

RECOUPMENT – OVERPAID PENSIONS BEING SEIZED

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PENSIONS BEING
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Recoupment

“Overpaid Pensions Being Seized”

April 15, 2013

Dear Governor Parnell,

Congratulations on the fine job you are doing in keeping the ship of Alaska running smooth through some rough waters. My friends feel you are doing a credible job and deserve another term as governor, which will make you the longest serving governor in the State's history. Go for it.

On this national day I am left without very important information my tax firm states is needed to complete my return firmly. It turns out I have been receiving overpayment for over 10 years amounting to \$120,000.00.

The Division of Retirement and Benefits admitted it was a computer glitch that caused the problem. Thus a high percentage of culpability belongs to the Division. Usually "criminals" are pardoned after they have served their sentence or paid their debt to society for the wrong they have done. In this state of satisfying overpayment the "criminal" it is determined "should have known" and is punished for life even though the State has been fully reimbursed.

I do not object to my making restitution for the overpayment but feel the law and Department officials are taking advantage of those caught in the trap of an unknown

or unaware of the situation of receiving excess
pension payments. The current law needs to be
adjusted to wholly reestablish the former
employee when the State has received full
compensation. There should be a schedule of
repayment for the "loan" and not be double
taxed for the loan.

I often wonder how many people in the
past and present have long ago fully reimburs-
ed the State and still are paying for the
rest of their life.

Asking for a time certain when the pay-
ments will be completed is not asking too much
since in my case it was agreed I will be
reinstated when actuality has been fulfilled.

Although it is the law a life sentence in
these cases is grossly unjustified. Governor
would you consider asking the Legislature to
review the law and study the cases involved?
And at least ask the Division to inform me
how much interest I am paying yearly to adjust
my income tax form.

Thank you very much for your considera-
tion.

May the Blessings of the Good Lord
be yours always.

Terry Martin

Dec 31, 2012

Mr. Jim Puckett - Director
AK Div. of Retirement & Benefits
P.O. Box 110203
Juneau, AK 99811-0203

Dear Mr. Puckett,

Happy New Year! Hopefully you can help me have a happier year by my requests.

From the enclosed copy of my letter sent to Mrs. Voigt, I am seeking information pertaining to my receiving pension overpayment settlement particularly to a taper, interest and other options to payment. Please help.

The law, Sec. 39.35.570 and the Administration Codes associated with it need to be re-evaluated for fairness to former employees and assurance of quicker reimbursement to meet full actualization of overpayment for each case.

First, delete the phrase "for life". To day most people caught in this situation will live beyond the period of full payment. This "full life" phrase usually refers to a judges decision for a major crime; i.e. murder, rape or a bank robbery for the third time. Perhaps the law should read "until full actuality is established" without the unmentioned "income tax" outflow. In the case that I have read the settlements state \$1,000 pension. Thus a total income of \$12,000 with no

tapes withheld. The remainder of the pension is a credit holding. The victims of the Division's missteps have already paid an excess tax due to overpayments. Now you are withholding tapes for income not received. The pay back could be completed three or four years earlier.

In my settlement there is a 7% interest add on to reach actuary. This seems to ensure a "life time" provision. There should be more flexibility in the law. The Division should not try to balance it's books on those entrapped with overpayments due to it's failures, i.e. "computer glitch" as stated in my case. I wonder how many former retirees of overpayment have fully reimbursed the Division and yet are still deprived of being reinstated to pension income. A "life sentence" for a misstep by the Division is excessive punishment. The Division in their defense always states the retiree should have known. However some of us suffer with blind trust or faith the Division is doing what is right. It's their responsibility.

If you should consider having the Legislature review the present law and AC's, I would be glad to give testimony of one who see a different point of view than only the administrators who may have other goals to reach.

Another problem brought up by others who I talked to about my case is the additional eight (8) years I served as an elected Representative. I am given no credit for. I did continue giving to PERS and was always considered a full time employee.

In my earlier letter to staff concerning my knowledge of my retirement status, I mentioned talking with a Division representative in Anchorage when I was $64\frac{3}{4}$ years old. We met in Anchorage and she had my files in front of her. I have recently found the name of the person to be Ana Schubert, manager of the Anchorage Field office. It was at this meeting that I was assured of receiving credit for 24 years of service. Your staff said they do not keep records of meeting with employees. I can't believe this.

I do appreciate you taking the time to read this long letter and look forward to your positive response.

Once again

HAPPY NEW YEAR.

former Representative Terry Martin

BARRON'S

October 25, 2010 | METROPOLITAN CLUB | NEW YORK CITY

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RETIREMENT PLANNING | AUGUST 13, 2010

'Overpaid' Pensions Being Seized

By ELLEN E. SCHULTZ

Ralph Yore, a retired aircraft inspector, found out the hard way what happens when companies make pension errors.

Paying Back Pension Mistakes



[View Slideshow](#)

Mike Belleme for The Wall Street Journal

A photo of Harold Kenneth Phillips' mining crew, taken around 1995, hangs on the wall of his home in Clintwood, Va.



[View Full Image](#)

Mike Belleme for The Wall Street Journal

Harold Kenneth Phillips, a retired coal miner, sued Brink's to recover the amount of overpaid pension funds it clawed back from him. He won.

Mr. Yore, 73 years old, received a letter earlier this year saying the pension he had been receiving in retirement was too large. The pension would be cut by two-thirds, to \$967 a month, the letter said—and he had to repay \$100,000.

His former employer—Vought Aircraft Industries Inc., now a division of Triumph Group Inc.—says retirees don't have a right to keep excess benefits paid to them erroneously, and that the pension plan is required to correct such mistakes.

The case of Mr. Yore underscores a trend where some companies, amid internal audits of their pension plans, are discovering they have mistakenly overpaid retirees and are taking action to recoup the funds.

"Retirees are often confused and shocked to learn that their pension plan overpaid them," says Justin Freeborn, a lawyer with the Western States Pension Assistance Project, a Sacramento, Calif., group that is partly funded by the U.S. Administration on Aging.

There aren't any statistics regarding pension overpayments, but senior advocates say they have seen a spike of "recoupment" cases, which are now one of the most common pension problems some advocacy groups are handling. Mr. Freeborn now spends almost one-third of his working time handling recoupment cases; a few years ago, the staff rarely saw such cases.

Federal law requires that overpayments be returned to the pension plan. But it doesn't specify who should do so. Companies almost always seek repayment from retirees or surviving spouses, usually by reducing the person's pension, or stopping it altogether, until the

overpayment is recovered.

Of course, companies shouldn't be overpaying pensions. And former workers shouldn't be receiving more than they are entitled to get.

But retiree advocates say it is unfair for retirees struggling with small pensions on fixed incomes to pay for a company's mistakes. "In most cases, they had no idea they were receiving the wrong amount," Mr. Freeborn says.

"They've already spent the overpaid money, and they have no way to pay it back."

In early 2009, Sylvia Glaab, a 71-year-old retiree in Aliso Viejo, Calif., tried to roll her "Cash Account Plan"—a type of pension that can be cashed out, like a 401(k)—at Macy's Inc. into an individual retirement account. Macy's didn't release her money. Instead, it sent her a letter in March 2009 saying it had just discovered it had overpaid the separate pension she had been receiving since she retired in 1994 after 24 years as a Macy's manager.

The pension should have been \$181 a month, not \$360, the letter said. Unless Ms. Glaab sent a check to Macy's for the total overpayments of \$32,973, the letter said, the company would keep the \$19,828 in her Cash Account Plan—and deduct \$110 a month from her \$180 a month pension, leaving her with a monthly pension of \$70 for life.

"We apologize for any inconvenience," the letter said.

Without legal help, it is difficult for retirees to challenge whether they have actually been overpaid, or to negotiate an affordable repayment plan.

Even after prodding by the Western States Pension Assistance Project, Macy's didn't release Ms. Glaab's retirement account until February 2010, at which point it dropped its demand for repayment.

A Macy's spokesman says an overpayment is a "very rare occurrence. But when an overpayment does come to our attention, we contact the participant and resolve the situation by reducing the benefit to the proper amount and/or working out a reasonable process to recover any overpayment. We are committed to paying out the full amount of pension that a participant is owed."

Federal pension law doesn't address the issue of fairness. But recoupments also fall under state trust laws, which consider whether the action is equitable. This determination can hinge on how much time has elapsed since the overpayment began, among other things.

It took Brink's Co. seven years to discover it was overpaying Harold Kenneth Phillips, a retired coal miner. Mr. Phillips had worked for the company, then known as Pittston Co., for 23 years until a coal cart he was riding in crashed, leaving him permanently disabled.

He began receiving his monthly pension of \$1,751 in 1997, but in 2005 a new pension administrator recalculated the amount, and concluded that Mr. Phillips was being overpaid \$341 a month.

Dozens of other retirees were being overpaid, too.

To recover the \$26,000 overpayment, the pension administrator reduced Mr. Phillips's pension by \$517 a month. With interest, Mr. Phillips, who now is 57, would have repaid \$50,000 by age 81.



[View Full Image](#)

Michal Czerwonka for The Wall Street Journal

Sylvia Glaab tried to roll her 'Cash Account Plan' at Macy's into an IRA. Macy's then discovered it had overpaid her and sought repayment.

Mr. Phillips sued, and a federal judge in Richmond, Va., ruled in July 2009 that because the company had taken so long to detect the overpayments, it would be unfair to require Mr. Phillips to repay the amounts. The judge ordered Brink's to return the amount it had recouped from 2005 to November 2009, plus interest.

Brink's declined to comment.

Federal law doesn't put a ceiling on the amount of an overpayment that a private pension plan can seek to recover. Multiemployer pension plans, which cover retirees at different companies, are limited to 25% reductions, while the Pension Benefit Guaranty Corp., which takes over failed plans, can reduce a pension by no more than 10%, and doesn't charge interest.

Most companies, however, reduce pensions by 25% or more of the newly reduced pension, so the impact can be significant.

Mr. Yore, the aircraft retiree in Westminster, Calif., who owes \$100,000, had been getting \$2,900 a month since he retired in 2001. This included an early-retirement incentive that was the equivalent of the Social Security he would receive at 65, of \$1,300 a month.

His former employer, Vought Aircraft, forgot to end the supplement and reduce his pension to \$1,676 when Mr. Yore turned 65 in 2002. To recover the overpayment, it is recouping \$709 a month from the correct amount of \$1,676—a 58% reduction, leaving Mr. Yore with a monthly pension of \$967. That is 76% less than he has been receiving.

"I'm really in a bind," Mr. Yore says, "and may have to go back to work."

Write to Ellen E. Schultz at ellen.schultz@wsj.com

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THE ORANGE COUNTY REGISTER

That pension? You might have to pay it back

By TERYL ZARNOW

2010-08-27 12:36:17



Ralph Yore made a career out of being careful.

After 12 years in the Marines, including a tour in Vietnam, he began his life's work in aircraft maintenance. He was a quality control inspector and supervisor with the Department of Defense in Vietnam, for Bell Helicopters in Iran and several airlines. Eventually, in 1984, he landed at Northrop Grumman in Hawthorne.

Yore, 73, spent 17 years at Northrop ensuring in essence that planes didn't fall apart during flight. Small things like that.

Now, in his retirement, another small thing has knocked him sideways.

When this husband and father of two took early retirement in 2001, he began receiving pension payments of \$2,937.93 per month.

In April of 2009, he received a letter saying that an audit discovered a mistake: For the past eight years he had been paid \$1,261 per month too much. His payments should have been reduced when he began collecting Social Security.

Yore's payments were corrected to \$1,676.93 per month.

The letter came from Vought Aircraft that inherited his pension plan when it was split from Northrop. Vought is now part of the Triumph Group.

In March of 2010, Yore received a second letter: To recover the overpayment, the pension plan will deduct \$709.40 per month. His new monthly payment is suddenly \$967.53.

Ouch.

Clearly, Yore shouldn't be overpaid – but pension plans shouldn't make mistakes. Issues of fairness and responsibility here are tangled – unless it happens to you. Then it seems obvious.

Yore just wants to live a comfortable life in Westminster taking care of his family, his house and his fruit trees.

Instead he's making minimum payments on his credit cards, refiguring his bills and feeling stressed – none of which can be good for his blood pressure. His current payment leaves Yore in the hole about \$100 per month.

He's patriotic and proud of his military service; he doesn't want handouts.

"If I had known, I never would have taken the money."

But Yore wonders: Doesn't a company audit its books every year? Why is he penalized?

Bookkeepers made a seven-year mistake and now he is paying for it – all because they weren't very careful.

Yore doesn't want to spend the rest of his life paying back a debt he didn't know he had.

Legally, he might have to.

Turns out pensions paid by single employers fall into a murky area of federal law governed under Treasury and

Department of Labor regulations.

It is clear that, when administrators make a mistake, the plans are supposed to recoup the money, but nothing specifies from whom.

Common sense questions remain: Should there be a statute of limitations on mistakes? Should it matter if you can't afford repayments? Should plans really be allowed to charge interest?

The answers come case by case.

Justin Freeborn is an attorney with the Western States Pension Assistance Project, funded by the U.S. Administration of Aging, which provides free pension counseling. He says although court opinions conflict, he believes a major consideration should be whether an individual has an ability to repay.

"A lot of times our clients have no idea they are being overpaid. If you miscalculate \$50 a month over 10 years, that really starts to add up."

Yore was overpaid \$113,490. The plan has denied his claim to waive the repayment; now Freeborn is drafting an appeal. The last resort is court.

"Pension plans are legally responsible for calculating the benefits they pay," Freeborn notes. "Why should the individual participant have to pay for the errors caused by a pension plan?"

Pension plan rules are complex, and the appeals process is time-consuming, says Freeborn, who is helping Yore and spends about one-third of his time on similar cases.

Getting the plan documents and files for Yore's case and writing the appeal has consumed about 50 hours to date. He doesn't think typical retirees could do this themselves.

A basic question is: who bears responsibility?

Ultimately the retiree is not responsible to monitor his or her pension plan, says Rebecca Davis, legislative counsel for the Pension Rights Center. The plan's mistake is not the retiree's fault.

Ironically, if a bankrupt plan is taken over by the Pension Benefit Guarantee Corp., federal law protects retirees very well. Nearly always, benefits can be reduced by no more than 10% to recoup overpayments.

In single employer, private plans, Davis adds, there aren't a whole lot of rules to protect individuals.

There should be.

Sylvia Glaab from Aliso Viejo knew nothing of this when her letter came in 2009.

Glaab had two retirement plans. The first she earned from nearly 25 years working as a manager at Broadway that was sold to Macy's. The second was from nine subsequent years working at Macy's.

When she turned 71 in 2009, she wanted to roll her second plan over into an IRA and contacted the benefits folks for help.

Instead, her request triggered an audit and Macy's determined Glaab had been overpaid on her first plan since 1994. Meantime, the \$19,000 she had built up in her second plan disappeared from her statements.

"That threw me into a panic," she recalls. "Finally someone said: 'You've been overpaid \$179 per month. You owe us \$32,000.'"

