupment was revoked under the 1926 Act.\(^{397}\) But there are several problems with this analysis. First, in stating the proposition that the Board no longer had jurisdiction to apply equitable recoupment, \textit{Gooch} cited \textit{Barry}.\(^{398}\) This reference was incorrect because \textit{Barry} did not involve a true equitable recoupment claim at all, but rather, a \textit{Lewis v. Reynolds}-related offset. Indeed, although admit-

\(^{392}\) \textit{Id.} at 56. The Act states:

The Board in redetermining a deficiency in respect of any taxable year shall consider such facts with relation to the taxes for other taxable years as may be necessary correctly to redetermine the amount of such deficiency, but in so doing shall have no jurisdiction to determine whether or not the tax for any other taxable year has been overpaid or underpaid.

\textit{Id.}

\(^{393}\) \textit{See} Dubroff, \textit{supra} note 387, at 126-28 (discussing deficiency and limited refund jurisdiction of the Board).

\(^{394}\) Indeed, this had been the government's argument in \textit{Barry}. \textit{See} 1 B.T.A. at 157. A further rationale is that it would have increased the Board's case load.

\(^{395}\) \textit{See}, e.g., \textit{Scaife Co. v. Commissioner, 47 B.T.A. 964, 966 (1942)} ("[T]o deduct from the amount of the admitted deficiency the amount of the overassessment would be to exercise authority over a refund, which authority Congress has not given."); \textit{Red Wing Potteries, Inc. v. Commissioner, 43 B.T.A. 841, 846 (1941)} (holding that Board of Tax Appeals has no jurisdiction to apply recoupment); \textit{Estate of Highland v. Commissioner, 43 B.T.A. 598, 611-12 (1941)} (considering issue \textit{sua sponte}, \textit{aff'd sub nom. Helvering v. Highland, 124 F.2d 556} (4th Cir. 1942)). It made no difference whether the equitable recoupment claim was used as a defense or as an independent jurisdictional basis. By the same token, an appellate court reviewing a Board decision also lacked jurisdiction to consider recoupment because it was confined only to review of the record in the lower court. Dubroff, \textit{supra} note 387, at 123 (quoting S. Rep. No. 52, 69th Cong., 1st Sess. 37 (1926)); \textit{see} H.R. Rep. No. 1, 69th Cong., 1st Sess. 20 (1925); \textit{see also} \textit{Commissioner v. Gooch Milling \& Elevator Co., 320 U.S. 418, 420 (1943)} (holding that Board has no jurisdiction to apply doctrine of equitable recoupment). \textit{But see} McConnell, \textit{supra} note 7, at 579-86 (discussing recoupment's development as a common law doctrine).

\(^{396}\) 320 U.S. 418 (1943).

\(^{397}\) \textit{See}, e.g., \textit{Rothensies v. Electric Storage Battery Co., 329 U.S. 296, 303 (1946)}. It has also been held that an appellate court reviewing a Tax Court decision is restricted to reviewing only those matters over which the Tax Court had jurisdiction. \textit{Commissioner v. McCoy, 484 U.S. 3, 6} (1987).

\(^{398}\) 320 U.S. at 421 n.7.
EQUITABLE RECOUPMENT

Notably not dispositive, the *Barry* opinion never used the term "recoupment." Second, *Gooch* involved an erroneous inventory valuation which resulted in an income tax deficiency in the open year and an overpayment in the earlier, then barred, taxable year. Because of the nature of inventory, such a misvaluation would have involved a redetermination of the entire tax liability for that taxable year. This is because inventory has a substantial effect on gross income in the sale of goods. This meant that the effect of a misvaluation could only be determined after examining all taxable events related to the sale of the inventory over the entire taxable year in which the misvaluation occurred. This would not have been permitted under the 1926 Act.

Furthermore, because of its consequent effect on other taxable years, an inventory misvaluation should not constitute a "transaction" or "single taxable event" for purposes of recoupment. Finally, in a true equitable recoupment claim, a consideration by the Board/Tax Court of an inconsistent tax treatment of a single transaction or taxable event in a previous taxable year (i.e., in a taxable year not before the court by virtue of the notice of deficiency) does not involve a redetermination of the *entire tax liability for the previous taxable year*. Instead, it should fall under the category of "other facts" that may be considered in redetermining the amount of the deficiency for the taxable year in question. This is consistent with the rationale behind the 1926 Act.

In 1942, the Board became the Tax Court of the United States, although there was no substantive change in its jurisdiction. The court remained an independent agency within the Executive Branch, and a quasi-judicial body until 1969, when it became the United

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399. *See* Treas. Reg. § 1.61-3(a) (1963) ("In a manufacturing, merchandising, or mining business, 'gross income' means the total sales, less the cost of goods sold, plus any income from investments and from incidental or outside operations or sources.").

