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**Equitable Considerations Held Not Applicable to
Defense of Lack of Overpayment—
*Dysart v. United States****

Taxpayer treated the proceeds of a judgment recovered in 1954 as capital gain. Although the Commissioner of Internal Revenue did not object to the capital-gain treatment,¹ he assessed a penalty

* 340 F.2d 624 (Ct. Cl. 1965) (hereinafter cited as principal case).

1. Principal case at 633.

tax for failure to report the judgment in a declaration of estimated income for 1954.² In 1958 the regulation providing for the penalty tax was declared invalid,³ and taxpayer filed a timely claim for refund. Although an independent affirmative action by the Commissioner contesting the 1954 return would have been barred by the statute of limitations,⁴ the Commissioner disallowed the refund, contending that because the proceeds of the 1954 judgment should have been treated as ordinary income, the taxpayer had not in fact overpaid his 1954 tax. On taxpayer's motion to the Court of Claims for summary judgment, *held*, denied, two judges dissenting. When a taxpayer sues for a refund, the Commissioner's right to offset against the overpayment an underpayment of tax with respect to a separate item in the same tax return is subject neither to the statute of limitations nor to equitable considerations.

Courts have long struggled with the problem of the offsetting of mutual debts, a problem further complicated when one of the claims is barred as an independent cause of action by the passage of time. If the stale counterdemand⁵ satisfies the traditional requirements of a set-off—a claim of liquidated debt arising out of a transaction extrinsic to that in controversy—it is defeated by the statute of limitations.⁶ The effect of the statute of limitations as a bar to the stale counterdemand can be avoided if the counterdemand is in the nature of a recoupment—a claim arising out of the same transaction in controversy⁷—but the equitable doctrine of laches limits the time

2. The penalty was assessed pursuant to Treas. Reg. 111, § 29.294-1(b)(3)(A) (1943), interpreting Int. Rev. Code of 1939, ch. 63, § 118(a), 58 Stat. 37 (1944), amending 53 Stat. 88.

3. *Acker v. Commissioner*, 258 F.2d 568 (6th Cir. 1958), *aff'd*, 361 U.S. 87 (1959).

4. INT. REV. CODE OF 1954, § 6501(a) requires assessment of any tax under the title to be imposed within three years after the return was filed, unless otherwise provided by law.

5. The term "counterdemand" is used in this note to signify a claim set up by the defendant in opposition to the complaint of the plaintiff, and includes both a demand for an affirmative recovery and a demand for a reduction in the plaintiff's recovery.

6. A set-off is a claim arising out of subject matter extrinsic to the subject matter of the suit. It involves a debt which is either liquidated or capable of liquidation, and will support an affirmative recovery on the part of the defendant. WATERMAN, A TREATISE ON THE LAW OF SET-OFF, RECOURPMENT & COUNTERCLAIM §§ 2-6 (1st ed. 1869). See generally CLARK, CODE PLEADING 635-36 (2d ed. 1947). A set-off is subject to the bar of a statute of limitations. *Flying Tiger Line, Inc. v. United States*, 170 F. Supp. 422, 425 (Ct. Cl. 1959); *Keckley v. Payton*, 157 F. Supp. 820, 822 (N.D. W. Va. 1958); *Ready-Mix Concrete Co. v. United States*, 130 F. Supp. 390, 392 (Ct. Cl. 1955); CLARK, *op. cit. supra*, at 636; 3 MOORE, FEDERAL PRACTICE § 13.11 (2d ed. 1964).

7. Recoupment, an equitable remedy, is a purely defensive claim seeking to reduce or eliminate plaintiff's recovery but not allowing an affirmative recovery by the defendant. WATERMAN, *op. cit. supra* note 6, §§ 413-25. See generally CLARK, *op. cit. supra* note 6, at 633-35; McConnell, *The Doctrine of Recoupment in Federal Taxation*, 28 VA. L. REV. 577 (1942). "Such a defense [recoupment] is never barred by the statute of limitations so long as the main action itself is timely." *Bull v. United States*, 295 U.S. 247, 262 (1935).

within which the counterdemand may be offset against the original claim.⁸ The court in the principal case, however, surmounted the bars imposed upon counterdemands by statutes of limitation and the doctrine of laches and sanctioned a separate classification of counterdemand—the defense of lack of overpayment. This category of counterdemands applicable regardless of any time limitations includes all counterdemands on the part of the Commissioner concerning the same tax for the same year by the same taxpayer. Thus, the Commissioner has acquired a powerful advantage in a narrow category of cases, for regardless of his own lack of diligence he need only show an underpayment with respect to the taxpayer's total tax return to reduce or eliminate the taxpayer's recovery.