The form letter that followed said she could send a check or they would keep her second account and reduce Glaab's monthly payments. Her correct payment of \$180 per month would be cut to \$70 per month for life.

"I don't have \$32,000 to write a check. I had received that amount for 15 years ... I have no idea where they were getting those numbers."

She contacted the Pension Assistance Project. In response to an appeal, Macy's released Glaab's \$19,000 in 2010 and agreed to waive repayment.

Freeborn believes Macy's ultimately did the right thing, but wishes they had done it sooner.

"Would they have waived the overpayment and agreed to give her access to her account if we hadn't gotten involved? I highly doubt it."

Glaab, who receives Social Security, now receives an adjusted payment of \$180. She continues to work part-time, and doesn't know when she will be able to stop.

In fact, she points out she has worked hard all her life – and these benefits are part of her compensation.

She wants other retirees to know:

"You don't have to just do whatever you are told to do in an impersonal form letter. There is recourse."

To get help

Contact the writer: Send story ideas to: terylzarnow@gmail.com.



www.pensionrights.org

1350 Connecticut Avenue NW, Suite 206
Washington, DC 20036 | (202) 296-3776

29 C.F.R. Subpart E—PBGC Recoupment and Reimbursement of Benefit Overpayments and Underpayments

Title 29 - Labor

Title 29: Labor

PART 4022—BENEFITS PAYABLE IN TERMINATED SINGLE-EMPLOYER PLANS

Subpart E—PBGC Recoupment and Reimbursement of Benefit Overpayments and Underpayments

§ 4022.81 General rules.

(a) *Recoupment of benefit overpayments.* If at any time the PBGC determines that net benefits paid with respect to any participant in a PBGC-trusted plan exceed the total amount to which the participant (and any beneficiary) is entitled up to that time under title IV of ERISA, and the participant (or beneficiary) is, as of the termination date, entitled to receive future benefit payments, the PBGC will recoup the net overpayment in accordance with paragraph (c) of this section and §4022.82. Notwithstanding the previous sentence, the PBGC may, in its discretion, recover overpayments by methods other than recouping in accordance with the rules in this subpart. The PBGC will not normally do so unless net benefits paid after the termination date exceed those to which a participant (and any beneficiary) is entitled under the terms of the plan before any reductions under subpart D.

(b) *Reimbursement of benefit underpayments.* If at any time the PBGC determines that net benefits paid with respect to a participant in a PBGC-trusted plan are less than the amount to which the participant (and any beneficiary) is entitled up to that time under title IV of ERISA, the PBGC will reimburse the participant or beneficiary for the net underpayment in accordance with paragraph (c) of this section and §4022.83.

(c) *Amount to be recouped or reimbursed.* In order to determine the amount to be recouped from, or reimbursed to, a participant (or beneficiary), the PBGC will calculate a monthly account balance for each month ending after the termination date. The PBGC will start with a balance of zero as of the end of the calendar month ending immediately prior to the termination date and determine the account balance as of the end of each month thereafter as follows:

(1) *Debit for overpayments.* The PBGC will subtract from the account balance the amount of overpayments made in that month. Only overpayments made on or after the latest of the proposed termination date, the termination date, or, if no notice of intent to terminate was issued, the date on which proceedings to terminate the plan are instituted pursuant to section 4042 of ERISA will be included.

(2) *Credit for underpayments.* The PBGC will add to the account balance the amount of underpayments made in that month. Only underpayments made on or after the termination date will be included.

(3) *Credit for interest on net underpayments.* If at the end of a month there is a positive account balance (a net underpayment), the PBGC will add to the account balance interest thereon for that month using—

(i) For months after May 1998, the applicable federal mid-term rate (as determined by the Secretary of the Treasury pursuant to section 1274(d)(1)(C)(ii) of the Code) for that month (or, where the rate for a month is not available at the time the PBGC calculates the amount to be recouped or reimbursed, the most recent month for which the rate is available) based on monthly compounding; and

(ii) For May 1998 and earlier months, the immediate annuity rate established for lump sum valuations as set forth in Table II of Appendix B of part 4044 of this chapter.

(4) *No interest on net overpayments.* If at the end of a month, there is a negative account balance (a net overpayment), there will be no interest adjustment for that month.

(d) *Death of participant—(1) Benefit overpayments.* If the PBGC determines that, at the time of a participant's death, there was a net overpayment to the participant—

(i) *Future annuity payments.* If the participant was entitled to future annuity payments as of the plan's termination date, the PBGC will (except as provided in paragraph (a) of this section) recoup the overpayment from the person (if any) who is receiving survivor benefits under the annuity.

(ii) *No future annuity payments.* If the participant was not entitled to future annuity benefits as of the plan's termination date, the PBGC may seek repayment of the overpayment from the participant's estate.

(2) *Benefit underpayments.* If the PBGC determines that, at the time of a participant's death, there was a net underpayment to the participant—

(i) *Future annuity payments.* If the benefit is in the form of a joint-and-survivor or other annuity under which payments may continue after the participant's death, the PBGC will pay the underpayment to the person who is receiving survivor benefits; for this purpose, if the person receiving survivor benefits is an alternate payee under a qualified domestic relations order, the PBGC will treat the benefit as if payments do not continue after the participant's death (see paragraph (d)(2)(ii) of this section).

(ii) *No future annuity payments.* If the benefit is not in the form of a joint-and-survivor or other annuity (e.g., a certain-and-continuous annuity) under which payments may continue after the participant's death or although the benefit is in such a form payments do not continue after the participant's death (i.e., in the case of a joint-and-survivor annuity, the person designated to

receive survivor benefits predeceased the participant or, in the case of another annuity under which payments may continue after the participant's death the participant died with no payments owed for future periods), the PBGC will pay the underpayment to the person determined under the rules in §§4022.91 through 4022.95.

[63 FR 29354, May 29, 1998, as amended at 67 FR 16956, Apr. 8, 2002]

§ 4022.82 Method of recoupment.

(a) *Future benefit reduction.* The PBGC will recoup net overpayments of benefits by reducing the amount of each future benefit payment to which the participant or any beneficiary is entitled by the fraction determined under paragraphs (a)(1) and (a)(2) of this section, except that benefit reduction will cease when the amount (without interest) of the net overpayment is recouped. Notwithstanding the preceding sentence, the PBGC may accept repayment ahead of the recoupment schedule.

(1) *Computation.* The PBGC will determine the fractional multiplier by dividing the amount of the net overpayment by the present value of the benefit payable with respect to the participant under title IV of ERISA. The PBGC will determine the present value of the benefit to which a participant or beneficiary is entitled under title IV of ERISA as of the termination date, using the PBGC interest rates and factors in effect on that date. The PBGC may, however, utilize a different date of determination if warranted by the facts and circumstances of a particular case.

(2) *Limitation on benefit reduction.* Except as provided in paragraph (a)(1) of this section, the PBGC will reduce benefits with respect to a participant or beneficiary by no more than the greater of—

(i) Ten percent per month; or

(ii) The amount of benefit per month in excess of the maximum guaranteeable benefit payable under section 4022(b)(3)(B) of ERISA, determined without adjustment for age and benefit form.

(3) *PBGC notice to participant or beneficiary.* Before effecting a benefit reduction pursuant to this paragraph, the PBGC will notify the participant or beneficiary in writing of the amount of the net overpayment and of the amount of the reduced benefit computed under this section.

(4) *Waiver of de minimis amounts.* The PBGC may, in its discretion, decide not to recoup net overpayments that it determines to be *de minimis*.

(5) *Final installment.* The PBGC will cease recoupment one month early if the amount remaining to be recouped in the final month is less than the amount of the monthly reduction.

(b) *Full repayment through recoupment.* Recoupment under this section constitutes full repayment of the net overpayment.

[63 FR 29354, May 29, 1998]

§ 4022.83 PBGC reimbursement of benefit underpayments.

When the PBGC determines that there has been a net benefit underpayment made with respect to a participant, it shall pay the participant or beneficiary the amount of the net underpayment, determined in accordance with §4022.81(c), in a single payment.

[61 FR 34028, July 1, 1996, as amended at 63 FR 29355, May 29, 1998]



PENSION RIGHTS
CENTER

Unfair Pension Takebacks:
What Can Be Done to Protect Retirees

A Working Paper by
Eric Loi and Rebecca Davis

Pension Rights Center

Unfair Pension Takebacks: What Can Be Done to Protect Retirees

In 2001, Ralph Yore took early retirement from the aerospace company where he had been a maintenance inspector for 17 years. He began receiving \$2937.97 per month in pension benefits. Then, in 2009, the pension plan informed him that, for eight years, he had been overpaid by \$1261 per month. His correct benefit should have been \$1676.93 per month. The plan notified the 73-year-old that, not only would his benefit be lowered to the correct amount, but an additional \$709.40 per month would be deducted from his corrected monthly pension to recoup the overpayment. Therefore, Yore's monthly pension is now \$967.53.

In one month's time, his pension income was reduced by two-thirds. His request for a waiver on grounds of financial hardship was denied. He is making minimum payments on his credit cards, refiguring his bills, and feeling stressed, which is not good for his blood pressure. He is now in the hole about \$100 a month.

What happened to Ralph Yore is called "recoupment."¹ His pension plan made an error with his pension amount, he thought the amount was correct, and spent the money. Now his pension plan is taking back the overpayments. Ralph Yore's situation is all too common.

What Is Recoupment?

Recoupment occurs when a pension plan administrator erroneously overpays pension benefits to retirees. Often these overpayments are made for many years before anyone realizes that a mistake has been made. When a plan finally realizes it has made a mistake, it corrects future payments and recoups the overpaid amounts either by reducing future payments or demanding a lump sum.

These reductions are typically done with little or no warning to retirees and with no formal process for challenging the plan's action. A recoupment action can happen within one month's time. In extreme cases benefits are reduced to zero until the full overpaid amount has been recovered -- some plans also collect interest on the overpaid amounts. Plans justify recoupment actions by claiming that the plan has a fiduciary duty to collect overpayments on behalf of all other participants of the plan. The idea is that overpaid amounts are plan assets that belong to participants of the plan.

Currently, pension plans write their own rules on how they go about collecting money they negligently paid out. Typical recoupment schemes place the entire burden of repayment on retirees even when plan negligence causes the overpayment error and the overpaid amount is negligible when compared to the loss of income amount for the retiree.

Why/When Does Overpayment of Benefits Occur?

Common situations in which overpayment occurs with:

- (1) **Miscalculation or plan error:** The plan or third-party administrator inaccurately calculates a participant's benefits or otherwise misapplies the provisions of the plan, resulting in too high a benefit being paid to participant.
- (2) **Participant error:** A retiree receiving benefits from a multiemployer plan returns to work in the industry, trade or craft, in the geographic area covered by the plan and the retiree's benefits should have been suspended under the terms of the plan, an overpayment results.
- (3) **Benefit offsets:** A participant receives an income benefit from some other source, which should reduce (or be offset against) the benefits paid to the participant by the plan. Overpayments occur in this context when the plan fails to include the offset in the benefit calculation. Plan benefits may be offset against a variety of collateral benefit or income stream sources, including Social Security, worker's compensation, or disability benefits.
- (4) **Double-dipping/collateral source:** Generally arising from health or insurance plan situations in which the beneficiary's retention of a duplicative benefit from a non-plan source results in double reimbursement for the participant. Secondary payment typically takes the form of lump-sum tort awards, making the original benefit paid by the plan an overpayment.
- (5) **Termination of an underfunded plan:** When plans terminate without enough funds to pay participants all accrued benefits, the PBGC takes over administration of the plan. The PBGC insures benefits up to certain amounts, so participants who receive benefits above the guarantee limits may suffer a benefit reduction as a result of the termination. While the PBGC is in the process of taking over a plan -- a process that can take several years -- participants may be overpaid above the guarantee limit. The PBGC has protections in place to guard against drastic benefit reductions in their recoupment cases.

The Legal Basis for Recoupment

Recoupment of an overpayment is permissible

Generally, a tax-qualified plan must provide that benefits provided under the plan may not be anticipated, assigned (either at law or in equity), alienated, or subject to attachment, garnishment, levy, execution, or other legal or equitable process.² Therefore, an arrangement for a plan to garnish/levy/assign a portion of a participant's normal monthly pension payment to "recoup" past overpayments, without a stated exception, would normally violate the "anti-alienation and anti-assignment" rule.

However, Treasury Regulation § 1.401(a)-13 identifies a few arrangements that it does not consider an assignment or alienation under IRC § 401(a)(13). One such exception is for recoupment arrangements -- "any arrangement for the recovery by the plan of overpayments of benefits previously made to a participant."³ In other words, recoupment is not an illegal alienation of benefits.⁴

Why plans recoup benefits

Typically, plan trustees read ERISA § 404(a)(1)(B) as requiring them to recoup any overpaid amounts. They view the requirement that they act solely in the interests of participants "with the care, skill, prudence and diligence under the circumstances prevailing..." as obligating them to recover erroneous payments. From their perspective, a fiduciary has the obligation to preserve and protect assets of a pension trust for all plan participants and so the overpayment of pension assets to any one individual is viewed as harming all other participants. Therefore, despite the fact that the mistake was through their negligence, fiduciaries argue they have a duty to recover erroneous overpayments on behalf of, and for the benefit of, all participants.

The Labor Department permits a fiduciary to recover prior overpayments through suspensions of, or offsets against, future payments but only when such recovery does not violate his/her fiduciary standards. With recoupment actions, ERISA fiduciary standards require that the fiduciary prudently weighs the plan's financial interest against individual circumstances, including the financial hardship to the participant.⁵

Plans may waive recoupment

Department of Labor Advisory Opinion 77-08 specifically authorizes a plan administrator or trustee to consider the hardship of a participant when deciding whether or not to recoup an overpayment. A fiduciary could be limited in its duties to recoup overpayments from a participant if "the facts and circumstances involved," include hardship to the participant or high plan costs that make it imprudent to seek recoupment.⁶

The DOL's guidance to consider hardship on the participant when deciding to bring a recoupment action is not widely known. Additionally, Advisory Opinion 77-08's hardship element is subjective as it does not define the type or level of hardship the participant must demonstrate before a plan may waive a recoupment action.

Equitable Estoppel fails as a remedy

Generally, most equitable estoppel defenses by retirees hoping to prevent a recoupment action fail in court.⁷ Although a few retirees have been able to successfully claim equitable estoppel when courts have found "extraordinary circumstances," these situations are very fact-specific and apply in only rare situations.⁸ Generally, equitable estoppel arguments alone cannot overcome a fiduciary's duty to maintain the actuarial soundness of a pension plan on behalf of all other participants. An overpayment by a plan to a retiree is seen as an "advance payment" of the retirees' pension money. This rationale helps justify a plan's recoupment action that is generally based on the fiduciary's obligation, on behalf of all other participants, to maintain the plan's actuarial soundness.⁹

Proposed Legislative Reform

The Restoring Pension Promises to Workers Act of 2007 (S.1725, 110th Congress), introduced by Senator Tom Harkin, proposed limitations on a pension plan's ability to collect money from pension recipients for overpayments. The bill would have prohibited recoupment actions in situations where it would cause a financial hardship to the retiree or where the amount sought would be insignificant relative to the plan's overall funding ratio. The bill also imposed a three year statute of limitations for plans to bring recoupment actions. Under this statute, plans would only be able to reach back three years from when it discovers an overpayment. Finally, the bill

would have required plans to notify retirees and any eligible beneficiaries of the right to appeal a plan's decision to enforce a recoupment action. The bill has not been reintroduced but it was a promising start in the effort to address the overpayment and recoupment issue.

