Taxation -- Barred Claims -- Equitable Recoupment

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NOTES AND COMMENTS

Taxation—Barred Claims—Equitable Recoupment

Plaintiff, as administratrix, paid estate tax on her deceased husband's estate. After the period of limitations on claim for refund of the estate tax had expired, the Commissioner assessed against the estate a deficiency assessment for income taxes and penalties. The plaintiff paid same and sought a refund of estate tax to accord with the resultant decrease of the taxable estate, but was denied recovery in the district court\(^1\) because of a three year statute of limitations on refund of estate tax.\(^2\) The plaintiff then brought suit for refund of income tax, seeking to recoup the estate tax overpayments against the income tax deficiency assessments, a refund of which the statute of limitations had not yet barred. The court allowed full recovery with interest.\(^3\)

The doctrine of recoupment, an equitable remedy of common law origin, is the act of rebating a part of a claim on which one is sued, by means of a legal or equitable right resulting from a counterclaim arising out of the same transaction.\(^4\) In Bull v. United States,\(^5\) the first case in which this remedy was extended to federal taxation, the United States Supreme Court limited recoupment to situations arising out of "some feature of the same transaction upon which the plaintiff's claim is grounded."\(^6\) The basic problem in recoupment cases stems from the difficulty in determining what constitutes the same transaction.

Four times the Supreme Court has considered the matter of recoup-
ment in tax cases, twice allowing the remedy—*Bull v. United States* and *Stone v. White*—and twice denying it—*McEachern v. Rose* and *Rothensies v. Electric Storage Battery Co.* The *McEachern* case, decided squarely on the basis of statutory provisions, presents a situation similar to that in the *Bull* case, yet the statutes applied in the former were never mentioned in the latter opinion, though they were in effect at the time involved. It is possible to argue that the *McEachern* and *Electric Storage Battery* cases do not present same-transaction situations such as are found in the *Bull* and *Stone* cases. Literally this is true in that in the latter two cases the taxable event was a single one—the receipt of a sum of money by the taxpayer—while in the other two cases there was no such receipt of a single fund of money. But to adopt this criterion is to confine the doctrine of recoupment to an area well within the boundaries established by the lower courts. Rather, the *McEachern* case may be distinguished from the *Bull* case in that in the former (1) recoupment was not pleaded, though the courts have held that, to be applied, it must be pleaded, and (2) the Commissioner did not introduce into evidence the amount sought to be recouped. Furthermore, the Court never mentioned the *McEachern* case in the *Electric Storage Battery* decision, which leads one to suspect that the Court

7. *301 U.S. 532 (1937).* Testamentary trustees paid tax on trust income which should have been paid by the beneficiary. After the statute had run on an action by the government to collect the tax from the beneficiary, the trustees brought an action to recover their erroneous tax payment. The Court allowed the government to recoup the barred amount due from the beneficiary against the refund of the erroneous payment by the trustees.

8. *302 U.S. 56 (1937).* Decedent sold a block of stock and agreed to be paid in equal yearly payments. The administrator, plaintiff in this action, erroneously reported as income of the estate each installment in the year received, instead of cumulating the remaining installments and reporting them as estate assets. After the statute of limitations had run on the year in which the estate tax was paid, the plaintiff brought this action to recover the income tax paid as a result of reporting the installments as yearly income. The Court refused to allow the government to recoup the barred estate tax deficiency of the earlier year against the refund of income tax paid in the later years.

9. *329 U.S. 296 (1946).* Plaintiff paid excise tax which was not due under the statute although assessed by the Commissioner. Subsequently the Commissioner realized that the tax was illegal and refunded the amounts paid in years not yet barred. Plaintiff owed income tax on this refund but sought to recoup the amount of barred excise tax overpayments against the income tax deficiency. The Court denied recoupment.

10. If a tax may not be refunded or collected because barred by statutes of limitations, a credit or debit therefor may not be made by the Commissioner. Revenue Act of 1928, §§ 607-609, 45 Stat. 874, 875 (now INT. REV. CODE OF 1954, §§ 6401(a), 6514(a), (b)). "These provisions preclude the government from taking any benefit from the taxpayer's overpayment by crediting it against an unpaid tax whose collection has been barred by limitation.” *302 U.S.* at 60.