400. *See supra* text accompanying notes 301-04. *Contra* Crossett Lumber Co. v. United States, 87 F.2d 930, 933 (8th Cir. 1937) (holding that deficiency in barred year attributable to overvalued inventory was same transaction as overassessment in following year attributable to misvaluation).

401. *See* I.R.C. § 6214(c) (1994). The statute specifically states:

*The Tax Court, in redetermining a deficiency of any tax imposed . . . for any period, act, or failure to act, shall consider such facts with relation to the taxes . . . for other periods, acts, or failures to act as may be necessary correctly to redetermine the amount of such deficiency, but in so doing shall have no jurisdiction to determine whether or not the taxes . . . for any other period, act, or failure to act have been overpaid or underpaid.*

*Id.*

402. For a discussion of the problems involved in this change, see Dubroff, *supra* note 387, at 165-204.

403. Examples of its quasi-judicial status include the appellate (rather than collateral) review of its decisions, its exclusive jurisdiction, and the finality of its decisions. *See id.* at 111-64.
States Tax Court, an Article I legislative court within the federal judicial system.\textsuperscript{404}

While the Tax Court continued to take the position that it did not have jurisdiction to apply recoupment,\textsuperscript{405} it nevertheless applied other equitable principles.\textsuperscript{406} Moreover, the legislative history of the statutory mitigation provisions indicates that mitigation was intended to be a supplement to recoupment and other equitable remedies.\textsuperscript{407} Because mitigation applies in the Tax Court, it is curious that Congress did not mention the restriction of equitable jurisdiction in the Tax Court, if indeed this had been the intent, because there is, otherwise, no specific prohibition on the court's equity jurisdiction. On the other hand, because the Tax Court has exclusive jurisdiction, once a taxpayer brings suit in the Tax Court, the merits of that claim may not be relitigated in either the federal district court or the U.S. Court of Federal Claims.\textsuperscript{408} Thus, the decision of the Tax Court is final and binding.\textsuperscript{409} Given this finality, it is irrational to assume that Congress


\textsuperscript{405} See, e.g., Stoller v. Commissioner, 60 T.C.M. (CCH) 1554, 1567-68 (1990) (citing Dalm and holding that it had no jurisdiction to consider a taxable year not before the court and thus could not apply recoupment), aff'd in part, rev'd in part, 994 F.2d 855, amended by 3 F.3d 1576 (D.C. Cir. 1993); Estate of Schneider v. Commissioner, 93 T.C. 568, 570 (1989) (noting that absent a notice of deficiency and timely action on that notice, the court does not have jurisdiction to determine a tax liability for a year not before the court).


\textsuperscript{407} S. Rep. No. 1567, 75th Cong., 3d Sess. 49 (1938). The legislative history states:

\begin{quote}
The purpose of the statute of limitations to prevent the litigation of stale claims is fully recognized and approved. But it was never intended to sanction active exploitation, by the beneficiary of the statutory bar, of opportunities only open to him if he assumes a position diametrically opposed to that taken prior to the running of the statute. The Federal courts in many somewhat similar tax cases have sought to prevent inequitable results by applying principles variously designated as estoppel, quasi-estoppel, recoupment and set-off. For various reasons, mostly technical, these judicial efforts cannot extend to all problems of this type. Nor can they provide a uniform, systematic solution of these problems. Legislation has long been needed to supplement the equitable principles applied by the courts and to check the growing volume of litigation by taking the profit out of inconsistency, whether exhibited by taxpayers or revenue officials and whether fortuitous or the result of design.
\end{quote}

\textsuperscript{408} See I.R.C. § 6512(a) (1994) (prohibiting simultaneous suits over deficiencies in the Tax Court and refunds in the district courts and U.S. Claims Court); I.R.C. § 7422(e) (1994) (providing that district court and U.S. Claims Court lose jurisdiction to the extent that the Tax Court acquires jurisdiction).

\textsuperscript{409} See I.R.C. § 7481(a) (1994) (providing that decision of Tax Court is final and binding).
would not have been more explicit if it intended to deny the Tax Court equity jurisdiction. Indeed, since the merger of law and equity in the nineteenth century, the presumption is that all federal courts have equity jurisdiction, unless such jurisdiction is specifically restricted.\textsuperscript{410}

It is also irrational to conclude that the Tax Court must wear blinders and cannot consider other factors in previous taxable years that may have a direct bearing on the deficiency at issue—as long as those factors do not involve a redetermination of the entire tax liability for a year not before the court. \textit{Dalm} highlights the irrationality of this position. Because Mrs. Dalm chose to litigate the merits of her income tax deficiency in the Tax Court, she obtained the advantage of a hearing on the merits of the contested deficiency without first having to pay the tax liability,\textsuperscript{411} but she was disadvantaged because she could not have raised the recoupment claim in the deficiency proceeding. Because the Tax Court assumed jurisdiction over the income tax deficiency, the claim could not be heard by any court other than the court of appeals, which could consider only the issues raised in the original action.\textsuperscript{412} Thus, Mrs. Dalm was denied a remedy because she chose to exercise her right to bring suit in a prepayment forum.\textsuperscript{413}