Regulatory Reform Options

Modify and publicize the DOL Advisory Opinion 77-08's participant hardship principle

The Department of Labor could protect many retirees from unfair recoupment actions by modifying the content of Advisory Opinion 77-08 and publishing the revised guidance in the form of a regulation or field advisory bulletin. New guidance could reemphasize the principles of Advisory Opinion 77-08 by highlighting the fact that waiving recoupment of an overpayment is not a breach of fiduciary duty and, when considering any recoupment action, financial hardship of the participant should be considered. This guidance should detail the types and levels of hardship that, if demonstrated, would preclude recoupment.

Limit the monthly amount that can be recouped

Once an overpayment has been detected plans should reduce a retiree's benefits to the correct amount. But plans then should be limited by a capped percentage in further reducing retirees' benefits for the purposes of recoupment. Since a retiree's monthly benefit payment will have already been reduced prospectively as a result of recalculating the benefit to the correct amount, it is unreasonable to allow plans to further lower the benefit without any limitations or notice. Retirees often depend on their monthly pension payments as a sole source of retirement income. Reducing such a payment twice, without any notice and without any limitation, can be detrimental to a retiree. These actions are especially unreasonable when the overpayments occurred for many years because of a plan's negligence.

Limiting the amount a plan can recoup is not unprecedented. For example, **DOL Reg. § 2530.203-3** specifically authorizes a plan to recoup early retirement benefits paid out to multiemployer plan retirees that should have been suspended upon participant's re-employment in the same craft, trade, or geographic area. However, such recoupment is limited to a maximum of 25 percent of any benefit moving forward and cannot reduce the actuarial value of participant's normal retirement benefit.

Similarly, the Pension Benefit Guaranty Corporation also has recoupment limits to avoid creating financial hardship to pensioners. ERISA § 4022.82(a)(2)(ii) limits the recoupment of overpayments due under Title IV to no more than the greater of 10 percent of the "overpayment percentage" or the amounts in excess of the maximum guaranteed benefit under ERISA § 4022(b)(3)(B).¹⁰

Require plans to give participants advance notice of recoupment and right to appeal

A plan's recoupment action is subject to a participant's appeal through the administrative claims and appeals process, but yet most plans do not notify participants of their right to appeal a recoupment action. Plans should be required to notify participants and retirees of an adverse benefit determination and provide 90 days appeal period during which benefit payments could be reduced to the corrected amount, but not further reduced to collect any overpayments. Only after the 90-day period and a failed appeal should a plan be permitted to impose a recoupment action.¹¹

Conclusion

The recoupment problem is a difficult situation for both plans and participants. Plans must balance their duty to an individual participant with the plans' duty to all participants. However, retirees should not be subject to unexpected and excessive financial burdens because of a plan's mistake. Retirees should receive the benefits they earned, no more or less, but the repayment process must be equitable. The competing interests at play in an overpayment situation demand accountability and reasonable accommodations on the part of everyone. Plans should be permitted to recoup overpayments, but appropriate limits on the amount of benefits a plan may recoup should be imposed along with a fiduciary's ability to waive overpayments in situations of financial hardship.

¹ For the purposes of this paper, the term "recoupment" refers to the instance where a plan automatically arranges for a participant's pension payment to be reduced below its "corrected amount" to provide for reimbursement to the plan of overpaid amounts received by the participant.

² IRC § 401(a)(13); Treas. Reg. § 1.401(a)-13. Assignment and alienation defined as "(1) any arrangement providing for the payment to the employer of plan benefits which otherwise would be due the participant under the plan, and (2) any direct or indirect arrangement (whether revocable or irrevocable) whereby a party acquires from a participant or beneficiary a right or interest enforceable against the plan in, or to, all or any part of a plan benefit payment which is, or may become, payable to the participant or beneficiary".

³ Treas. Reg. § 1.401(a)-13(c)(iii).

⁴ Other "carve-outs" to the Anti-Alienation Rules: The following arrangements/conditions allow for the proceeds of a pension plan to be assigned to another individual or entity: Qualified Domestic Relations Order (QDRO); Personal Bankruptcy; Federal Tax liens and Crimes Against the Plan -- In addition to these carved-out arrangements, there are "exceptions" to the general rule -- the following exceptions: (1) Revocable 10% Assignment: Once a benefit is in pay status, a plan may permit a participant to make a voluntary, revocable assignment of up to 10% of each future benefit payment, (2) Security for Plan Loans: Non-forfeitable benefits may be used as security for plan loans to participants so long as such loans meet certain fairness and reasonableness requirements as set forth in ERISA § 408(b)(1) and are IRC § 4975(d)(1)(operating to exempt plan loans from ERISA's prohibited transaction rules).

⁵ See DOL Adv. Ops. (AO) 77-07, 77-33, 77-34, 77-08 and unnumbered opinion dated April 4, 1977.

⁶ See DOL Adv. Ops. (AO) 77-08.

⁷ Generally, equitable estoppel arguments by the retiree fail because they fail to demonstrate an "extraordinary circumstance in which justifies the absence of recoupment of overpayments by a plan". The idea is that "The actuarial soundness of pension funds is, absent extraordinary circumstances, too important to permit trustees to obligate the fund to pay pensions to persons not entitled to them under the express terms of the pension plan." *Philips v. Kennedy*, 542 F.2d 52, at footnote 8.

⁸ See *Bloemker v. Laborer's Local, 265 Pension Fund*, 605 F.3d 436 (6th Cir. 2010).

⁹ See DOL Adv. Ops. (AO) 77-08.

¹⁰ Generally, after termination of a plan occurs, the PBGC will take over as trustee and determine what benefits are due to participants under the PBGC's guaranteed limits. Between the plan's termination date and when the PBGC's final benefit determination is made, participants could receive overpayments. The PBGC recoups overpaid amounts over a certain period of time by reducing a participant's final benefit determination amount going forward. The amount a PBGC can recoup from each payment is limited by the "overpayment percentage." The "overpayment percentage" is determined by dividing the value of the total amount of the overpayments by the value of the correct payments. For Example: A person's finalized benefit is determined to be worth a lump sum value of \$100,000, and their monthly benefit is finalized at \$1,000. The person had been receiving \$1300 for the 10 months between plan termination and final benefit determination. The overpayment percentage is three percent (\$3,000 in overpayments divided by the lump sum value of the finalized benefit amount, \$100,000 at termination date). The participant's

benefit will be reduced by \$30 per month (three percent of the finalized monthly benefit amount, \$1000) for 100 months.

¹¹ It would also be helpful if participants were notified of the availability of assistance through EBSA. EBSA field staff could, where appropriate, refer retirees to the National Pension Lawyers Network or an Administration on Aging pension counseling project.



Pensions ask retirees to pay back tens of thousands

By Melanie Hicken @melhicken October 24, 2013: 9:33 AM ET



COURTESY: CHRISTOPHER GRANT

Carole Grant, 75, has been told she owes almost \$61,000 for nearly 20 years of pension overpayments.

NEW YORK (CNNMoney)

Some pension plans have overpaid retirees for years -- now they're demanding their money back.

For retirees, it can mean owing tens of thousands of dollars. And with little warning, their pension checks are being slashed to cover their debt.

In April 2011, New Jersey resident Carol Montague received a letter from American Water Works Co.'s pension plan saying it had overpaid her for more than five years and wanted its money back -- plus interest. Montague, now 67, was told she owed roughly \$45,000.

Two weeks later, Montague's pension benefits dropped from \$1,246 to around \$325 a month, or half what she should have been paid all along. The plan takes out roughly \$300 a month in order to pay itself back.

Once Montague's health care premium is deducted, her monthly pension check shrinks to less than \$25. She gets another \$1,200 a month from Social Security, but it's not enough. So, in addition to her part-time job as a school crossing guard, she is working as a salesperson at Macy's.

So far, Montague has repaid almost \$9,000 -- calculations show that she won't repay her debt in full until 2024.

Share your story: Were you overpaid by your pension plan?

American Water said Montague signed a document verifying the correct pension amount and that they are legally allowed to collect any overpayment, with interest, to protect the viability of the pension fund. Montague acknowledges she made a mistake, but didn't think she needed to confirm that her benefits matched the amount in the letter she had signed almost a year before she retired.

"I put it away in a steel box. I never looked at it again. It was stupid on my part," she said. "But it took (almost) six years for them to find out they overpaid me?"

With the help of the Mid-Atlantic Pension Counseling Project, a government-sponsored program, she has appealed to the pension plan to waive the interest, as well as ease some of the overpayment burden. But the plan has refused.

As pensions face increased financial scrutiny -- and shrinking funds -- pension counseling programs are seeing even more cases like Montague's.

This year, nearly 600 retired metal workers and their spouses are facing these so-called recoupment demands from the Sheet Metal Workers Local Union No. 73 Pension Fund, based outside of Chicago.

Related: Will your congressman retire richer than you?

In a letter sent to the pension recipients in May, the fund said a 2010 audit found that certain pensions were calculated incorrectly from 1974 to 2004, resulting in more than \$5 million in overpayments, according to an IRS filing. The fund is now demanding that the retirees pay back decades worth of mistakes, including interest based on the plan's rates of return.

In July, the pension fund reduced hundreds of checks to the proper payment amount and then again, to make up for the overpayments, often by as much as 25%.

Since the pension fund is forecasting that many of the retirees will die before their debts are repaid, it is asking many of them to make large upfront payments.

It's unclear why the pension fund, which did not respond to requests for comment, waited several years to make the adjustments.

Carole Grant, 75, was told by the sheet metal worker's plan that she owed almost \$61,000 (roughly half of which was interest) for nearly 20 years of overpayments on the spousal benefits she received from her deceased husband's pension. Her monthly benefit of \$394 should have actually been \$249, the pension fund said.

Related: Are you saving enough for retirement?

As a result, she's been asked to make an upfront payment of \$54,000 and her check has been reduced to \$187 a month. While she has other sources of income, she doesn't think she should have to turn over her retirement savings.

"I don't feel that I should be penalized for the mistakes that they made," she said.



Save money without a steady income

Karen Ferguson, director of the Pension Rights Center, a Washington D.C.-based advocacy group, said that, in most cases, retirees have no idea they are being overpaid since "the way a benefit is figured in a typical pension plan is impossible for an ordinary person to fathom."

She called the sheet metal workers case the "most egregious" she's seen, underscoring the need for federal regulations, such as imposing a statute of limitations and limiting how dramatically a pension check can be reduced. She also said many retirees don't realize that plans rarely take legal actions to recover the lump sums.

Money 101: Planning for retirement

While some of the retired sheet metal workers have been able to get their debts forgiven or reduced by filing "hardship waivers," many have had appeals denied, said Tim Kelly, an attorney representing some of the retirees.

One of his clients, 63-year-old Ed Cochran, has received a disability pension since 1995 and was told he owes the fund nearly \$100,000, \$42,464 of which is interest. His monthly checks had included an excess \$262 a month.

Should we put this in Statute?

Cochran paid years' worth of income taxes and child support based on the amounts he received. And he's heard of many retirees in worse financial shape than him.

"There are so many other older retirees who didn't plan for rainy days," Cochran said. "This is all they have."

Have you received a recoupment demand? Visit the [Pension Rights Center website](#) for advice or for pension counseling referrals. ■

First Published: October 24, 2013: 6:59 AM ET

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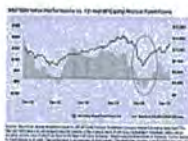
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RETIREMENT PLANNING | August 13, 2010

'Overpaid' Pensions Being Seized

By ELLEN E. SCHULTZ

Ralph Yore, a retired aircraft inspector, found out the hard way what happens when companies make pension errors.

Paying Back Pension Mistakes

Mike Belleme for The Wall Street Journal

A photo of Harold Kenneth Phillips' mining crew, taken around 1995, hangs on the wall of his home in Clintwood, Va.



Mike Belleme for The Wall Street Journal

Harold Kenneth Phillips, a retired coal miner, sued Brink's to recover the amount of overpaid pension funds it clawed back from him. He won.

Mr. Yore, 73 years old, received a letter earlier this year saying the pension he had been receiving in retirement was too large. The pension would be cut by two-thirds, to \$967 a month, the letter said—and he had to repay \$100,000.

His former employer—Vought Aircraft Industries Inc., now a division of Triumph Group Inc.—says retirees don't have a right to keep excess benefits paid to them erroneously, and that the pension plan is required to correct such mistakes.

The case of Mr. Yore underscores a trend where some companies, amid internal audits of their pension plans, are discovering they have mistakenly overpaid retirees and are taking action to recoup the funds.

"Retirees are often confused and shocked to learn that their pension plan overpaid them," says Justin Freeborn, a lawyer with the Western States Pension Assistance Project, a Sacramento, Calif., group that is partly funded by the U.S. Administration on Aging.

There aren't any statistics regarding pension overpayments, but senior advocates say they have seen a spike of "recoupment" cases, which are now one of the most common pension problems some advocacy groups are handling. Mr. Freeborn now spends almost one-third of his working time handling recoupment cases; a few years ago, the staff rarely saw such cases.

Look into this get law #
Federal law requires that overpayments be returned to the pension plan. But it doesn't specify who should do so. Companies almost always seek repayment from retirees or surviving spouses, usually by reducing the person's pension, or stopping it altogether, until the overpayment is recovered. *← what is the states position*

Of course, companies shouldn't be overpaying pensions. And former workers shouldn't be receiving more than they are entitled to get.

* But retiree advocates say it is unfair for retirees struggling with small pensions on fixed incomes to pay for a company's mistakes. "In most cases, they had no idea they were receiving the wrong amount," Mr. Freeborn says. "They've already spent the overpaid money, and they have no way to pay it back."

In early 2009, Sylvia Glaab, a 71-year-old retiree in Aliso Viejo, Calif., tried to roll her "Cash Account Plan"—a type of pension that can be cashed out, like a 401(k)—at Macy's Inc. into an individual retirement account. Macy's didn't release her money. Instead, it sent her a letter in March 2009 saying it had just discovered it had overpaid the separate pension she had been receiving since she retired in 1994 after 24 years as a Macy's manager.

The pension should have been \$181 a month, not \$360, the letter said. Unless Ms. Glaab sent a check to Macy's for the total overpayments of \$32,973, the letter said, the company would keep the \$19,828 in her Cash Account Plan—and deduct \$110 a month from her \$180 a month pension, leaving her with a monthly pension of \$70 for life.

"We apologize for any inconvenience," the letter said.

(Without legal help, it is difficult for retirees to challenge whether they have actually been overpaid, or to negotiate an affordable repayment plan.