While appearing to do justice, since the Commissioner, though not allowed to harass the taxpayer by making affirmative claims after the expiration of a statute of limitations, is allowed to prevent a taxpayer from obtaining a refund on one item while owing the government on another item in the same tax return, the decision of the court in the principal case is subject to several criticisms. First, it appears to be based upon a misapplication of prior case law. The defense of lack of overpayment was first enunciated in *Lewis v. Reynolds*,⁹ in which the Supreme Court allowed the Commissioner to offset a tax deficiency against a taxpayer's refund claim, despite the fact that the Commissioner was barred by the statute of limitations from bringing a separate action. The *Lewis* Court reasoned, as did the court in the principal case, that the taxpayer had not in fact overpaid his tax and that, regardless of the statute of limitations, his entire tax liability for the same year was subject to redetermination. The *Lewis* Court pointed out that the refund action was "in the nature of an action for money had and received"¹⁰—the equitable action of assumpsit. The fact that the Court in *Lewis* mentioned equitable considerations—an unnecessary discussion if the defense of lack of overpayment is unconditional—implies that the court did not view the defense as unconditional. Certainly the *Lewis* decision does not preclude courts from looking beyond the question of lack of overpayment to see if other relevant equitable considerations should be applied. The citing of *Lewis* in the principal case for the proposition that equities are irrelevant in a consideration of the defense of lack of overpayment is contrary to the implication in *Lewis* that equities are indeed relevant, and is also contrary to numerous Supreme Court holdings that an issue not ruled on by the Court cannot be considered as having been decided so as to constitute prec-

8. See *McNaghten v. United States*, 17 F. Supp. 509, 515 (Ct. Cl. 1937).

9. 284 U.S. 281 (1932).

10. *Id.* at 283.

edent.¹¹ Indeed, one Sixth Circuit opinion has expressly labeled the *Lewis* doctrine of lack of overpayment an equitable defense comparable to equitable recoupment.¹² Furthermore, the Court of Claims itself has stated that the *Lewis* doctrine is an equitable offset based on equitable principles.¹³

Second, the court in the principal case was in error in seeking to analogize the principal case to cases arising under the mitigation provisions of the Internal Revenue Code,¹⁴ which allow either a taxpayer or the Commissioner to recover on a claim barred as an independent cause of action by the statute of limitations if the statutory requirements are met. In such cases the statute precludes equitable considerations. The court in the principal case said that the same rationale should apply if the requirements for the defense of lack of overpayment are met.¹⁵ While Congress did place certain factual situations within the purview of the mitigation provisions, it did so with the intent to "supplement the equitable principles applied by the courts"¹⁶ to prevent injustice. By providing a statutory remedy to determine the court's course of action in certain limited factual situations, Congress could not have intended to preclude traditional applications of equitable principles in situations not specifically governed by the statute.

Third, a forceful argument can be made that the Commissioner's defense in the principal case meets the traditional requirements of a recoupment, and thus is to be governed by equitable principles.¹⁷ The claim of the taxpayer and the defense of the Commissioner seem to satisfy the "same transaction" requirement, for both concern the same tax liability—the taxpayer's treatment of the 1954 judgment. Just as in a contract situation one claim on a contract can be established as a recoupment defense against a separate claim on the

11. *Bingham v. United States*, 296 U.S. 211, 218 (1935); *United States v. Mitchell*, 271 U.S. 9, 14 (1926); *Webster v. Fall*, 266 U.S. 507, 511 (1925).

12. *Routzahn v. Brown*, 95 F.2d 766, 769 (6th Cir. 1938). While this decision did not rest precisely on the issue of the equitable nature of the *Lewis* doctrine, the court made it clear that, although the case concerned the appropriateness of amendments to pleading by the government, the equitable nature of the defense raised by the government was an important element in the decision. "What we have to decide is a question that transcends technical rules of pleading and involves the question of whether the United States . . . may . . . assert in diminution of the plaintiff's right to recover a tax liability . . . the doctrine of equitable recoupment." *Id.* at 769-70.