As a result of the \textit{Dalm} decision, equitable recoupment becomes a remedy for the wealthy if taxpayers are truly foreclosed from raising the issue in the Tax Court.\textsuperscript{414} The Supreme Court in \textit{Dalm}, however,

\begin{footnotesize}
\begin{enumerate}
\item See McClintock, supra note 31, at 12-19 (discussing development of equity in the U.S.). According to McClintock, equity should be regarded not as a separate system, but as a part of each area of law. The problem is that most law school curricula do not deal adequately with equity, and thus judges are poorly trained in this area. \textit{Id.} at 17-19.
\item United States v. Dalm, 494 U.S. 596, 599 (1990). In Ms. Dalm's case, the amount of tax liability she was required to pay was substantial. \textit{Id.} In order to avail herself of the federal district court, she would have been forced to pay the tax liability in full first and then file a claim for refund with the IRS. \textit{Mulroney}, supra note 221, § 12.3(b). Only after this claim had been denied could she have availed herself of the federal district court forum. If she had brought suit for refund in the district court, she clearly would have prevailed on the merits under the direct authority of \textit{Bull}. Cf \textit{Dalm}, 494 U.S. at 606-08.
\item It has been suggested that unscrupulous government agents might artificially inflate a proposed deficiency in order to force the taxpayer into Tax Court. Fuller, supra note 265, at 58.
\item See I.R.C. § 7482(a) (1994).
\item This is a point Justice Stevens made in his dissent. \textit{Dalm}, 494 U.S. at 613-15 (Stevens, J., dissenting). \textit{But see Kolom v. United States}, 791 F.2d 762, 765-68 (9th Cir. 1986) (allowing taxpayer to raise issue in district court after litigating deficiency in Tax Court on ground that recoupment claim did not arise until prior decision created the inconsistency); \textit{O'Brien v. United States}, 582 F. Supp. 203, 206 (C.D. Ill. 1984) (same), rev'd, 766 F.2d 1038 (7th Cir. 1985). Note that the \textit{Dalm} decision does not affect the government's use of equitable recoupment, because the government is never the plaintiff in a Tax Court proceeding.
\item Although, as Justice Stevens noted, if the Supreme Court had considered the issue of whether the Tax Court has equity jurisdiction, and had decided that issue in the affirmative, the reasoning in \textit{Dalm} would have been rendered obsolete. \textit{Dalm}, 494 U.S. at 615 n.3 (Stevens, J., dissenting). While Justice Stevens was correct, the result
\end{enumerate}
\end{footnotesize}
reserved judgment on the issue of whether the Tax Court has equity jurisdiction.\textsuperscript{415} Regarding that reservation as an invitation to review its position, the Tax Court recently decided in a reviewed decision, \textit{Estate of Mueller v. Commissioner},\textsuperscript{416} that it can consider the issue of recoupment as long as it is validly raised as an affirmative defense in a suit over which the court, otherwise, has jurisdiction.\textsuperscript{417}

In so holding, the court reasoned that nothing in the Internal Revenue Code indicated that Congress intended to restrict the application of equitable principles in deciding "matters within our jurisdiction."\textsuperscript{418} Instead, such a limitation had emanated from the \textit{Barry} and \textit{Gooch} decisions.

The court dismissed \textit{Barry} by noting that it had involved the issue of setoff versus recoupment.\textsuperscript{419} \textit{Gooch}, however, was a more formidable opinion because it dealt directly with the issue of Tax Court jurisdiction and equitable recoupment. But the \textit{Mueller} court also dismissed \textit{Gooch} as inapplicable because recoupment had not been "properly raised in a timely suit for redetermination of a tax deficiency over which we have jurisdiction."\textsuperscript{420} Perhaps the subtext of the court's

would have been the same because Ms. Dalm's suit would then have been barred by res judicata. \textit{See supra} note 408.