Even after prodding by the Western States Pension Assistance Project, Macy's didn't release Ms. Glaab's retirement account until February 2010, at which point it dropped its demand for repayment.

→ A Macy's spokesman says an overpayment is a "very rare occurrence. But when an overpayment does come to our attention, we contact the participant and resolve the situation by reducing the benefit to the proper amount and/or working out a reasonable process to recover any overpayment. We are committed to paying out the full amount of pension that a participant is owed."

Federal pension law doesn't address the issue of fairness. But recoupments also fall under state trust laws, which consider whether the action is equitable. This determination can hinge on how much time has elapsed since the overpayment began, among other things. * *Alaska Trust Laws*

It took Brink's Co. seven years to discover it was overpaying Harold Kenneth Phillips, a retired coal miner. Mr. Phillips had worked for the company, then known as Pittston Co., for 23 years until a coal cart he was riding in crashed, leaving him permanently disabled.

He began receiving his monthly pension of \$1,751 in 1997, but in 2005 a new pension administrator recalculated the amount, and concluded that Mr. Phillips was being overpaid \$341 a month.

Dozens of other retirees were being overpaid, too.

To recover the \$26,000 overpayment, the pension administrator reduced Mr. Phillips's pension by \$517 a month. With interest, Mr. Phillips, who now is 57, would have repaid \$50,000 by age 81.



Michal Czerwonka for The Wall Street Journal
Sylvia Glaab tried to roll her 'Cash Account Plan' at Macy's into an IRA. Macy's then discovered it had overpaid her and sought repayment.

Mr. Phillips sued, and a federal judge in Richmond, Va., ruled in July 2009 that because the company had taken so long to detect the overpayments, it would be unfair to require Mr. Phillips to repay the amounts. The judge ordered Brink's to return the amount it had recouped from 2005 to November 2009, plus interest.

Brink's declined to comment.

Federal law doesn't put a ceiling on the amount of an overpayment that a private pension plan can seek to recover. Multiemployer pension plans, which cover retirees at different companies, are limited to 25%

reductions, while the Pension Benefit Guaranty Corp., which takes over failed plans, can reduce a pension by no more than 10%, and doesn't charge interest.

Most companies, however, reduce pensions by 25% or more of the newly reduced pension, so the impact can be significant.

Terry? Mr. Yore, the aircraft retiree in Westminster, Calif., who owes \$100,000, had been getting \$2,900 a month since he retired in 2001. This included an early-retirement incentive that was the equivalent of the Social Security he would receive at 65, of \$1,300 a month.

His former employer, Vought Aircraft, forgot to end the supplement and reduce his pension to \$1,676 when Mr. Yore turned 65 in 2002. To recover the overpayment, it is recouping \$709 a month from the correct amount of \$1,676—a 58% reduction, leaving Mr. Yore with a monthly pension of \$967. That is 76% less than he has been receiving.

"I'm really in a bind," Mr. Yore says, "and may have to go back to work."

Write to Ellen E. Schultz at ellen.schultz@wsj.com

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McLaren Bay Region: Pension overpayments a 'regrettable error;' affected retirees must make a decision by Feb. 1



By Heather Jordan | heather_jordan@mlive.com

on January 15, 2013 at 1:00 PM, updated January 15, 2013 at 2:45 PM

BAY CITY, MI — A calculation error made years ago and only recently discovered caused 283 McLaren Bay Region retirees to be either overpaid or underpaid when it came to their pensions, and now those affected must make a choice.

The error was discovered "when McLaren Bay Region began to consolidate its pension programs into the corporation's pension programs," said Kurt Miller, director of marketing and public relations for McLaren Bay Region.

The hospital has been with the McLaren system since 2002.

"The letters to those affected went out by last week," Miller said.

Seventy employees were underpaid a total of \$1.1 million, and 213 employees were overpaid a total of \$832,000, according to a McLaren Bay Region news release issued Tuesday, Jan. 15.

Those who were underpaid were people who retired late, after the age of 65, and those who were over-paid were people who retired early, or before the age of 65.

Those who were overpaid must choose between writing a check for the total amount they owe or having their monthly pension benefit reduced to correct the error and make up for the over-payments.

"They make a decision by Feb. 1, and the calculations and payments and repayments in either direction begin March 1."

Miller said no particular department was affected.

"It's a regrettable error, and these things happen from time to time," he said. "...We're doing our best to be able to work with people to be able to correct the situation."

Sharon Roberts, who retired from the pharmacy department at the former Bay Medical Center almost 13 years ago, told MLive she is being asked to repay \$8,689.52. Roberts said she was receiving \$311.65 monthly, which her letter said was an overpayment of \$38.70 per month.

After doing her own calculations, she came up with a total overpayment of \$6,037.20.

"We don't know where this extra is coming from, if it's interest or inflation," she said. "What I want to know is, how come it is that they waited 13 years before anybody finds this thing?"

Miller declined to comment on individual cases and encouraged anyone who is affected by the error and has questions to call human resources at 866-238-2419.

Heather Jordan can be reached at 989-450-2652 or heather_jordan@mlive.com. Follow [@HeatherLJordan](https://twitter.com/HeatherLJordan) on Twitter and Facebook.

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Surprise, Retirees! Return the Benefits

Companies that discover pension overpayments can demand participants pay back the money or see their future benefits slashed.

By **Eleanor Laise**, July 2012

EDITOR'S NOTE: This article was originally published in the July 2012 issue of Kiplinger's Retirement Report.

Retirees collecting a steady monthly pension benefit have a great foundation for retirement security -- unless one day their pension plan demands some money back.

A growing number of retirees are finding their reliable pension income suddenly disrupted by a "recoupment," in which a plan administrator orders a participant to return benefit amounts that he was accidentally overpaid. The overpayments can stem from a plan math error or misapplication of plan rules. Retirees often have no idea they've received excess benefits until the plan hands them the recoupment bill. When administrators discover the mistake, often during a plan audit, they generally demand full repayment in a lump sum or by slashing future monthly benefits.

Recoupment can turn into a triple whammy for retirees: Plans first adjust monthly benefits to the correct amount, then demand repayment of excess benefits paid in years past, and sometimes ask for interest on those overpayments. Recoupment can continue even after plan participants have died, leaving survivors to pay the bill. "The retiree rarely, if ever, knows a mistake has been made," says Karen Ferguson, director of the Pension Rights Center, an advocacy group. "So they spend the money and many years later are told to pay it all back right now."

Although recoupments aren't new, some pension experts say they've seen an uptick in recent years as cash-hungry plans scrutinize records more closely. Overpayments can come back to bite plan participants long after they began. After a years-long court battle, the Oregon Public Employees Retirement System is now proceeding to recover roughly \$165 million in overpayments from more than 29,000 benefit recipients. Many of the beneficiaries retired between 2000 and 2004.

The affected Oregon retirees who receive monthly benefits will be asked to repay the entire amount in a lump sum, set up a payment plan or see their monthly benefit reduced. Those without ongoing monthly benefits, such as people who received a lump sum at retirement, must make a lump-sum repayment or set up a payment plan.

Marc Feldesman, who has been receiving monthly benefits from the Oregon plan since retiring in 2002, says he'll have to repay about \$14,000. "It has caused a lot of aggravation," says Feldesman, 65, a former college professor and administrator in Lake Oswego, Ore. "I gave up a

very good job in exchange for this permanent benefit, and at no time was there a little asterisk" indicating that the benefit could change, he says.

Fighting the Pension Plan

Retirees may have more power to fend off a recoupment than they -- or their plan administrators -- realize. In an advisory opinion that's not widely known among administrators, the federal Department of Labor has said that plans can consider the hardship to a participant when determining whether to seek recovery of overpayments. By pointing to this advisory opinion, as well as the fact that participants generally don't even realize they're getting the incorrect amount, attorneys are often able to get recoupments sharply reduced or waived, says Jeanne Medeiros, managing attorney at the New England Pension Assistance Project.

Given the possibility of a waiver, participants faced with a recoupment should seek legal help. The U.S. Administration on Aging's Pension Counseling and Information Program offers free assistance. Find a program in your area at www.pensionrights.org/counseling-projects, or go to www.pensionhelp.net to connect with other organizations offering free help.

Most participants, of course, would rather avoid a repayment request in the first place. One preventive measure is to carefully read your summary plan description and check individual benefit statements to ensure they correctly reflect your years of service and other details. "If it looks as though there's an obvious mistake in your favor, don't just keep quiet," Ferguson says, because you're setting yourself up for a recoupment down the road.

Read more at <http://www.kiplinger.com/article/retirement/T037-C000-S001-surprise-retirees-return-the-benefits.html#rDzOpSp0O4rwM0lt.99>

Upper Midwest Pension Rights Project helps widow avoid recoupment for overpayment

Pension plans can often make mistakes when calculating pension benefits. These errors can result in retirees, through no fault of their own, receiving pensions in the wrong amount. To correct their own mistakes, pension plans often ask retirees to repay the amount that has been overpaid. Below is a description of what happened when Annie*, a client of the Upper Midwest Pension Rights Project, found herself in this situation and how counseling project staff used their knowledge of pension plans to help Annie.

After her husband died in 2000, Annie began receiving a monthly survivor's pension in the amount of \$270. More than five years later, Annie was notified by her husband's pension plan that they had overpaid her by more than double. The plan told Annie that her monthly benefit should have been \$124, which meant that Annie had been overpaid by more than \$9,300. To correct their error, the pension plan told Annie that her survivor's benefit would not only be adjusted to the proper amount, but it would be reduced by an additional \$50, leaving Annie with a monthly pension of just \$74.

Knowing that, in extreme circumstances like Annie's, pension plans sometimes waive the recoupment of an overpayment, staff of the Upper Midwest Pension Rights Project contacted the pension plan, asking them to do so for Annie. In 2006, less than a year after it had first informed Annie that her benefit would be reduced, the pension plan told Annie that it would forego the repayment. As a result, Annie was saved from having to repay the \$9,300 the pension plan had overpaid her.

*For privacy reasons, the name of the person featured in this story has been changed.

Learn about the [Upper Midwest Pension Rights Project](#).

Learn about the [Pension Counseling and Information Program](#).

Tags: [Benefit calculation](#), [Older Americans Month](#), [Overpayment](#), [Pension counseling](#), [Story](#), [Survivor benefits](#)

Nancy Manly

From: Davis, Larry A (DOA) <larry.davis@alaska.gov>
Sent: Friday, June 06, 2014 3:42 PM
To: Nancy Manly
Cc: Lea, Kathleen S (DOA); Thayer, Curtis W (DOA); Mills, Andy J (DOA); Barnhill, Michael A (DOA)
Subject: RE: Pension Recoupment

Follow Up Flag: Follow up
Flag Status: Flagged

Hello,

Thank you for your patience. Here are the answers to your questions. Let me know if you need additional information.

- 1) Are there limits to how much pension income the state can take?

There are limits on recovery of overpayment. Both AS 39.35.520(b) and AS 14.25.173(b) prohibit the recovery of benefit overpayments if: (1) the incorrect benefit was first paid two years or more before the member or beneficiary was notified of the error; (2) the error was not the result of erroneous information supplied by the member or beneficiary; *and* (3) the member or beneficiary did not have a reasonable grounds to believe that the amount of the benefit was in error. The governing statute for PERS is AS 39.35.520 and for TRS it is AS 14.25.173 which requires the plans to correct errors and, unless the person qualifies for a waiver, collect any overpayment or pay any underpayment to the member with interest. Members who have been overpaid or underpaid may choose either a lump sum payment or an actuarial increase or reduction to their benefit depending on whether we have an under or over payment. There is no limit to the amount of the actuarial reduction if the member chooses not to repay benefits in a lump sum. The plan can recoup the entire monthly amount if that is what the actuarial calculation determines to repay the benefits over the lifetime of the member.

- 2) What are some of the causes of state pension overpayments?

One of the principle causes of overpayment of benefits is the Alaska Cost of Living Allowance (COLA) and member's failure to notify the division they will be out of the state more than 90 days leading to an overpayment of benefits. Another cause is a late notification of death in the case of the 66 2/3% Last Survivor Option. This option pays a higher benefit while both the member and the designated beneficiary are alive; however, in the event of the death of either the member or designated beneficiary the remaining survivor's benefit reduces to two-thirds. We will occasionally have a member receiving an overpayment due to the Level Income Option which pays a member an increased benefit before age 65 then reduces down when Social Security payments would begin at age 65 to a lower amount that, when added to the Social Security benefit, provides the pre-65 benefit keeping the benefit "level". Because this is an old option that was in effect before much of the automation the division has now, there are some members who do not notify us their benefits should reduce and we are missing the system reminders due to conversion problems on some accounts in 1997 when we converted to a different computer system. We had several members who were affected, appealed to the PERS Board and received a settlement allowing them a benefit of \$1 in order to keep their health insurance because their monthly actuarial reduction exceeded their benefit

amount. While we have conducted a project to ensure all LIO members are coded in our system for an automatic decrease at age 65, we have on occasion had a member that was not identified during the project crop up. We will also have overpayment of benefits if a member returns to work in a participating position and fails to notify us or is a RIP retiree sustaining a RIP reemployment penalty. LIO and reemployment are very infrequent occurrences.

3) What laws must you follow when covering pension recoupment?

We must follow PERS AS 39.35.520 and TRS AS 14.25.173. There may also be legal principles such as unjust enrichment and fiduciary obligations that are applicable.

4) If a retiree has been overpaid on his/her pension, is recoupment the state plan's only option?

If the person qualifies for a waiver of overpayment under AS 39.35.522(a) or AS 14.25.175(a) the administrator can waive the overpayment. This requires the member to show the adjustment will cause undue hardship, they had not provided the division with erroneous or fraudulent information, before the adjustment was made they received confirmation from the administrator that their records were correct, *and* they had no reasonable grounds to believe the records were incorrect before the adjustment was made. If the member meets the criteria, the overpayment may be waived. If there is reason to believe the member does not meet the waiver criterion, they may appeal an administrator's decision for recoupment to the Office of Administrative Hearings. (Formerly appeals were to either the PERS or TRS boards which were disbanded in 2005).

5) Does the state have fiduciary insurance policies or error and omission insurance when a state pension plan employee makes a mistake? If not, why not?

No, the pension plans do not purchase errors and omissions insurance because we are government plans. Our errors and omissions are self-insured by the plans themselves.

6) What is the process the State of Alaska takes when an overpayment error has been discovered?

The PERS or TRS will research the error and determine the cause. Based on the cause, the plans will determine the appropriate action, either process for a waiver of overpayment, enter into mediation, or notify the member of the overpayment and request repayment.

7) How many state retirees have been affected by a state pension recoupment and over what period of time?

Here are the numbers for fiscal years 2013 and 2014:

FY 13 Total Overpayments	178
FY 13 COLA Overpayments	153
FY 13 J&S 66 Late Notice of Spouse Death Reductions Overpayments	14
FY 13 Incorrect DOB used in retirement calculation	1
FY 14 Total Overpayments	212
FY 14 COLA Overpayments	186

• FY 14 J&S 66 Late Notice of Spouse Death Reductions Overpayments 25

FY 14 RIP Reemployment Overpayment 1

The applicable statutes have been in effect in the PERS and TRS since plan inception. We do not track this information back that far.