13. "The right of allowing an offset . . . is an equitable right given to the government based on the equitable principles and, as such, should not be abused." *Missouri Pac. R.R. v. United States*, 338 F.2d 668, 672 (Ct. Cl. 1964).

14. INT. REV. CODE OF 1954, §§ 1311-15.

15. Principal case at 628.

16. S. REP. NO. 1567, 75th Cong., 3d Sess. 49 (1938). This report deals with Int. Rev. Code of 1939, ch. 289, § 820, 52 Stat. 581, which was the predecessor to the mitigation provisions of the 1954 Code.

17. See note 7 *supra* and accompanying text. The dissent in the principal case indicates that this is a recoupment situation. The Commissioner sought the recoupment remedy of reduction of the taxpayer's recovery. Brief for Defendant, pp. 5-10.

same contract,¹⁸ so in the principal case one claim on the liability of a taxpayer can be set up as a recoupment defense against a separate claim based on the same liability.¹⁹ If the Commissioner's defense is indeed a recoupment, equitable principles apply by the nature of the action.²⁰ The court in the principal case avoided the application of equitable considerations by distinguishing this case from the general doctrine of recoupment and classifying it within a narrower category of cases involving the same tax for the same year by the same taxpayer. As Chief Judge Cowen pointed out in dissent, however, it is difficult to see the relevance of this distinction in deciding whether equitable considerations are appropriate in a recoupment situation.²¹ It would seem no less fair to subject the Commissioner's defense to equitable considerations when that defense concerns the same tax for the same year by the same taxpayer than to subject it to similar considerations when the defense concerns the same transaction but different taxes, years, or taxpayers. In both cases, only a single transaction is involved, whether it concerns various parts of one tax return or one part in each of several tax returns. The lack of overpayment is the same in either case. The fact that the class of cases involving a single tax return lends itself to an easy classification is not a compelling reason to work a basic change in a long-standing policy of law.

Fourth, attention must be paid to the nature of a tax-refund action, in which a taxpayer must have paid his tax before he can challenge the validity of the imposition.²² The Commissioner, in levying and collecting the taxes, would in reality appear to be the claimant of the tax money, but the requirement that the taxpayer pay first and then sue places the taxpayer in the position of formal claimant. The taxpayer bears the burden of persuasion and must

18. *Branch v. Wilson*, 12 Fla. 543, 550 (1868).

19. "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." *Mills v. United States*, 35 F. Supp. 738, 739 (N.D.N.Y. 1940).

20. Even if it can be successfully advanced that the Commissioner's defense is a set-off—*i.e.*, that the defense fails to meet the requirements for recoupment because the claim is found to arise out of a separate transaction—cognizance of equitable considerations is still necessary. Only a showing of special equitable considerations demonstrating the injustice of applying the statute of limitations would justify the court in lifting its bar. *CLARK, op. cit. supra* note 6, at 636 n.17 and accompanying text. See *North Chicago Rolling Mill Co. v. Saint Louis Ore & Steel Co.*, 152 U.S. 596, 615 (1894).

21. Principal case at 631.

22. *Bull v. United States*, 295 U.S. 247, 260 (1935). To challenge the validity of a tax assessment in the federal district courts or in the Court of Claims, the taxpayer must pay the tax and then sue for a refund. On the other hand, a taxpayer may refuse to pay the tax and file a petition with the Tax Court challenging the validity of the tax. The Tax Court, being limited to deficiency cases, has no jurisdiction over refund cases. *BITTKER, FEDERAL INCOME, ESTATE & GIFT TAXATION* 23 (3d ed. 1964).

prove his right to the refund, rather than the Commissioner having to prove his right to collect the tax.²³ Thus, the Commissioner, with the aid of the courts, has built into the tax system a legal device for the acquisition of funds which may subsequently be utilized to satisfy debts owed to the government but which the government is barred by law from collecting on its own initiative. Whatever superficial merit it may have, the rule laid down by the court in the principal case, allowing the Commissioner to use this device without regard to equitable considerations, should be rejected as a rule of unconditional application, since by removing a check on the Commissioner's conduct in handling tax returns it has taken from the taxpayer both the legal and equitable remedies designed to protect him from arbitrary actions of the government.

23. *Bull v. United States*, *supra* note 22, at 260.