The problems of the alleged inability of the Tax Court to hear equitable recoupment claims is exacerbated procedurally, because if taxpayers are precluded from raising recoupment claims in the Tax Court and must instead resort to a refund forum, the burden of proof shifts. In the Tax Court, the taxpayer is always the plaintiff and thus has the burden of proving not only that the government's determination of a deficiency is arbitrary, but also the correct amount of tax liability. \textit{See generally} \textit{Johnson, Burden of Proof}, \textit{supra} note 102 (discussing the allocation of the burden of proof in the litigation of refund claims).

\begin{itemize}
  \item \textit{Dalm}, 494 U.S. at 611 n.8.
  \item 101 T.C. 551 (1993).
  \item \textit{Id.} at 556 ("[E]xercising jurisdiction over petitioner's recoupment defense does not require us to exercise jurisdiction that is beyond the scope of petitioner's main claim for the redetermination of its estate tax deficiency.").
  \item The Supreme Court has held that the Tax Court may not expand its jurisdiction based upon equitable considerations. \textit{Commissioner v. McCoy}, 484 U.S. 3, 6 (1987). This has been interpreted to mean that the Tax Court may not expand its statutorily prescribed jurisdiction through an exercise of general equitable powers. \textit{Woods v. Commissioner}, 92 T.C. 776, 785 (1989); \textit{see, e.g.}, \textit{Estate of Kelley v. Commissioner}, 45 F.3d 348, 352 (9th Cir. 1995) (holding that Tax Court has limited equitable jurisdiction and can reform consent-to-delay agreements that are properly before the court); \textit{Phillips Petroleum Co. v. Commissioner}, 92 T.C. 885, 890-91 (1989) (holding that Tax Court cannot use equitable recoupment to assume jurisdiction over excise taxes because these taxes are not otherwise within its jurisdiction).
  \item Because the taxpayer is always the plaintiff in the Tax Court, "An issue based on the statute of limitations is a defense and not a plea to the jurisdiction of [the] Court." \textit{Woods}, 92 T.C. at 787 (citing \textit{Badger Materials}, Inc. v. \textit{Commissioner}, 40 T.C. 1061 (1963)).
  \item \textit{Mueller}, 101 T.C. at 558 (quoting \textit{Woods}, 92 T.C. at 788-89).
  \item \textit{Id.} at 559.
  \item \textit{Id.} at 560.
\end{itemize}
statement is that the entire tax liability for the closed year would have had to be redetermined in order for recoupment to apply in Gooch.\textsuperscript{421}

\section*{C. Administrative Claims and Settlements}

Taxpayers also may raise an equitable recoupment defense in administrative proceedings before the IRS.\textsuperscript{422} Indeed, if a taxpayer is audited, or is otherwise before the IRS, there may be a quasi-exhaustion requirement in order to obtain relief in the federal courts.\textsuperscript{423} For instance, in no reported case in which the taxpayer and the government have first reached a settlement agreement have the courts permitted the taxpayer to use equitable recoupment in a subsequent refund suit, although various other reasons for the taxpayer's loss have been proffered by the courts.\textsuperscript{424} The equities do not, however, favor a party who inadvertently fails to raise the issue at the opport-

\textsuperscript{421} The Supreme Court so noted in Commissioner v. Gooch Milling & Elevator Co., 320 U.S. 418, 420-21 (1943); see also supra note 401 (discussing Tax Court statutory jurisdiction).

\textsuperscript{422} See Rev. Rul. 71-56, 1971-1 C.B. 404, 404-05 (revoking Rev. Rul. 55-226, 1955-1 C.B. 469, 470, which stated that the government had no authority to apply a barred overpayment against an open deficiency); Rev. Rul. 81-287, 1981-2 C.B. 184, 185 (ruling that government may use recoupment to offset a valid estate tax overpayment against a barred income tax deficiency); see also Priv. Ltr. Rul. 85-52-005 (Aug. 29, 1985) (ruling that taxpayer may recoup barred excise tax overpayment against open income tax deficiency); Priv. Ltr. Rul. 84-41-003 (June 6, 1984) (permitting government to use recoupment to offset valid estate tax refund with barred income tax deficiency).

\textsuperscript{423} See Fairley v. United States, 901 F.2d 691, 694 (8th Cir. 1990) (rejecting taxpayer's plea for recoupment on ground that taxpayer failed to raise the issue in earlier administrative proceedings). The Fairley court misconstrued Dalm in noting that Dalm required a rejection of the taxpayer's claim for failure to raise the issue in the administrative proceedings. Id. Dalm, however, did not establish such a requirement. Instead, Dalm noted, almost as an apology, that taxpayers could raise the issue of recoupment in administrative proceedings; thus, the holding in Dalm was not as harsh as it appeared. United States v. Dalm, 494 U.S. 596, 610 (1990).

\textsuperscript{424} See, e.g., Kojes v. United States, 241 F. Supp. 762, 764-65 (E.D.N.Y. 1965) (noting failure of single transaction element); Evans Trust v. United States, 462 F.2d 521, 526 (Ct. Cl. 1972) (describing case where recoupment was not used as a defense and facts were not similar to those of Bull).