Larry Davis, Appeals and Risk Mitigation Manager
Retirement & Benefits Specialist III



Alaska Division of Retirement and Benefits
PO Box 110203, Juneau, AK 99811-0203
Phone: (907) 465-5699
Toll-free: (800) 821-2251
Fax: (907) 465-5404

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From: Nancy Manly [mailto:Nancy.Manly@akleg.gov]
Sent: Tuesday, June 03, 2014 3:08 PM
To: Davis, Larry A (DOA)
Cc: Lea, Kathleen S (DOA); Thayer, Curtis W (DOA); Mills, Andy J (DOA)
Subject: RE: Pension Recoupment

Thanks you!

Nancy Manly, Chief of Staff and
House State Affairs Committee Aide for
Representative Bob Lynn
House District 23
907-465-2794 Fax: 907-465-4316

From: Davis, Larry A (DOA) [mailto:larry.davis@alaska.gov]
Sent: Tuesday, June 03, 2014 3:08 PM
To: Nancy Manly

Cc: Lea, Kathleen S (DOA); Thayer, Curtis W (DOA); Mills, Andy J (DOA)
Subject: RE: Pension Recoupment

Hello,

We have a draft response but are still gathering statistics on your item #7. These should be available soon so we will be able to provide the final response. Thank you.

Larry Davis, Appeals and Risk Mitigation Manager
Retirement & Benefits Specialist III



Alaska Division of Retirement and Benefits
PO Box 110203, Juneau, AK 99811-0203
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From: Nancy Manly [<mailto:Nancy.Manly@akleg.gov>]
Sent: Tuesday, June 03, 2014 3:04 PM
To: Davis, Larry A (DOA)
Cc: Lea, Kathleen S (DOA); Thayer, Curtis W (DOA); Mills, Andy J (DOA)
Subject: RE: Pension Recoupment

6/3/2014

Larry:

This is a follow-up letter to our questions regarding Pension Recoupment. We were expecting to hear from you early in the week of May 19 but have still not heard back. Is there anybody else that can answer Representative Lynn's questions? Thanks!

Nancy Manly, Chief of Staff and
House State Affairs Committee Aide for
Representative Bob Lynn

From: Davis, Larry A (DOA) [<mailto:larry.davis@alaska.gov>]
Sent: Thursday, May 15, 2014 4:40 PM
To: Nancy Manly
Subject: RE: Pension Recoupment

Hello,

I will be able to answer these questions. You will have my response early next week.

Larry Davis, Appeals and Risk Mitigation Manager
Retirement & Benefits Specialist III



Alaska Division of Retirement and Benefits
PO Box 110203, Juneau, AK 99811-0203
Phone: (907) 465-5699
Toll-free: (800) 821-2251
Fax: (907) 465-5404

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For your protection your response may be sent in a separate encrypted email if it contains personal or financial information. If so, you will receive an email notification that you have received a secure email from the State of Alaska with instructions on how to access it.

From: Nancy Manly [<mailto:Nancy.Manly@akleg.gov>]
Sent: Thursday, May 15, 2014 4:21 PM
To: Davis, Larry A (DOA)
Subject: FW: Pension Recoupment

Larry – per Kathy Lea’s email that she is out of town until June 9, are these questions you can answer?

Nancy Manly, Chief of Staff and
House State Affairs Committee Aide for
Representative Bob Lynn
House District 23
907-465-2794 Fax: 907-465-4316

From: Nancy Manly
Sent: Thursday, May 15, 2014 4:10 PM
To: 'kathy.lea@alaska.gov'
Subject: Pension Recoupment

5/15/2014

Kathy:

Representative Lynn has asked me to do some research into the State of Alaska pension plan with regards to some retirees being overpaid and then when the state discovers the error, seeks to recoup that money from the retiree. I'm looking to open discussion with you on this topic. We are at the beginning states of this research but have a few questions to ask:

- 1) Are there limits to how much pension income the state can take?
- 2) What are some of the causes of state pension overpayments?
- 3) What laws must you follow when covering pension recoupment?
- 4) If a retiree has been overpaid on his/her pension, is recoupment the state plan's only option?
- 5) Does the state have fiduciary insurance policies or error and omission insurance when a state pension plan employee makes a mistake? If not, why not?
- 6) What is the process the State of Alaska takes when an overpayment error has been discovered?
- 7) How many state retirees have been affected by a state pension recoupment and over what period of time?

Thanks Kathy! Look forward to hearing back from you.

Nancy Manly, Chief of Staff and
House State Affairs Committee Aide *for*
Representative Bob Lynn
House District 23
907-465-2794 Fax: 907-465-4316

Nancy Manly

From: Leighow, Sharon W (GOV) <sharon.leighow@alaska.gov>
Sent: Wednesday, October 15, 2014 10:32 AM
To: Leighow, Sharon W (GOV)
Subject: PR 14-172 Governor Parnell Brings in National Guard Auditors 101514
Attachments: PR 14-172 Governor Parnell Brings in National Guard Auditors 101514.pdf



FOR IMMEDIATE RELEASE

No. 14-172

Governor Parnell Brings in National Guard Auditors

October 15, 2014, Anchorage, Alaska – In August, Governor Sean Parnell called for an expanded investigation into allegations of fraud in the Alaska National Guard. Today, the governor announced that a team of three auditors from the National Guard Bureau has arrived in Alaska to determine the adequacy and management of federal resources handled by the Alaska National Guard.

"We take the allegations of fraud extremely seriously," said Governor Parnell. "I called for an immediate investigation of these fraud allegations. Those found to have been engaging in fraud or misuse of official resources can and will be prosecuted to the fullest extent."

The director of Internal Review, chief of Audit Operations, and a senior auditor assigned to National Guard Internal Review Office make up the team. The team will conduct an internal review audit of the management of federal fiscal resources in the Alaska National Guard. This internal review audit is directly related to the alleged theft and misuse of federal resources by service members.

The audit team will focus on types of funding, reimbursements, and the management of funds. The team will analyze all previous internal and external audits conducted in the areas of family programs and cooperative agreements, expenditures. The team will interview Alaska National Guard personnel as a part of the audit.

A draft report is due by mid-December.

###

BEFORE THE STATE OF ALASKA OFFICE OF ADMINISTRATIVE HEARINGS

In the Matter of
B. W. J.

)
) OAH No. 07-0713-PER
) Div. R&B No. 2007-034

DECISION ON SUMMARY ADJUDICATION

I. Introduction

This is B. J.'s second appeal arising from the Public Employee Retirement System (PERS) administrator's suspension of payments for pension benefits and medical insurance premiums pending repayment of overpayments resulting from Mr. J. securing appointment to early retirement under an incentive program using a birth certificate that misrepresented his age and hence his eligibility for the program. The administrator's first decision was to suspend payments because Mr. J. was indebted to PERS for an amount in excess of what could be recouped through a reduction in his monthly pension payments. That decision was affirmed on appeal.¹

Subsequently, Mr. J. asked the administrator to reinstate medical coverage while he made payments to reduce his indebtedness. The administrator denied the request and Mr. J. appealed. The administrator filed a motion for summary adjudication, asserting that Mr. J. is not entitled to medical coverage unless he is receiving a monthly retirement benefit. Mr. J. did not file an opposition to the motion. The administrator's motion is granted.

II. Facts

B. J. applied for early retirement in 1990, under a retirement incentive program allowing individuals who were not yet eligible for retirement but were within a specified number of years of eligibility to qualify for retirement in advance of their retirement date.² He represented in his application and with what purported to be a certified copy of his birth certificate that he was born in 1943.³ He was appointed to retirement effective November 1, 1990, and began receiving benefit payments that month.⁴

The PERS administrator learned from a 2006 certified copy of Mr. J.'s birth certificate that he had been born in 1945, not 1943, and thus had not been eligible for the retirement incentive program.⁵ After Mr. J. had collected sixteen years worth of retirement benefits, the

¹ *In re B. W. J.*, OAH No. 07-0069-PER (September 10, 2007) (Hemenway, J.) (granting summary adjudication in favor of the PERS administrator).

² *Id.* at 1.

³ *Id.*

⁴ *Id.*

⁵ *See id.*

this was
fraud

Perhaps AS 39.35.535(b)
Should be changed if
Recoupment was no fault
of the retiree.

administrator notified him that he had not been eligible for the incentive program and would have been eligible for retirement, at the earliest, on August 1, 1995.⁶ The Division of Retirement and Benefits recalculated Mr. J.'s pension benefits from that date, concluded that he had been overpaid pension benefits and medical insurance premiums in excess of \$100,000, and found that with interest he was indebted to PERS for more than \$200,000.⁷

Because the amount of Mr. J.'s total indebtedness was greater than his monthly pension payment, the administrator suspended Mr. J.'s retirement benefits, including both the monthly pension benefit and medical insurance premium payments.⁸ Mr. J. appealed the suspension decision, the division moved for summary adjudication, and the motion was granted, affirming the administrator's decision.⁹

In an informal conference with the PERS administrator, Mr. J. asked that his medical coverage be reinstated in exchange for monthly payments of \$448.75 to be applied to his indebtedness.¹⁰ The administrator denied the request, explaining that a PERS member's entitlement to medical insurance "stops when the member is no longer eligible to receive a monthly benefit" and citing AS 39.35.535(b) as the basis for the decision.¹¹ Mr. J. appealed.

During a telephonic case planning conference, the parties agreed to a briefing schedule for the matter to be considered on summary adjudication.¹² The division timely filed a motion for summary adjudication on behalf of the PERS administrator.¹³ Mr. J. filed nothing in response.

III. Discussion

In administrative adjudications, the right to a hearing does not require development of facts through an evidentiary hearing when no factual dispute exists.¹⁴ Summary adjudication of an administrative appeal uses the same standard as summary judgment in court: if the material facts are undisputed, they are applied to the relevant law and the resulting legal conclusions determine the outcome. Only if the parties genuinely dispute a material fact (not legal

⁶ *Id.*

⁷ *Id.* at 2. The indebtedness was projected to be almost \$250,000 by March 2008. February 29, 2008 Affidavit of Paul Carlson at ¶ 2.

⁸ *Id.* at 1-2.

⁹ *See generally id.*

¹⁰ October 15, 2007 Letter from Shier to J. (Agency Rec. 10).

¹¹ *Id.*

¹² February 7, 2008 Order Scheduling Briefing at 1.

¹³ March 3, 2008 Motion for Summary Adjudication

¹⁴ *See Smith v. Dep't of Revenue*, 790 P.2d 1352, 1353 (Alaska 1990).

conclusion) is it necessary to hold an evidentiary hearing. A fact is not "material" unless it would make a difference to the outcome.¹⁵

Mr. J.'s appeal does not show that he disputes the facts concerning overpayment of benefits, but rather shows that he questions the administrator's legal determination.¹⁶ Because he did not file an opposition to the division's motion, Mr. J. has not disputed the facts on which the division's motion is based.¹⁷ Accordingly, Mr. J.'s appeal can be decided on summary adjudication. The issue is simply whether the administrator is correct that AS 39.35.535(b) precludes Mr. J. from receiving PERS-provided medical coverage while he is not receiving monthly pension benefit payments.

In most pertinent part, AS 39.35.535(b) states that "major medical insurance coverage takes effect on the same date that benefits begin, and stops when the member ... is no longer eligible to receive a monthly benefit." The subsection also goes on to say that "[t]he medical premium ... owed by a member ... shall be deducted from the benefit owed to the member...before payment of the benefit." This reinforces the notion that medical coverage for retirees (including those required to pay premiums) is linked to receipt of benefit payments.

*if the dept
decides they
want 100% of
of retirees
pension, they
can lose
ins too.*

Under the statutory language of AS 39.35.535, Mr. J. is not entitled to medical coverage because he is not "receiving" a monthly benefit. Mr. J.'s request was that medical coverage be reinstated upon monthly payment of \$448.75 by him toward the \$200,000-plus indebtedness was properly denied. Even if he were making much larger monthly payments into the system, he would not be entitled to medical coverage until such time as his monthly payments had reduced his indebtedness to the point at which he could receive monthly benefit payments again.

In light of the undisputed facts about the amount of his indebtedness, as a matter of law, Mr. J. is not entitled to medical coverage and will not be until such time as he once again becomes eligible to receive monthly pension benefit payments. The administrator's decision, therefore, was correct.

¹⁵ *Whaley v. State*, 438 P.2d 718, 720 (Alaska 1968).

¹⁶ November 24, 2007 Notice of Appeal (Agency Rec. 1) (stating, as Mr. J.'s reason for appealing, that "I believe that repayment can be made by monthly short fall payments and accounted for in the same month as a Reduction in Benefit payment[; I] ask that this decision be revisited").

¹⁷ 2 AAC 64.250(b) (requiring a party opposing a motion for summary adjudication on grounds of a fact dispute to do more than deny the moving party's facts but instead to show a genuine dispute by affidavit or other evidence).

IV. Conclusion

Mr. J. has not identified any error in the PERS administrator's decision. The administrator's decision, therefore, is AFFIRMED and summary adjudication is granted to the administrator.

DATED this 19th day of May, 2009.

By: Signed
Terry L. Thurbon
Chief Administrative Law Judge

Adoption

This Decision is issued under the authority of AS 39.35.006. The undersigned, in accordance with AS 44.64.060, adopts this Decision as the final administrative determination in this matter.

Judicial review of this decision may be obtained by filing an appeal in the Alaska Superior Court in accordance with Alaska R. App. P. 602(a)(2) within 30 days after the date of this decision.

DATED this 12th day of June, 2009.

By: Signed
Terry L. Thurbon
Chief Administrative Law Judge

[This document has been modified to conform to technical standards for publication.]

1996

Equitable Recoupment: Revisiting an Old and Inconsistent Remedy

Camilla E. Watson

Recommended Citation

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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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"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

1. Benjamin N. Cardozo, *The Nature of the Judicial Process* 33 (1921), quoted in *Estate of Carter v. Commissioner*, 453 F.2d 61, 64 (2d Cir. 1971).

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").

3. See 26 U.S.C. §§ 1-9722 (1994) [hereinafter I.R.C.].

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. Hoefflich, *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").

5. See generally Charles W. Davis, *Playing Safe with Statutes of Limitations*, 16 N.Y.U. Ann. Inst. Fed. Tax'n 453 (1958) (discussing the application of the statute of limitations in federal tax cases). The statute may run in favor of either the taxpayer or the government. Although it is designed to be a neutral final settlement, in the public interest, the statute is generally construed strictly in favor of the government. *Id.* at 453; accord *Badaracco v. Commissioner*, 464 U.S. 386, 398 (1984) ("[W]hen courts construe a statute of limitations, [they] must receive a strict construction in favor of the Government." (quoting *E.I. DuPont de Nemours & Co. v. Davis*, 264 U.S. 456, 462 (1924))); see also *Bowers v. New York & Albany Lighterage Co.*, 273 U.S. 346, 350 (1927) ("[T]he public interest should not be prejudiced by the default or negligence of public officers.").