11. *329 U.S.* at 300-300.


may not regard *McEachern* as limiting the scope of recoupment. Moreover, in the *Electric Storage Battery* case, the Court expressly stated that its intention was to narrow the scope of the recoupment doctrine in the tax field, and it rested the decision on the grounds that (1) there were separate transactions here, and (2) the age of the barred claim was too great.\(^{14}\) It is possible to infer from the language of the Court that the compelling reason for the denial of recoupment was that it would be unwise policy to allow claims over twenty years old to be asserted in recoupment.\(^{15}\) In any event, both cases denying recoupment are frequently cited and are strongly relied upon by the lower courts and the Commissioner to defeat recoupment even in situations where the remedy seemingly should be applied.\(^{16}\)

Recoupment is invariably applied where the fund of money is the same in the main claim as in the one asserted in recoupment. This situation occurs most frequently where, as in the principal case, an estate is diminished by a deficiency income tax assessment after the estate tax thereon has been paid and suit is brought to recoup the barred estate tax overpayment against the income tax deficiency payment.\(^{17}\) There must always be some obligation on which the statute has not run against which the barred estate tax overpayment may be recouped.\(^{18}\) Both claims, moreover, must be between the same parties,\(^{19}\) except in the trust situation hereinafter considered. Although there is no case authority to support such a position, the Commissioner has indicated that recoupment will not be allowed even where all of these requirements are met.\(^{20}\)

The trust cases offer an interesting variant in that the parties to the transaction are not literally the same. Nonetheless, the government in the *Stone* case recouped a barred deficiency of the beneficiary against a recovery by the trustees on the ground that any recovery by the latter

\(^{14}\)329 U.S. at 302-03.
\(^{15}\)McConnell, *Recoupment—Dead or Alive*, 26 TAXES 1059, 1060 (1948).
\(^{18}\)United States v. Frauenthal, 138 F.2d 188 (8th Cir. 1943) (estate decreased by an obligation to a party other than the government).
\(^{19}\)Wells Fargo Bank & Union Trust Co. v. United States, 245 F.2d 524 (9th Cir. 1957) (court refused to recoup a barred deficiency of a widow's estate against a claim for refund due the widow's husband's estate, even though the beneficiaries of each were the same).
would inure automatically to the benefit of the former. Conversely, recoupment was not applied to offset a barred deficiency of the trustees against an overpayment by the beneficiary. Moreover, the settlor is considered a separate entity from both the trustee and the beneficiary, thus precluding recoupment. Although there is an early decision to the contrary, it seems erroneous to consider all relations between the trust and any other entity a single transaction merely because the trust involved is the same.

The courts appear very reluctant to grant recoupment where there has been procedurally inconsistent tax treatment of the same property as distinguished from essentially inconsistent treatment of the identical fund of money as in the Bull case. Recoupment has been denied the government where the taxpayer incorrectly treated the receipt of property as a gift or as incidental to a tax-free reorganization, thus avoiding the payment of income tax in the year of receipt and then, after that year was barred, correctly viewing the receipt transaction so as to effect a substantial reduction in the capital gains tax due as a result of subsequent sale. Likewise the government was not allowed to recoup the income tax due in several barred years of receipt against a refund of income tax resulting from the incorrect cumulative reporting of the income, theretofore unreported, in the current year. But where the Commissioner approved taxpayer’s erroneous method of computing gain from liquidating dividends and subsequently reversed his earlier decision, thereby causing an income tax overpayment in the now barred year of receipt and an income tax deficiency in open years, recoupment was allowed the taxpayer.

However, the taxpayer was not allowed to recoup the income tax he would have saved in a now barred year if he had correctly reported certain deductions against the additional income tax owed because of a disallowance of the deduction in an open year, even though, in one

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24 Lit v. United States, 18 F. Supp. 435 (E.D. Pa. 1937). The barred deficiency was a gift tax due on the establishment of the trust and the overpayment was in connection with an incorrect valuation of a reversionary interest in the trust which settlor had at his death.
25 American Light & Traction Co. v. Harrison, 142 F.2d 639 (7th Cir. 1944); Rotenberg v. Sheehan, 48 F. Supp. 584 (E.D. Mo. 1943), appeal dismissed, 144 F.2d 992 (8th Cir. 1944).
26 Grand Central Public Market v. United States, 22 F. Supp. 119 (S.D. Cal. 1938), aff’d, 98 F.2d 1023 (9th Cir. 1938).
28 Wood v. United States, 213 F.2d 660 (2d Cir. 1954); Longyear Realty Co. v. Kavanagh, 156 F.2d 462 (6th Cir. 1946); Hall v. United States, 95 Ct. Cl. 539, 43 F. Supp. 130, cert. denied, 316 U.S. 664 (1942).
of the cases, the Commissioner had refused to allow the deductions when they were properly put forth. But the government was allowed to recoup a barred corporate income tax deficiency resulting from the taxpayer's deduction in a single year of tooling costs properly depreciable over three years against the total overpayments of corporate income tax which resulted from later assigning the deduction proportionately to the proper years which were still open.