In Kojes, the taxpayer was an estate that filed suit for refund of a barred estate tax overpayment resulting from a subsequent income tax deficiency. 241 F. Supp. at 763. The court held that the taxpayer could not recoup the barred estate tax because the income tax deficiency and the estate tax overpayment did not arise from the same transaction, and also because the refund suit was barred by the statute of limitations. Id. at 765. Under Professor Andrews's two tax effect theory, however, the income tax deficiency would produce an automatic estate tax deficiency; thus the two would constitute a single transaction. The appropriate suit would have been a suit for refund of the open income tax overpayment. If that were the case, the suit for the barred estate tax overpayment would have been a "meaningless procedural distinction." Tierney, supra note 28, at 136. The result in Kojes is correct, however, because the taxpayer had the opportunity to raise the issue in the settlement negotiations and did not. Accordingly, the situation was not an appropriate one for the application of recoupment. Cf. West Va. Pulp & Paper Co. v. McElligott, 40 F. Supp. 765, 770-71 (S.D.N.Y. 1941) (permitting government to recoup barred deficiency against open refund despite ear-
tune time. Thus, the failure to raise the issue during the settlement negotiations could be tantamount to collateral estoppel.425

VII. RECENT CASES AND COMMENTS: CONTINUING CONFUSION

A. Hall v. United States426

The judicial decisions since Dalm indicate that, despite Professor Andrews's enlightening article, confusion remains. By way of illustration, consider the case of Hall v. United States. There, the plaintiff was a family partnership that owned a royalty interest in a federal oil and gas lease. Amoco Production Company ("Amoco") was the operator of the lease. For the taxable years 1980 through 1985, the plaintiff was subject to windfall profits taxes that Amoco withheld and remitted to the government on behalf of the plaintiff.427

In 1986, the Bureau of Land Management revised the mineral acreage downward retroactive to 1976, thus reducing the plaintiff's revenue interest. The plaintiff then refunded the excess income to Amoco, who, properly, did not credit the windfall profits taxes it had withheld.

In 1987, the plaintiff filed with the IRS a claim for refund of the overpaid windfall profits taxes. While the plaintiff obtained a refund for the open years, the refund claim was disallowed for the taxable years 1980 and 1981 because those years were closed by the statute of limitations. The plaintiff then brought suit against the government, requesting relief through either the mitigation provisions or through equitable recoupment.

The district court dismissed the recoupment claim in a footnote in which it misstated the holding of Dalm.428 Professor Willis correctly

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425. But see Ohlson v. United States, 93-1 U.S. Tax Cas. (CCH) ¶ 50,266, at 88,006-07 (D. Colo. 1992) (rejecting taxpayer's argument that recoupment should apply against government because IRS failed to detect and correct his miscalculations and noting that the "taxpayer, not the IRS, bears the burden of filing correct tax returns").

426. 91-1 U.S. Tax Cas. (CCH) ¶ 50,104 (D. Utah 1991), rev'd, 975 F.2d 722 (10th Cir. 1992).

427. Id. at 87,426-27; see Crude Oil Windfall Profit Tax Act of 1980, Pub. L. No. 96-223, 94 Stat. 229, 230-54, repealed by Omnibus Trade and Competitiveness Act of 1988, Pub. L. No. 100-418, § 1941, 102 Stat. 1107, 1322-24. The purpose of this tax was to control rising oil prices in the wake of deregulation by the Carter Administration. Although the obligation to withhold and remit the tax liability fell upon the first purchaser, Amoco, the tax liability was deemed to have been paid by the person with the economic interest in the production, the plaintiff. See S. Rep. No. 394, 96th Cong., 2d Sess. 60, 65-66 (1979), reprinted in 1980 U.S.C.C.A.N. 410, 474-76.

As Professor Willis notes, the opinion is unclear as to whether Amoco actually withheld the taxes from payments due the plaintiffs or whether Amoco paid the entire amount to the plaintiffs then collected the tax liability from them. Professor Willis further notes that the difference is immaterial for the purpose of recoupment. Willis, Correction of Errors, supra note 385, at 1421 n.6.

428. The Utah court incorrectly noted that Dalm had held that "taxpayers may not invoke the equitable recoupment doctrine where there has not been a timely adminis-
observes that the court technically reached the right result, but for the wrong reason.\textsuperscript{429} Professor Willis's reasoning with respect to recoupment, however, was equally wrong. He states that Amoco, not the plaintiff at bar, was the proper party and that Amoco would have asserted recoupment by underpaying the correct excise tax "in the same dollar amount as the prior erroneous but uncorrectable overpayment."\textsuperscript{430} He goes on to note that, in any event, recoupment would not have applied because there was no identity of interest between Amoco and the plaintiff.\textsuperscript{431}

First, Amoco was not the proper party; the plaintiff was. Amoco's role was similar to that of an employer who is required to withhold income tax on the compensation of an employee. The legislative history of the Crude Oil Windfall Profit Tax Act of 1980 is clear on this point.\textsuperscript{432} Amoco had a duty to withhold the excise tax from the plaintiff's payments and to remit that amount to the government. Once that obligation was fulfilled, Amoco's duty to the government was complete. Amoco acted in good faith and in accordance with applicable law at the time of the withholding. Any overpayment belonged to the plaintiff, and only the plaintiff could file a claim for the refund. Moreover, the battle over the proper amount of the tax liability belonged to the plaintiff, not Amoco. If Amoco had underwithheld, it would have opened itself to liability.\textsuperscript{433}