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).

nitely 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.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.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.⁹ This principle ensures that each taxpayer pays a fair share of taxes for the proper annual accounting period and

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, *The Doctrine of Recoupment in Federal Taxation*, 28 Va. L. Rev. 577, 602 (1942) (discussing the function of federal tax statutes of limitations).

8. See I.R.C. § 441 (1994). Such a period may be either a calendar year or a fiscal year. *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. 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), *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. See *infra* text accompanying notes 262-85 (discussing statutory mitigation provisions); see also *infra* parts I-II (enumerating equitable remedies).

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, *The Taxpayer's Duty of Consistency*, 46 Tax L. Rev. 537, 547-48 & n.59 (1991) [hereinafter Johnson, *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.¹⁰ 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.¹¹

In cases in which equity demands relief, the remedy of recoupment might apply to lift the statutory bar.¹² If recoupment applied in the

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.¹³ 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.¹⁴

Similarly, the remedy could apply in favor of the government to credit a barred deficiency against an open refund claim.¹⁵ 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.¹⁶

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.¹⁷ The integrity of the limitations period, as well as the integrity of the tax-

nied, 510 U.S. 862 (1993); *Lee v. Schweiker*, 739 F.2d 870, 874-76 (3d Cir. 1984) (distinguishing setoff from recoupment in the bankruptcy context).

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.

13. See Arthur W. Andrews, *Modern-Day Equitable Recoupment and the "Two Tax Effect": Avoidance of the Statute of Limitation in Federal Tax Controversies*, 28 *Ariz. L. Rev.* 595, 632-34 (1986) (discussing the "two tax effect" of offsetting a barred estate tax overpayment against an open income tax deficiency—the *Herring-Bowcut* model). The remedy also has been characterized as "two wrongs make a right." Steven J. Willis, *Some Limits of Equitable Recoupment, Tax Mitigation, and Res Judicata: Reflections Prompted by Chertkof v. United States*, 38 *Tax Law.* 625, 633 (1985) [hereinafter Willis, *Limits*].

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.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 1946.¹⁹

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.²⁰ The second element is that the inconsistent claims must arise from the same transaction²¹ and must involve the same taxpayer, or two or more taxpayers who share an identity of interest.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.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.²⁴ The inconsistencies, in turn, lead to forum shopping and relegate recoupment to the ranks of an ineffective remedy, even in the narrow

nical and must be interpreted accordingly, like a game which must be played strictly in accordance with the rules."), *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.

20. *See Minskoff v. United States*, 490 F.2d 1283, 1285 (2d Cir. 1974); Stephen J. Legatzke, Note, *The Equitable Recoupment Doctrine in United States v. Dalm: Where's the Equity?*, 10 Va. Tax Rev. 861, 863 (1991).

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.²⁵ 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.²⁶ 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.²⁷ So effective was Professor Andrews's article that few substantive articles on recoupment have been written since.²⁸ But the courts have continued to struggle with recoupment issues, although relatively few seemed to have grasped the theory behind this extraordinary remedy.²⁹ 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.³⁰ 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.

28. These few articles have dealt primarily with jurisdiction. See, e.g., James E. Tierney, *Equitable Recoupment Revisited: The Scope of the Doctrine in Federal Tax Cases After United States v. Dalm*, 80 Ky. L.J. 95, 102-03 (1991) (discussing the effect of the *Dalm* decision); Legatzke, *supra* note 20, at 892-96, 897, 900 (same).

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,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 *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.³² Second, judicial decisions frequently fail to indicate that an equitable remedy has been applied even though the result may indicate otherwise.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.³⁴ The result is an inadequate remedy, in turn leading to

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).

32. See Lawrence J. Brannian, Note, *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).

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).

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.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.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."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.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.⁴⁰ 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,⁴¹ but it very seldom worked to the disadvantage of the government.⁴² 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 was proved.⁴³

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,⁴⁴ in practice the principal focus has shifted from intent⁴⁵ 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).

detriment.⁴⁶ 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.⁴⁸ For instance, a party seeking estoppel against the government must also establish affirmative misconduct beyond mere negligence.⁴⁹ The mere acceptance of a return by the government does not create an estoppel against the government,⁵⁰ nor, on the other hand, does the running of the statute of limitations create an estoppel in its favor.⁵¹ Further, there must be a balancing of the often conflicting interests of fair treatment of taxpayers and protection of the federal fisc.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. *Compare* *Gehl Co. v. Commissioner*, 795 F.2d 1324, 1334 (7th Cir. 1986) (holding that government is estopped from applying regulation retroactively) and *LeCroy Research Sys. Corp. v. Commissioner*, 751 F.2d 123, 128 (2d Cir. 1984) (same) with *CWT Farms, Inc. v. Commissioner*, 755 F.2d 790, 804 (11th Cir. 1985) (upholding retroactivity), *cert. denied*, 477 U.S. 903 (1986).

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."), *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.'" (quoting *United States v. Globe Indem. Co.*, 94 F.2d 576, 578 (2d Cir.), *cert. denied*, 304 U.S. 575 (1938))); 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." *R.J. Reynolds Tobacco Co.*, 306 U.S. at 116.

49. Mere misstatement of the law does not represent the government's position and therefore is not binding on the government. See *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).

50. See *supra* note 47.

51. See *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); *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).

52. See *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."); *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.⁵³ 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.⁵⁴ 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.⁵⁵

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.⁵⁶ 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 (Ct. Cl. 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 (Ct. Cl. 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 taxable 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 position 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

tations had expired), *cert. denied*, 335 U.S. 908 (1949) with *Uinta Livestock Corp. v. United States*, 355 F.2d 761, 767-68 (10th Cir. 1966) (holding that estoppel does not apply against taxpayer in absence of formal, binding agreement). *But cf.* *Botany Worsted Mills v. United States*, 278 U.S. 282, 289 (1929) (leaving open the question of whether a taxpayer may be estopped in the absence of a formal closing agreement).

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 accordingly); *Commissioner v. Garber*, 50 F.2d 588, 591 (9th Cir. 1931) (holding that taxpayer 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 government 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 purposes 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.⁶¹ 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.⁶² There is presently a conflict among the courts as to whether equitable tolling applies at all in federal tax cases,⁶³ and if so, under what conditions it applies.⁶⁴ These issues are currently pending before the U.S. Supreme Court,⁶⁵ 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.⁶⁶

C. Election

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

61. The U.S. Supreme Court endorsed the principle in suits against the government in *Irwin v. Department of Veterans Affairs*, 498 U.S. 89, 93-96 (1990).

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 Audobon 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).

65. See *Brockamp v. United States*, 67 F.3d 260 (9th Cir. 1995), *cert. granted*, 116 S. Ct. 1875 (1996).

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).

theories.⁶⁷ 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*,⁶⁸ 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.⁶⁹

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.⁷⁰ 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.⁷¹

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.⁷² The Commissioner initially assessed a tax liability under the second alternative

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.⁷³ 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.⁷⁴

Another important difference between election and estoppel is that taxpayers are generally more successful with election than with estoppel.⁷⁵ 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.⁷⁶ 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).

change of position will have on the opposing party.⁷⁷ 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*,⁷⁸ 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.⁷⁹

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."⁸⁰ 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

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."⁸¹

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.⁸² 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.⁸³ 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.⁸⁴ 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,

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 (Ct. Cl. 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.⁸⁵

II. 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.⁸⁶ Recoupment, like other equitable remedies, is regarded as a fairness doctrine designed to "promote justice, and to prevent useless litigation."⁸⁷ 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.⁸⁸

Recoupment, as an equitable remedy in federal tax cases, has been confused with other equitable remedies, such as estoppel.⁸⁹ It has also been confused with the remedy of setoff, which arose in the tax context in the case of *Lewis v. Reynolds*,⁹⁰ which in turn, paved the way for the application of recoupment.⁹¹

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 578.

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.

90. 284 U.S. 281, modified, 284 U.S. 599 (1932).

91. See, e.g., *First Nat'l Bank v. United States*, 565 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.⁹² At the time the refund claim was filed, the statute of limitations for assessment of the 1920 taxable year had expired.⁹³ 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.⁹⁴ 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 re-determining the total tax liability for 1920 because of the expiration of the statutory period.⁹⁵ 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.⁹⁶

The Supreme Court affirmed the lower courts in holding for the Commissioner.⁹⁷ The opinion quoted the appellate decision: "The action to recover on a claim for refund is in the nature of an action for

92. *Collinson v. Reynolds*, 43 F.2d 395, 395 (D. Wyo. 1930), *aff'd sub nom. Lewis v. Reynolds*, 48 F.2d 515 (10th Cir. 1931), *aff'd*, 284 U.S. 281, *modified*, 284 U.S. 599 (1932).

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."⁹⁸

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 *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 *Lewis* would not apply.⁹⁹

There appears to be some confusion as to whether setoff is an equitable remedy.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.¹⁰¹ Because *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.¹⁰² Nor should the application of setoff be subject to judicial discretion after weighing the equities of the individual case.¹⁰³

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

99. See I.R.C. § 6401 (1994); see also *Ewing v. United States*, 914 F.2d 499, 502-05 (4th Cir. 1990) (discussing distinction between payment and deposit for purposes of determining an overpayment), *cert. denied*, 500 U.S. 905 (1991).

100. Some courts have stated that setoff is not subject to equitable considerations. See, e.g., *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."); *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."); *Missouri Pub. Serv. Co. v. United States*, 245 F. Supp. 954, 961 (W.D. Mo. 1965) (same), *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., *Pacific Mills v. Nichols*, 31 F. Supp. 43, 44-45 (D. Mass. 1939) (noting several times that *Lewis v. Reynolds* is an equitable doctrine); Jones, *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 *Lewis v. Reynolds*"); Note, *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 *Lewis* and by an equitable policy against unjust enrichment).

Setoff, on occasion, has also been confused with recoupment. See *supra* text accompanying note 90.

101. See *infra* part VI.B (discussing Tax Court jurisdiction).

102. For a criticism of this position, however, see Richard M. Johnson, Comment, *Burden of Proof in Tax Litigation: Offset and Equitable Recoupment*, 15 Buff. L. Rev. 616, 624-25 (1966) [hereinafter Johnson, *Burden of Proof*].

103. See *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.¹⁰⁴

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.¹⁰⁵ Setoff, as exemplified by *Lewis*, is a narrow doctrine defining an overpayment.¹⁰⁶ Under *Lewis*, the determination involves a single taxpayer, a single

be fair, in the individual circumstances, to permit the government to assert the defense.").

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.").

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).

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).

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,¹⁰⁷ and a single tax.¹⁰⁸ That different transactions may be involved is of no consequence.

B. *The Equitable Recoupment Decisions of the Supreme Court*

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.

Lewis set the stage for an extension of the offset remedy under equitable principles. Three years after the Supreme Court decided *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. *Bull v. United States*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.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-

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).

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). *But see* *Morristown Trust Co. v. Manning*, 104 F. Supp. 621, 628 (D.N.J. 1951) (applying *Lewis* to bar estate tax refund), *aff'd*, 200 F.2d 194 (3d Cir. 1952), *cert. denied*, 345 U.S. 939 (1953).

109. 295 U.S. 247 (1935).

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. *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.¹¹¹

The estate appealed the deficiency to the Board of Tax Appeals, which sustained the Commissioner's determination.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.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 1921.¹¹⁴ 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.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.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.¹¹⁷

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

111. *Id.* at 252-53.

112. *Bull v. Commissioner*, 7 B.T.A. 993, 1002 (1927).

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.

114. *Bull*, 6 F. Supp. at 143-44.

115. *Id.* at 143.

116. *Bull v. United States*, 295 U.S. 247, 254 (1935).

117. *Id.* at 255.

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.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.¹¹⁹ The Court, in response, stressed the fundamental importance of the revenue raising function of the tax system¹²⁰ 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.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."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."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."¹²⁴ Because the partnership profits had already been subject to the estate tax, they could not be further subject to the income tax.¹²⁵

a. *The Nature of the Remedy*

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

118. *Id.* at 255-57.

119. *Id.* at 258.

120. The Court stated: "[T]axes are the life-blood of government, and their prompt and certain availability an imperious need." *Id.* at 259.

121. Because of the overriding need for an efficient functioning of the revenue raising process:

[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.

Id. at 260.

122. *Id.*

123. *Id.* at 260-61.

124. *Id.* at 262.

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).

126. *Bull v. United States*, 295 U.S. 247, 261 (1935).

would then be compelled to refund the taxpayer's money under a constructive trust theory.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.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.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.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

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.

128. See Manning, *supra* note 35, at 378.

129. *Bull*, 295 U.S. at 253-54.

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.¹³¹ 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.¹³² 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-

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.

quirement 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,¹³³ nor does it apply when the inconsistent taxes are income taxes, because that issue has been preempted by the statutory mitigation provisions.¹³⁴ Questions have arisen, however, as to whether mitigation is an exclusive remedy that preempts the application of recoupment.¹³⁵

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

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.¹³⁸ In 1933, the Supreme Court decided the case of *Helvering v. Butterworth*,¹³⁹ which held such trust income was properly taxable to the beneficiary.¹⁴⁰

In reliance on *Butterworth*, the trust then brought suit for a refund of the income tax wrongfully collected.¹⁴¹ 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.¹⁴²

a. *The Balance of Equities*

The Supreme Court, in holding for the government, discussed the equitable nature of the refund action.¹⁴³ The Court again appeared to be considering the holistic situation.¹⁴⁴ 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.¹⁴⁵ 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."¹⁴⁶

138. *Id.*

139. 290 U.S. 365 (1933).

140. *Id.* at 370.

141. *Stone v. White*, 301 U.S. 532, 533-34 (1937). The district court held in favor of the trust, but the decision was reversed on appeal to the First Circuit. *Stone v. White*, 8 F. Supp. 354, 355 (D. Mass. 1934), *rev'd*, 78 F.2d 136 (1st Cir.1935), *aff'd*, 301 U.S. 532 (1937).

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."¹⁵¹ 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.¹⁵²

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.¹⁵³ In another, it was a defense "comparable to an equitable recoupment or diminution of petitioners' right to recover."¹⁵⁴ 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

151. *Id.* at 537.

152. Note that the government was allowed to recoup only the amount of income tax liability that had been paid by the trust. The shortfall, representing the difference between the amount the beneficiary owed and the amount the trust paid, was forfeited because the statute of limitations prevented the government from collecting that amount from the beneficiary. It could not be collected from the trust because it was not an obligation of the trust. *Id.* at 534.

For a contrary decision, see *Smith v. United States*, 373 F.2d 419 (4th Cir. 1966), where under similar circumstances to those of *Stone*, the government was denied the use of equitable recoupment. In *Smith*, the beneficiary had only a limited interest in the trust (he could not encumber the trust and the trust was not liable for his debts), and his entire interest had been distributed to him. Because the beneficiary was not before the court, the trustee and remainderman stood to be adversely affected if the government prevailed and the beneficiary did not repay the trust. *Id.* at 423-24.

153. *Stone v. White*, 301 U.S. 532, 538 (1937).

154. *Id.* at 539.