On one occasion the taxpayer was allowed to recoup barred overpayments resulting from an erroneously assessed excise tax against open income tax deficiencies resulting from the refund of that portion of the excise tax paid and not yet barred. In another case the taxpayer was allowed to recoup an income tax deficiency in open years resulting from an erroneous allocation of an excess profits tax compromise. In these two cases the courts reason that both deficiencies and overpayments are caused by a single erroneous act, either by the Commissioner or the taxpayer, and therefore arise out of the same transaction. This ground for allowing recoupment was not considered in two subsequently decided, widely cited cases.

Recoupment is an equitable remedy and will be denied if the party seeking to have it applied is guilty of fraud. Nor may the remedy be applied by the Tax Court, since its jurisdiction is limited to the single year under consideration at that time. Furthermore, recoupment will not be granted if there is any other adequate remedy. In this regard it is interesting to note that for twenty years there have been statutory provisions apparently intended and able to rectify many of the situations described above, but the courts have not referred to these provisions in the later recoupment cases.

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30 Hall v. United States, supra note 29.
31 Crosley Corp. v. United States, 229 F.2d 376 (6th Cir. 1956).
32 Dixie Margarine Co. v. Commissioner, 115 F.2d 445 (6th Cir. 1940).
35 J. J. Dix, Inc. v. Commissioner, 233 F.2d 436 (2d Cir. 1955); Elber v. Johnson, 164 F.2d 421 (2d Cir. 1947). But see United States v. Herring, 240 F.2d 225 (4th Cir. 1957), where fraud penalties were assessed.
37 Wells Fargo Bank & Union Trust Co. v. United States, 245 F.2d 524, 536 (9th Cir. 1957).
38 Revenue Act of 1938, § 820, 52 STAT. 581 (now INT. REV. CODE OF 1954, §§ 1311-1314), which provides for the suspension of the bar of limitations on a claim where the party in whose favor the statute has run seeks (1) a double inclusion or exclusion of an item in or from gross income, (2) a double allowance or disallowance of a deduction or credit, (3) the allowance or disallowance of correlative deductions or inclusions for certain related taxpayers, or (4) a different determination of basis after the erroneous treatment of a prior transaction. In the Wells Fargo case, supra note 37, the court stated one of its reasons for denying recoupment to be the existence of these provisions affording a statutory remedy.
CONCLUSION

In spite of frequent statements to the contrary, the doctrine of recoupment in federal taxation still lives, as evidenced by the many recent cases which employ it to effect an equitable result seemingly otherwise unobtainable because of the specific language of the statutes barring the claim. The taxes must arise out of the same transaction and the parties in interest must be the same. The longer the period of time which the transaction covers, the more doubtful is the application of the doctrine by the courts. If fresh claims could be created by act of one of the parties in favor of the other to enable the creator to recoup barred claims, the whole policy of barring claims would be defeated and no equities demand the application of the remedy. Like most other problems in law, questions such as "What constitutes a single taxable event or the same transaction?" and "How long is too long?" may never be finally answered but can only be circumscribed by recurring decisions.

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Tort Claims Act—Distinction between Nonfeasance and Misfeasance

In Flynn v. State Highway Comm'n, plaintiff's intestate was killed when the truck in which he was a passenger was wrecked as a result of its wheel striking a hole in the road, causing its driver to lose control. In plaintiff's action against the state for negligence in leaving the road in disrepair, the Supreme Court affirmed the lower court, which had affirmed the Industrial Commission, holding that the Tort Claims Act covers only negligent acts by state employees and not negligent omissions. In reaching this decision the court stated:

In order to authorize the payment of compensation, the Industrial Commission's finding must include (1) a negligent act, (2) on the part of a state employee, (3) while acting in the scope of his employment, etc. The first requirement is that the claimant show a negligent act. Is a failure to repair a hole in the highway caused by ordinary public travel a negligent act? The requirement of the statute is not met by showing negligence, for negligence may consist of an act or an omission. Failure to act is not an act. We think it was the intent of the legislature to permit recovery only for the negligent acts of its employees, for the things done by them, not for the things left undone. If the intent had been otherwise, it would have been easy to permit recovery for the negligent acts and omissions of State employees.

Wood v. United States, 213 F.2d 660, 661 (2d Cir. 1954).
St. Louis Union Trust Co. v. Finnegan, 53-1 CCH U.S. Tax Cas. ¶ 9299 (E.D. Mo. 1953).

244 N.C. 617, 94 S.E.2d 571 (1956).
Id. at 620, 94 S.E.2d at 572.