Second, because the single transaction requirement was not met, recoupment should not have applied in this case, unless the court had chosen to extend the doctrine of recoupment. The vast weight of authority regards an excise tax attributable to one taxable year as a different transaction from an excise tax attributable to a different taxable year.\textsuperscript{434} Because of that precedent, the plaintiff would not be entitled to relief under the doctrine of equitable recoupment because the

\textsuperscript{429} See Willis, \textit{Correction of Errors}, \textit{supra} note 385, at 1421.

\textsuperscript{430} Id. at 1427.

\textsuperscript{431} Id.

\textsuperscript{432} See S. Rep. 394, 96th Cong., 2d Sess. 60, 62, 64 (1979), \textit{reprinted in 1980 U.S.C.C.A.N.} 410, 469-70, 472, 473-74 (noting that the withholding obligation is similar to that imposed upon an employer and that overpayments of the tax may be credited against the owner's income tax).

\textsuperscript{433} See I.R.C. § 3403 (1994) (holding employer liable for tax required to be withheld and paid); I.R.C. § 6672(a) (1994) (imposing personal liability for failure to collect and pay over tax); \textit{see also} Finley v. United States, 82 F.3d 966, 974 (10th Cir. 1996) (stating that responsible persons shall be held liable for willfully failing to remit payroll taxes). Once the employer withholds, the employee is credited with having paid the tax liability, regardless of whether or not the employer remits the withheld amount to the government. Thus, the only recourse the government has is against the employer. \textit{Id.} at 970.

\textsuperscript{434} See, e.g., Rothensies v. Electric Storage Battery Co., 329 U.S. 296, 299-303 (1946) (holding that rationale behind the statute of limitations requires such a policy). For a full discussion of Rothensies, see \textit{supra} part II.B.4.
plaintiff was requesting a refund of a barred tax—i.e., attempting to use recoupment as an independent jurisdictional ground. Perhaps this was what the district court was trying to convey in its footnote.

B. Fairley v. United States

In Fairley, the IRS audited the joint income tax returns of two decedents for the taxable years 1978, 1979, and 1980. As a result of these audits, one of the estates was forced to pay income tax deficiencies, interest, and penalties in 1984, attributable to these three taxable years. The payment of the income tax deficiencies produced a corresponding estate tax overpayment. The estate filed a claim for refund of the overpaid estate taxes in 1986, more than six months after the statute of limitations had run on the 1982 estate tax return. This claim was denied by the government on the ground that it was not timely.

The estate then filed an amended income tax return for 1978, the only one of the three taxable years on which the statute of limitations had not expired, seeking a refund of the income taxes. The estate alleged that it was entitled to recoup the entire amount of the overpaid estate taxes against the income tax liability for that year.

The government conceded that the estate was entitled to recoup the estate tax overpayment attributable to the 1978 income tax payment against the 1978 income tax liability. But the government contested the estate’s right to recoup the entire amount of the estate tax overpayment against the 1978 income tax liability, because the estate had failed to file a timely claim for refund attributable to the 1979 and 1980 taxable years.

The district court granted summary judgement to the taxpayer, holding that the main claim was timely and that equitable recoupment was “meant to avoid the bar of the statute of limitations.” The court went on to state that it would be “most ‘inequitable’ to bar plaintiff’s recovery on the basis of his failure to seek recoupment proportionately against the deficiency payments for 1978, 1979, and 1980.”

While equitable recoupment does allow the claimant to avoid the bar of the statute of limitations to a limited extent, nevertheless, the

435. 901 F.2d 691 (8th Cir. 1990).
436. Id. at 692.
437. The reason the statute had not expired with respect to the 1978 taxable year was that the IRS had returned the 1978 income tax payment to the taxpayer because the payment was sixty-five cents short. The taxpayer then re-remitted the payment by check dated August 13, 1984. Id. at 692 n.1.
438. The reason the estate did not file a claim for refund of the income taxes attributable to the 1979 and 1980 taxable years was because the statute had run with respect to those payments. See Fairley v. United States, 89-1 U.S. Tax Cas. (CCH) ¶ 9128, at 87,098-99 (E.D. Ark. 1988), vacated, 901 F.2d 691 (8th Cir. 1990).
439. Id.
440. Id. at 87,099.
district court failed to grasp the message of McEachern. If the main claim is not timely, recoupment is not an appropriate remedy. In Fairley, the main claim was an income tax refund claim with respect to three taxable years. This claim requested recoupment of the overpaid estate tax. The claim was timely with respect to the 1978 taxable year, but not with respect to the 1979 and 1980 taxable years.