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*¹⁵⁵

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.¹⁵⁶ 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.¹⁵⁷ 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.¹⁵⁸

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.¹⁵⁹ The Fifth Circuit reasoned that the taxpayer owed the tax liability and "ought not in good conscience . . . have [it] back."¹⁶⁰ The Supreme Court reversed, up-

155. 302 U.S. 56 (1937).

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.

159. See *McEachern v. White*, 86 F.2d 231, 233 (5th Cir. 1936), *rev'd sub nom. McEachern v. Rose*, 302 U.S. 56 (1937).

160. *Id.*

holding the integrity of the statute of limitations.¹⁶¹ 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.¹⁶²

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.¹⁶³ Consequently, the decision has created much confusion, emanating primarily from a strained interpretation of the term "single transaction."¹⁶⁴ 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.¹⁶⁵

161. *McEachern v. Rose*, 302 U.S. 56, 62-63 (1937).

162. *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).

163. 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).

164. 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/income tax 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).

165. 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.¹⁶⁶ 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."¹⁶⁷ 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 *McEachern*.

The failure of the Supreme Court to apply recoupment in *McEachern* raises the issue of whether *Bull* and *Stone* are inconsistent with *McEachern*. If so, are *Bull* and *Stone* still valid decisions? If not, why did the reasoning of *McEachern* not apply in *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 *Stone* that it had in *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 *Stone*, under the rationale of *McEachern*, should also have constituted a statutory overpayment to which recoupment would not apply. But although a different result was reached in *Stone*, *McEachern* did not explicitly overrule *Stone*. Perhaps this is because *Stone* and *McEachern* are not necessarily inconsistent. The *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.¹⁶⁸ 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 *Lewis v. Reynolds*.

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

and 1929 payments were potentially available to offset the estate's refund claim. The problem, however, was that at the time the payments were made, the tax liability had not been ascertained or assessed. Therefore, any credit of these payments against any outstanding tax liability would occur after the statute of limitations on assessment had expired. *McEachern*, 302 U.S. at 60-62.

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 *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.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*.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*.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.¹⁷²

169. See *supra* note 152.

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).

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).

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.¹⁷⁵ 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.¹⁷⁶

4. *Rothensies v. Electric Storage Battery Co.*¹⁷⁷

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.¹⁷⁸ 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-

timely assessment. Compare *Ewing v. United States*, 914 F.2d 499, 505 (4th Cir. 1990) (holding that payment made pursuant to a closing agreement without assessment constituted a payment, not a deposit), *cert. denied*, 500 U.S. 905 (1991) with *Ford v. United States*, 618 F.2d 357, 361 (5th Cir. 1980) (holding that there can be no payment of taxes prior to assessment, but noting that the precedent upon which it relied should be overruled). The Supreme Court had decided that a payment under protest constitutes a deposit, not a payment. *Rosenman v. United States*, 323 U.S. 658, 662-63 (1945). Lower courts are divided, however, on the significance of *Rosenman*.

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.¹⁷⁹ 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.¹⁸⁰

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.¹⁸¹

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.¹⁸² 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.¹⁸³

The Court further noted that many cases involve either hardships to the taxpayer or loss of revenue to the government.¹⁸⁴ 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.¹⁸⁵ 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 26.¹⁸⁶ 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.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.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.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.¹⁹⁰ Therefore, the earlier overpayments could not offset the later deficiency. The shortcoming of the

186. *Id.* at 298.

187. *Id.*

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, *Rothensies* is characterized as a laches case in *Boyle v. United States*, 355 F.2d 233, 236 (3d Cir. 1965). Moreover, the *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 . . ." *Rothensies v. Electric Storage Battery Co.*, 329 U.S. 296, 303 (1946).

189. *Rothensies*, 329 U.S. at 302.

190. Note, however, that three justices, Murphy, Black, and Rutledge, dissented in *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.¹⁹¹ 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—

ment in 1935 of additional taxes for the taxable years 1922-26. *Id.* at 303 (Murphy, Black, & Rutledge, J.J., dissenting).

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.¹⁹² Further, there is apparently a growing trend requiring the party requesting recoupment to have engaged in self-help before bringing suit.¹⁹³

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."¹⁹⁴

The problem, however, is that the term "single transaction" is susceptible to inconsistent interpretations.¹⁹⁵ The result is an inadequate

192. See *United States v. Dalm*, 494 U.S. 596, 610-11 (1990) (quoting *Rothensies*, 329 U.S. at 299 and *Bull v. United States*, 295 U.S. 247, 262 (1935)).

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) ("*Rosenthies* [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. *Ford v. United States*¹⁹⁷

In *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 misstated their basis. They maintained that the basis had been miscalculated originally, ar-

equitable recoupment is not a flexible doctrine, but . . . is to be strictly limited to those cases presenting facts similar to *Bull*. Consequently, the doctrine is only allowed as a defense to an asserted claim and only when it arises out of the same transaction."); *Mann v. United States*, 552 F. Supp. 1132, 1140 (N.D. Tex. 1982) (citing *Rothensies* for the proposition that equitable recoupment "is not a flexible doctrine, but a doctrine strictly limited, and limited for good reason"), *aff'd*, 731 F.2d 267 (5th Cir. 1984).

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 (Ct. Cl. 1960).

198. The original estate tax liability was calculated to be \$439.61. The deficiency notice proposed increasing the liability to \$52,221.61. *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. *Id.*

200. In fact, the executors, in briefs filed before the court, affirmatively approved the new valuation. *Id.*

201. *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.²⁰² 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.²⁰³ In holding for the plaintiffs, however, the Court of Claims emphasized the true value of the stock and the correct tax treatment.²⁰⁴

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.²⁰⁵ 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.²⁰⁶

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.*

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 (Ct. Cl. 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 (Ct. Cl. 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.²⁰⁷ Not only did the executors not do this, but they also acquiesced in the recalculated valuation in the Tax Court proceeding.²⁰⁸ 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 been applied in *Ford*, and indeed, their application was urged by the government.²⁰⁹ 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.²¹⁰ 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.

210. *Ford v. United States*, 276 F.2d 17, 22 (Ct. Cl. 1960).

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*.²¹¹ 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.²¹²

2. *Wilmington Trust Co. v. United States*²¹³

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,²¹⁴ 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

211. *Alamo Nat'l Bank v. Commissioner*, 95 F.2d 622 (5th Cir.), cert. denied, 304 U.S. 577 (1938). For a discussion of *Alamo National Bank*, see *supra* text accompanying notes 77-81.

212. *Ford*, 276 F.2d at 21-22. But see *Hess v. United States*, 537 F.2d 457, 462-64 (Ct. Cl. 1976) (retreating from *Ford* in holding that the duty of consistency applied on facts similar to those in *Ford*), cert. denied, 430 U.S. 931 (1977). For a discussion of *Ford* and *Hess* in the context of privity of consistency, see Johnson, *Duty of Consistency*, *supra* note 9, at 550-52. For a case in accordance with *Alamo National Bank*, see *Lefever v. Commissioner*, 103 T.C. 525, 541-46 (1994) (preventing taxpayers from subsequently changing position with respect to special use valuation after statute of limitations had run against correction of earlier mistake).

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.²¹⁵ The court based its decision on *Rothensies* which, it opined, narrowed the concept of the single transaction.²¹⁶

Professor Andrews correctly criticizes the *Wilmington Trust* decision as too narrow a construction of *Rothensies*.²¹⁷ 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.²¹⁸ Moreover, in neither *Wilmington Trust* nor *Ford* did the Court of Claims provide any substantive reasoning to support its conclusion.

Professor Andrews regards the *Wilmington Trust* decision as inconsistent with the Supreme Court's equitable recoupment cases.²¹⁹ But while the conclusion of the Court of Claims is inconsistent with the

215. *But see* McMullan v. United States, 686 F.2d 915, 924 (Ct. Cl. 1982) (granting relief to government under principle of equitable estoppel in companion case to *Wilmington Trust*).

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.²²⁰ 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.²²¹ 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.²²² 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

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).

222. *Wilmington Trust*, 610 F.2d at 714-15.

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.²²³

In *Wilmington Trust* the equities were not as compelling as they were in *Bull*. It is unfortunate that the *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 *Wilmington Trust* wisely did not rely upon the government's lack of diligence.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."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.²²⁶ In the application of most other equitable remedies, however, laches is an important defense.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.

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.").

224. Andrews, *supra* note 13, at 640.

225. *Id.* at 618. This opinion is echoed by Tierney, *supra* note 28, at 127-29.

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 . . ."), *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).

227. See McClintock, *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.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,²²⁹ displaying none of the flexibility and creativity of the earlier Supreme Court decisions.

For instance, in *Kramer v. United States*,²³⁰ the Court of Claims held there was no identity of interest between an estate and a single beneficiary. In *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.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.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.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

228. See *supra* text accompanying notes 145-46.

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).

230. 406 F.2d 1363 (Ct. Cl. 1969).

231. *Kramer*, 406 F.2d at 1364-65; see I.R.C. § 691(c) (1994).

232. *Kramer*, 406 F.2d at 1371.

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.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.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,²³⁶ which Andrews refers to as the "two tax effect."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.²³⁸

The cases he uses to exemplify this theory are *United States v. Herring*²³⁹ and *United States v. Bowcut*,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 (Ct. Cl. 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.

235. See Andrews, *supra* note 13, at 623-24.

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

241. Andrews, *supra* note 13, at 619.

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,²⁴⁸ even though the results of such a provision are sometimes harsh.²⁴⁹ 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.²⁵⁰

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'g* 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.²⁵¹ Thus, the five-week window period, that the court considered unimportant to the application of recoupment,²⁵² 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.²⁵³ 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 relegates 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

Bull 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-

to know that there was a substantial understatement, and (4) that it is inequitable, after taking into account all the facts and circumstances, to hold the other spouse liable for the deficiency in tax, including penalties, interest, and other amounts. I.R.C. § 6013(e) (1994). For a criticism of the innocent spouse provision, see Beck, *supra* note 248, at 348-69.

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.

252. *United States v. Bowcut*, 287 F.2d 654, 657 (9th Cir. 1961).

253. *Bowcut*, 175 F. Supp. 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).

259. See *Bull v. United States*, 295 U.S. 247, 262 (1935).

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.²⁶⁰ 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-

260. The assessment against the trust had occurred within the limitations period applicable to both the trust and the beneficiary. Also, the IRS was diligent in acting in accordance with then current law. See *supra* part II.B.2.a.2.

261. *Bull*, 295 U.S. at 261.

262. See I.R.C. §§ 1311-1314 (1994).

263. S. Rep. No. 1567, 75th Cong., 3d Sess. 49 (1938).

264. In general, before mitigation can apply, there must be two proceedings: one to establish the determination and the other to effect the adjustment. *Benenson v. United States*, 385 F.2d 26, 31 (2d Cir. 1967). Some courts, however, have circumvented this process and have allowed the adjustment claim to be raised in the deter-

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.*

271. I.R.C. § 1311(a) (1994).

272. *Id.*

273. I.R.C. § 1312 (1994).

stances of adjustment must necessarily arise from a single transaction.²⁷⁴ 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 inconsistent 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 assessment, the determination must establish that the taxpayer maintained the inconsistent position.²⁷⁵

There is currently a conflict among the lower courts as to whether the inconsistency must be active or whether it may be passive.²⁷⁶ 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 inconsistency 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 required.²⁷⁷ Thus, in the above example, the taxpayer's passive inconsistency (good faith omission of income) should not prevent the IRS from using the mitigation provisions to assess a deficiency in the earlier, closed year.

The mitigation adjustment also may be applied to a party other than the taxpayer who sought the determination if the requisite relationship exists between the two taxpayers.²⁷⁸ The delineated relationships

274. See *id.* Only § 1312(7) refers directly to a transaction, but considering the nature of the other circumstances, they must all involve a single transaction.

275. See Treas. Reg. § 1.1311(b)-1 (as amended in 1962).

276. Compare *Chertkof v. Commissioner*, 649 F.2d 264, 267 (4th Cir. 1981) (concluding 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 of legislative history of mitigation provisions), *cert. denied*, 414 U.S. 831 (1973).

277. The statute requires only that the position maintained and adopted in the determination 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 consider 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 determination 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.²⁷⁹ The relationship must also have been in existence at certain designated times.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.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,²⁸² this is easier said than done. First, the mitigation provisions are very complex—so complex that mitigation opportunities are frequently missed.²⁸³ Second, the provisions are sometimes very narrowly construed, thus resulting in inconsistencies.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,²⁸⁵ many of the recoupment problems may be alleviated without resorting to legislation that ultimately may lead to a more rigid, inflexible remedy.

279. Saltzman, *supra* note 244, ¶ 5.07[4].

280. 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).

281. See, 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), *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), *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 *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).

282. See, e.g., *Fuller*, *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, *Limits*, *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.").

283. See Steven J. Willis, *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).

284. See *id.*; see also *supra* text accompanying note 269 (stating that the mitigation provisions have fostered some inconsistencies in application).

285. See *infra* part VI.B.

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),²⁸⁶ 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).²⁸⁷

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.²⁸⁸ The remedy is not appropriate, however, where there is no inconsistency²⁸⁹ or where the inconsistency arises from a defensive use

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), *aff'd*, 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.²⁹⁰ Similarly, where the party requesting recoupment fails to take steps to protect itself, recoupment is not an appropriate remedy.²⁹¹ 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.²⁹² 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.²⁹³ 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 *Kojas 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.

297. *Black's Law Dictionary* 1496 (6th ed. 1990).

298. *Eisner v. Macomber*, 252 U.S. 189, 207 (1920).

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 depreciation 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.³⁰² Thus, one year's depreciation deductions cannot be offset by another year's depreciation deductions.³⁰³ 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.³⁰⁴

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.

303. *Missouri Pub. Serv. Co. v. United States*, 245 F. Supp. 954, 962 (W.D. Mo. 1965), *aff'd*, 370 F.2d 971 (8th Cir. 1967).

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.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.³⁰⁶ This was a mistake made by the Court of Claims in *Wilmington Trust*.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,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.

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 (Ct. 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)).

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.

307. For a full discussion of *Wilmington Trust*, see *supra* part III.A.2.

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.³⁰⁹ 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.³¹⁰ At least one court has implied that an absolute identity of interest is not required.³¹¹

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.³¹² 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."³¹³ 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."³¹⁴ Thus, the position of

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 *Claffin v. Godfrey*, 38 Mass. (21 Pick.) 1, 6 (1838)).

315. *Bull v. United States*, 295 U.S. 247, 261 (1935).

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.³¹⁹ In other words, for the equities to favor recoupment, either the opposing (nonrequesting) party must be the aggressor, as was the case in *Bull*, or the unjust enrichment element must be strong and the party requesting recoupment must have acted in good faith.³²⁰

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.³²¹ In no reported cases in which these two elements have been met has an equitable defense prevented the application of the remedy.³²² This is curious in light of the fact that recoupment is, after all, an equitable

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). 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).

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 *Bull* and *Stone*, the equities favored the application of recoupment because otherwise the government would be unjustly enriched); 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").