On appeal, the Eighth Circuit correctly held in favor of the government, allowing it to recoup the estate tax attributable to the 1979 and 1980 taxable years. But the court's reasoning was confused. First, it mischaracterized the taxpayer's earlier disallowed claim for refund of the estate tax as the main claim. The Eighth Circuit then vacated the district court's grant of summary judgment in favor of the taxpayer, holding that the district court lacked jurisdiction over the claim because the equitable recoupment claim was the sole basis for jurisdiction.

The Eighth Circuit cited Dalm for the proposition that "Fairley has invoked equitable recoupment in a separate suit for refund of estate tax, rather than as a defense to the government's assessment of an income tax deficiency." The court would have been correct in its reasoning if its characterization of the main claim had been correct. In that case, it would have been addressing a straightforward refund action for the estate tax, and equitable recoupment would not enter into the picture. In misconstruing the facts, the court never reached what should have been the correct reasoning in this case: recoupment was inappropriate because the single transaction element was not met.

While there is no doubt that the payment of the income tax deficiencies would directly produce an estate tax overpayment, recoupment is available only to the extent the main claim is timely. Because there were three taxable years involved, each of those years represented a separate "transaction" or "taxable event." For purposes of recoupment, the two closed years could not be bootstrapped by the open year into meeting the jurisdictional requirement.

The district court misunderstood this point. It noted that the estate was seeking to use recoupment as the sole basis for jurisdiction because it was invoking the doctrine "in a separate suit for refund of

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441. Fairley v. United States, 901 F.2d 691, 694 (8th Cir. 1990). Under this rationale, the Eighth Circuit would presumably have denied the taxpayer's claim for equitable recoupment of the estate taxes against the timely filed claim for refund of the 1978 income taxes.

442. Id.

443. It is curious that the court did not address this issue, since it was apparently raised by the parties themselves. Instead, the court stated that its "holding makes it unnecessary for us to reach this issue." Id. at 694 n.3.

444. See Rothensies v. Electric Storage Battery Co., 329 U.S. 296, 300 (1946); accord Wood v. United States, 213 F.2d 660, 661-62 (2d Cir. 1954) (holding that government may not offset an income tax refund for one taxable year by a deficiency in another).
estate tax, rather than as a defense to the government’s assessment of an income tax deficiency.\textsuperscript{445} It further cited \textit{Dalm} for what appears to be approval of a requirement to exhaust administrative remedies.\textsuperscript{446}

There are several fallacies in this reasoning, however. First, the court seems to have misunderstood the jurisdictional point of \textit{Dalm}. \textit{Dalm} involved a prior proceeding in the Tax Court. This is problematic for any further review in the district court, as \textit{Dalm} points out. Second, deficiencies in income tax are only challengeable in the Tax Court, not in the district court which has only refund jurisdiction. Third, Fairley was properly pursuing a refund claim of the 1978 income tax under equitable recoupment in the district court. Fourth, the Supreme Court in \textit{Dalm} raised the issue of the administrative remedy, not as a suggestion for an exhaustion requirement, but to soften the harshness of its holding. Fifth, the effectiveness of the administrative remedy depends upon taxpayers’ knowledge and understanding of the intricacies of the tax laws. If the courts cannot understand equitable recoupment, how can laymen be expected to understand it? Sixth, the administrative remedy is probably only as good as the integrity of the system itself. Because equitable recoupment is so often misunderstood and inconsistently applied, the government does not have much incentive to work things out administratively with the taxpayers. In other words, the better the government’s chances of success in court, the less likely it is to negotiate an informal settlement agreement with the taxpayers.

In a footnote, the Eighth Circuit raised the issue of whether recoupment was an appropriate remedy on equitable grounds.\textsuperscript{447} It noted that the estate had nearly a year in which to file a claim for refund of the estate tax attributable to the 1979 and 1980 income tax payments; however, it failed to do so.\textsuperscript{448} This is a recurring issue in the recoupment cases—one with no consistent resolution. The court summarily concluded that recoupment was not an appropriate remedy on that ground.\textsuperscript{449}

\section*{Conclusion}

Equity originated as a system of flexibility because the legal remedies were often inadequate. It has evolved, however, into a rigid system, which, except for jurisdictional issues, often cannot be distinguished from law. Although equitable recoupment is an extraordinary remedy, it is important because it directly addresses issues

\textsuperscript{445} Fairley, 901 F.2d at 694.
\textsuperscript{446} Id.
\textsuperscript{447} Id. at 694 n.4.
\textsuperscript{448} Id.
\textsuperscript{449} Id. In the same footnote, the court raised the issue of unclean hands, notwithstanding \textit{Bowcut}, noting that the income tax deficiencies arose in the first place because the decedents had defrauded the government. Id.
of fundamental fairness and indirectly affects public perception of the federal tax system as a system of voluntary compliance. Many courts and commentators seemingly have lost sight of the fact that recoupment is, first and foremost, an equitable remedy. As such, it should not apply automatically or be forced into artificial requirements. Equitable remedies, by their nature, are flexible, although they must conform to equitable elements. This is, perhaps, the message behind the Supreme Court's failure to establish clearly articulated guidelines and, perhaps, behind its failure to address substantively the issue of recoupment since 1947, even though there are many conflicts among the lower courts.