321. See, 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 *Stone* on ground that beneficiary had only a limited interest in the trust and to hold for the government would prejudice the remainderman).

322. In fact, some courts have remarked on the failure of the equitable defenses. See, 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), *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 *Dalm* the remedy was denied on jurisdictional grounds. See *infra* part VI.A.

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 (Cl. Ct. 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.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."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*,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.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

lie with the taxpayer who has only been 'hoist by his own petard'), *aff'd*, 490 F.2d 1283 (2d Cir. 1974).

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).

328. *Bull v. United States*, 295 U.S. 247, 261 (1935).

329. 355 F.2d 233 (3d Cir. 1965).

330. *Boyle v. United States*, 232 F. Supp. 543, 545 (D.N.J. 1964), *rev'd*, 355 F.2d 233 (3d Cir. 1965).

recoupment was warranted because the facts of the case were similar to those of *Bull*.³³¹ 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,"³³² 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."³³³ 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.³³⁴ 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.³³⁵ In equity, there are two important considerations in

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), *aff'd on other grounds*, 324 U.S. 200 (1945))); *Kellogg-Citizens Nat'l Bank v. United States*, 330 F.2d 635, 640 (Ct. 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 length³³⁶ 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."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.³³⁸ If the party was diligent, the defense of laches should not apply against her.³³⁹ In *Bull*, the executor had a one-month period in which to file a protective claim for refund before the statute of limitations expired.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.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."³⁴²

336. Mere lapse of time, however, does not amount to laches. *Jicarilla Apache Tribe*, 687 F.2d at 1338.

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

338. De Funiak, *supra* note 31, at 48.

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. *Id.*

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 *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).

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). 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).

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.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.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.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,³⁴⁶ apparently without serious consideration of the government's defense of unclean hands.³⁴⁷

343. *Bull v. Commissioner*, 7 B.T.A. 993 (1927).

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.").

345. See, e.g., *Elbert v. Johnson*, 164 F.2d 421, 424-25 (2d 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.'"), *aff'd*, 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.").

346. See *supra* text accompanying notes 244-53.

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.³⁴⁸ 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.³⁴⁹ 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.³⁵⁰ 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.³⁵¹

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.³⁵² One explanation is that, given the

that the settlement be structured solely in terms of a deficiency, but she did not do this. Brief for the Appellant at 2, *Bowcut* (No. 16,837). In response to Mrs. Bowcut's contention that civil fraud is compensatory in nature, the government argued that it makes no difference because the point was made not to further punish Mrs. Bowcut, but to deny her equitable relief. *Id.* at 5.

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. Hoey*, 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 renege after the expiration of the statute of limitations); *E.I. DuPont de Nemours & Co. v. United States*, 147 F. Supp. 486, 494 (Cl. 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).

353. 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).

354. 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).

355. Tierney, *supra* note 28, at 128 n.122.

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.³⁵⁸

Generally, when the government seeks recoupment, it will do so as a defense to a taxpayer's claim for refund.³⁵⁹ Given that the govern-

in the application of the statute against the taxpayer." (citing *United States v. Memphis Cotton Oil Co.*, 288 U.S. 62 (1933)). Consider, also, the statement of the court in *Bennet v. Helvering*, 137 F.2d 537 (2d Cir. 1943):

When a person seeks to recover money which he has paid, it does not offend our sense of fair play that before he is allowed to unravel what he has done, he should submit to the reopening of any past related transactions between him and the person against whom he is moving. But in assessing a tax, the Treasury is not on the defensive; it has the affirmative, it must bring the case within the statute which imposes the liability. If in order to do so, it must reopen a past transaction between the taxpayer and itself, which the law has declared definitively closed, its position is equitably much weaker than in the case of a refund.

Id. at 539; see also *Fuller*, *supra* note 265, at 56-57 (suggesting that it is more difficult for the government to satisfy the identity of interest requirement). Perhaps a further reason why it appears to be more difficult for the government to prevail in a recoupment action is that the cases in which the taxpayer requests recoupment greatly outnumber those in which the government is the requesting party. The number of recorded cases filed by taxpayers requesting recoupment relative to the number of cases filed by the government appears to support this theory, although information on the number of cases that settle without going to trial is unavailable.

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.

Id. (quoting *Commissioner v. Liberty Bank & Trust Co.*, 59 F.2d 320, 325 (6th Cir. 1932)); see also Note, *Recoupment and the Statute of Limitations in Federal Taxation*, 47 Colum. L. Rev. 1338, 1339 (1947) ("The government cannot be committed to an erroneous interpretation of the law, to the acceptance of an incorrect return, to an unauthorized waiver of the statute of limitations or to erroneous information in general.").

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.³⁶⁰ 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.³⁶¹

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."³⁶² 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."³⁶³

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.³⁶⁴ 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.³⁶⁵ 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.

Applying these elements, with hindsight to *Stone*, both parties had relied upon the prior case law. Retroactivity would have caused a hardship to the government, who would then have been time-barred from assessing the proper amount of tax.

362. *McClintock*, *supra* note 31, at 69.

363. *Bull v. United States*, 295 U.S. 247, 259 (1935).

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." *Kojas 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.

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*.³⁶⁶ 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.³⁶⁷ 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.³⁶⁸

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.³⁶⁹ Because the statute of limitations for refund of the gift tax had expired, recoupment could not apply.³⁷⁰

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.³⁷¹ The government then appealed to the U.S. Supreme Court, which reversed the Sixth Circuit, holding that

366. 494 U.S. 596 (1990).

367. *Id.* at 599.

368. *Dalm v. United States*, 89-1 U.S. Tax Cas. (CCH) ¶ 13,806, at 88,160-61 (S.D. Mich. 1987), *rev'd*, 867 F.2d 305 (6th Cir. 1989), *rev'd*, 494 U.S. 596 (1990).

369. *Id.* at 88,165-66.

370. *Id.*

371. *Dalm v. United States*, 867 F.2d 305, 312-13 (6th Cir. 1989), *rev'd*, 494 U.S. 596 (1990).

recoupment did not apply because the statute of limitations barred the suit for refund.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.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 *Dalm* are reminiscent of those of *Bull*, as Justice Stevens noted in his dissent.³⁷⁴ The problem for Mrs. Dalm, however, did not lie with the merits of the case, but rather with a technical procedural issue.

372. *United States v. Dalm*, 494 U.S. 596, 610-11 (1990); *accord Lovett v. United States*, 81 F.3d 143, 145-46 (Fed. Cir. 1996) (holding that taxpayer who mistakenly paid income tax on military severance pay could not sue for refund after statute of limitations had run), *cert. denied*, No. 96-5225, 1996 WL 411265 (U.S. Oct. 15, 1996).

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. 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. *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 *Dalm*. 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).

374. *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."³⁷⁵ Thus, recoupment may not be used as an independent jurisdictional ground for opening the statute of limitations.³⁷⁶ 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.³⁷⁷ 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.³⁷⁸ Such an offset would arise under the fiction that the barred overpayment would create a credit against the open deficiency.³⁷⁹ If the requirements for the application of recoupment are otherwise met, the statute of limitations will never bar such a suit.³⁸⁰

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

375. *Bull v. United States*, 295 U.S. 247, 262 (1935).

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).

378. See *Bull*, 295 U.S. at 262-63.

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,"³⁸¹ 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.³⁸²

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,³⁸³ situations in which there was no open deficiency,³⁸⁴ situations in which the party requesting recoupment was not the proper party,³⁸⁵ and where the court did not have jurisdiction because the

381. *United States v. Dalm*, 494 U.S. 596, 621-22 n.9 (1990) (Stevens, J., dissenting).

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 (Ct. Cl. 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 (Ct. Cl. 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 (Ct. Cl. 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.³⁸⁶ 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 1924.³⁸⁷ The Board was granted restricted jurisdiction over deficiencies and jeopardy assessments.³⁸⁸ 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.³⁸⁹

In *E.J. Barry*,³⁹⁰ 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 1926,³⁹¹ which forbade the Board from determining whether or not the tax for any

ing refund to corporation where taxpayer brought suit in individual capacity and statute of limitations had run against corporation of which he was sole shareholder).

386. See *United States v. Dalm*, 494 U.S. 596, 608-11 (1990).

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 *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 *Commissioner v. Gooch Milling & Elevator Co.*³⁹⁶ *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, *Gooch* cited *Barry*.³⁹⁸ This reference was incorrect because *Barry* did not involve a true equitable recoupment claim at all, but rather, a *Lewis v. Reynolds*-related offset. Indeed, although admit-

392. *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.

Id.

393. See Dubroff, *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 *Barry*. See 1 B.T.A. at 157. A further rationale is that it would have increased the Board's case load.

395. See, e.g., *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."); *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); *Estate of Highland v. Commissioner*, 43 B.T.A. 598, 611-12 (1941) (considering issue *sua sponte*), *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, *supra* note 387, at 123 (quoting S. Rep. No. 52, 69th Cong., 1st Sess. 37 (1926)); see H.R. Rep. No. 1, 69th Cong., 1st Sess. 20 (1925); see also *Commissioner v. Gooch Milling & Elevator Co.*, 320 U.S. 418, 420 (1943) (holding that Board has no jurisdiction to apply doctrine of equitable recoupment). But see McConnell, *supra* note 7, at 579-86 (discussing recoupment's development as a common law doctrine).

396. 320 U.S. 418 (1943).

397. See, e.g., *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. *Commissioner v. McCoy*, 484 U.S. 3, 6 (1987).

398. 320 U.S. at 421 n.7.

tedly 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.³⁹⁹ 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.⁴⁰⁰ 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.⁴⁰¹ 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.⁴⁰² The court remained an independent agency within the Executive Branch, and a quasi-judicial body⁴⁰³ until 1969, when it became the United

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.⁴⁰⁴

While the Tax Court continued to take the position that it did not have jurisdiction to apply recoupment,⁴⁰⁵ it nevertheless applied other equitable principles.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.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.⁴⁰⁸ Thus, the decision of the Tax Court is final and binding.⁴⁰⁹ Given this finality, it is irrational to assume that Congress

404. See Tax Reform Act of 1969, Pub. L. No. 91-172, § 951, 83 Stat. 730, 730. For a discussion of the effect of the 1969 Act on the court's jurisdiction, see *Continental Equities, Inc. v. Commissioner*, 551 F.2d 74, 82-84 (5th Cir. 1977).

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).

406. See, e.g., *Woods v. Commissioner*, 92 T.C. 776, 789 (1989) (reformation); *Boulez v. Commissioner*, 76 T.C. 209, 216 (1981) (considering application of estoppel, but declining to do so on the merits), *aff'd*, 810 F.2d 209 (D.C. Cir.), *cert. denied*, 484 U.S. 896 (1987); *Hillsboro Nat'l Bank v. Commissioner*, 73 T.C. 61, 66-70 (1979) (tax benefit rule), *aff'd*, 641 F.2d 529 (7th Cir. 1981), *rev'd*, 460 U.S. 370 (1983).

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

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.

Id.

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).

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.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. *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,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.⁴¹² Thus, Mrs. Dalm was denied a remedy because she chose to exercise her right to bring suit in a prepayment forum.⁴¹³

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

410. 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. *Id.* at 17-19.

411. *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. *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. Mulrone, *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 *Bull. Cf. Dalm*, 494 U.S. at 606-08.

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.

412. See I.R.C. § 7482(a) (1994).

413. This is a point Justice Stevens made in his dissent. *Dalm*, 494 U.S. at 613-15 (Stevens, J., dissenting). 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); *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 *Dalm* decision does not affect the government's use of equitable recoupment, because the government is never the plaintiff in a Tax Court proceeding.

414. 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 *Dalm* would have been rendered obsolete. *Dalm*, 494 U.S. at 615 n.3 (Stevens, J., dissenting). While Justice Stevens was correct, the result

reserved judgment on the issue of whether the Tax Court has equity jurisdiction.⁴¹⁵ Regarding that reservation as an invitation to review its position, the Tax Court recently decided in a reviewed decision, *Estate of Mueller v. Commissioner*,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.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."⁴¹⁸ Instead, such a limitation had emanated from the *Barry* and *Gooch* decisions.

The court dismissed *Barry* by noting that it had involved the issue of setoff versus recoupment.⁴¹⁹ *Gooch*, however, was a more formidable opinion because it dealt directly with the issue of Tax Court jurisdiction and equitable recoupment. But the *Mueller* court also dismissed *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."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. 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. See generally Johnson, *Burden of Proof*, *supra* note 102 (discussing the allocation of the burden of proof in the litigation of refund claims).

415. *Dalm*, 494 U.S. at 611 n.8.

416. 101 T.C. 551 (1993).

417. *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.").

The Supreme Court has held that the Tax Court may not expand its jurisdiction based upon equitable considerations. *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. *Woods v. Commissioner*, 92 T.C. 776, 785 (1989); see, e.g., *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-extend agreements that are properly before the court); *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).

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." *Woods*, 92 T.C. at 787 (citing *Badger Materials, Inc. v. Commissioner*, 40 T.C. 1061 (1963)).

418. *Mueller*, 101 T.C. at 558 (quoting *Woods*, 92 T.C. at 788-89).

419. *Id.* at 559.

420. *Id.* at 560.

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*.⁴²¹

C. Administrative Claims and Settlements

Taxpayers also may raise an equitable recoupment defense in administrative proceedings before the IRS.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.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.⁴²⁴ The equities do not, however, favor a party who inadvertently fails to raise the issue at the oppor-

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).

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).

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).

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 States*⁴²⁶

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

lier settlement because the subject of the settlement was different from the subject of the recoupment).

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.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."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.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.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.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.⁴³⁴ Because of that precedent, the plaintiff would not be entitled to relief under the doctrine of equitable recoupment because the

trative refund claim filed under § 6511(a)." *Hall*, 91-1 U.S. Tax Cas. (CCH) at 87,427 n.2.

429. See Willis, *Correction of Errors*, *supra* note 385, at 1421.

430. *Id.* at 1427.

431. *Id.*

432. See S. Rep. 394, 96th Cong., 2d Sess. 60, 62, 64 (1979), reprinted in 1980 U.S.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).

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); 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. *Id.* at 970.

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 *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*⁴³⁵

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.⁴³⁶

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,⁴³⁷ 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.⁴³⁸

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."⁴³⁹ 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."⁴⁴⁰

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.⁴⁴¹ 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."⁴⁴²

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.⁴⁴³ 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."⁴⁴⁴ 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

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."⁴⁴⁵ It further cited *Dalm* for what appears to be approval of a requirement to exhaust administrative remedies.⁴⁴⁶

There are several fallacies in this reasoning, however. First, the court seems to have misunderstood the jurisdictional point of *Dalm*. *Dalm* involved a prior proceeding in the Tax Court. This is problematic for any further review in the district court, as *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 *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.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.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.⁴⁴⁹

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

445. *Fairley*, 901 F.2d at 694.

446. *Id.*

447. *Id.* at 694 n.4.

448. *Id.*

449. *Id.* In the same footnote, the court raised the issue of unclean hands, notwithstanding *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." *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. *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,⁴⁵¹ 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.⁴⁵²

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.