Although the Supreme Court was, or should have been, aware of the lower courts' struggle to rationalize McEachern with Bull and Stone, it nevertheless passed up the opportunity to clarify the issue in Rothensies.450 Because of this lack of guidance, the established elements have become too narrowly construed. As a result, courts have struggled with the remedy for over fifty years. This struggle has produced inconsistent results that not only promote forum shopping, but

450. The pre-Rothensies struggle is exemplified by the Seventh Circuit's decision in American Light & Traction Co. v. Harrison, 142 F.2d 639 (7th Cir. 1944). In 1928, a taxpayer's wholly-owned subsidiary acquired a substantial block of stock in another corporation and shortly thereafter exchanged this stock for debentures of a third corporation. The taxpayer believed the exchange to be a tax-free corporate reorganization and failed to report any gain from the transaction. After the statute of limitations for assessment and collection of a deficiency for the taxable year 1928 had expired, it became apparent that the prior tax treatment of the gain had been erroneous.

In 1930 and 1931, the taxpayer sold some of the debentures. It maintained that no taxable gain resulted from this sale even though the earlier transaction had been mistakenly reported as a tax-exempt exchange. Therefore, the basis for purposes of the sale was the fair market value on the date of the exchange. Because the later sale did not net more than the redetermined basis, no taxable gain resulted. The IRS refused to accept this position. The taxpayer then brought suit before the Board of Tax Appeals, which held in favor of the taxpayer. American Light & Traction Co. v. Commissioner, 42 B.T.A. 1121, 1124 (1940), aff'd, 125 F.2d 365 (7th Cir. 1942).

In 1933 the taxpayer sold the remainder of the debentures and erroneously included an amount of gain in its income tax return for that year, attributable to the sale. The government admitted that the taxpayer had overpaid its taxes for 1933, but refused to allow a refund of this amount, claiming that it should be entitled to recoup the open overpayment against the barred deficiency from 1928. Harrison, 142 F.2d at 641.

The Seventh Circuit affirmed the Board's decision, opining that its "power to construe the statute [of limitations] is narrower than usual and closely circumscribed, because the Supreme Court has given an authoritative interpretation in the McEachern case." 450 id. at 643.

Judge Evans dissented, noting that the prior deficiency and the later overpayment arose from the same transaction and should be governed by the Bull case. 450 id. at 645 (Evans, J., dissenting). The Judge then stated: "I also think the disputed questions should be settled by the Supreme Court. Then inferior courts, the U.S. Tax Court, all taxpayers, and the Government will thereby be made happy, or at least less unhappy and less disputant." id. (Evans, J., dissenting).
also obfuscate the remedy of recoupment when it should most appropriately apply.

While recoupment is a narrow doctrine, as the Supreme Court has stated, it is nevertheless an equitable remedy that should produce an equitable result. But when the basic elements and their general application are inconsistent, the result is inequitable, both substantively and procedurally. Equitable remedies may occasionally produce substantively inconsistent results because these remedies require subjective determinations, based upon the specific facts of the individual cases. Reasonable minds may differ in a subjective determination, but there should be less subjectivity in the procedural aspect of the remedy. For instance, because consideration of a recoupment claim should initially focus on the individual facts, the decisions of the lower courts should be upheld, as long as those decisions are based on an appropriate consideration of the facts. But, when the elements and their application are inconsistent, the appellate courts should intervene, as they have.

But the flexibility of equity with its individualized remedy is less likely to be accommodated in the modern legal system with its crowded dockets. There is a danger of the remedy becoming inflexible, as well as inconsistent, if the elements continue to be narrowly construed. While Professor Andrews's two tax theory is a clever leap over the single transaction hurdle, an automatic, but inconsistent, application of this element relegates recoupment to a quasi-legal remedy. It also ignores the equitable elements that should be of primary importance.

While this Article's proposed elements may not alleviate the substantive inconsistencies among the courts, the remedy is nevertheless, historically, an equitable one and it should be applied as such. Although the remedy is still termed equitable recoupment, under its modern construction, there is little equity left.

451. See Andrews, supra note 13, at 647 (discussing the problem of forum shopping due to the inconsistencies in this area).

452. This sentiment has been echoed in Legatzke, supra note 20, at 861, although Legatzke is speaking only in terms of fairness rather than in terms of pure equity.