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TAXATION-MITIGATION OF THE STATUTE OF LIMITATION AND THE DOCTRINE OF RECOUPMENT

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TAXATION—MITIGATION OF THE STATUTE OF LIMITATION AND THE DOCTRINE OF RECOUPMENT—Excise taxes on the sale of batteries were illegally collected from taxpayer from April, 1919 to April, 1926. In 1926 taxpayer filed a claim for refund for taxes paid between 1922 and 1926. Refund for the payments made earlier was barred by the statute of limitations. In 1935 the refund was received, and it was taxed as income by the commissioner. In a suit by the taxpayer to recover payment of the assessment, the lower court permitted recoupment, against the income tax deficiency, of the amount of excise taxes illegally collected between 1919 and 1922. *Held*, reversed. The recoupment doctrine as applied to tax law must be limited to a single transaction or taxable event which has been subjected to two taxes on inconsistent legal theories. *Rothensies v. Electric Storage Battery Co.*, 329 U.S. 296, 67 S. Ct. 271 (1946).¹

A statute of limitations is an indispensable element of fairness as well as of practicality in the administration of an income tax. Such a statute is by definition arbitrary.² No one would suggest that these statutes be repealed. The employment of various tax devices, however, often give rise to situations where the bar of the statute works unusual hardships,³ and permits "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."⁴ It has become essential to find some way to prevent the inequitable operation of the statutes without undermining the theory of statutes of repose. Estoppel is often used on the theory that no one should be permitted to found a claim upon his own inequity, or take advantage of his own wrong. It would be "an unreasonable construction that would view the prohibition of the statute as overriding the doctrine of estoppel."⁵ The doctrine has not proved satisfactory.⁶ The limits of the estoppel doctrine exclude many cases with inequitable results.⁷ Moreover, estoppel freezes and perpetuates the effect of the error.⁸ Elimination of the causes of unethical conduct is more effective than estoppel against it.⁹ This method was attempted in the case of *Bull v. United States*¹⁰

¹ For decisions of the lower courts see (C.C.A. 3d, 1945) 152 F. (2d) 521; (D.C. Pa. 1944) 57 F. Supp. 731.

² Principal case at 301.

³ 10 MERTENS, LAW OF FEDERAL INCOME TAXATION, § 60.01 (1942).

⁴ Kent, "Mitigation of the Statute of Limitations in Federal Tax Cases," 27 CAL. L. REV. 109 at 122 (1939).

⁵ *R. H. Stearns Co. v. United States*, 291 U.S. 54 at 61, 54 S. Ct. 325 (1933).

⁶ Maguire and Zimet, "Hobson's Choice and Similar Practices in Federal Taxation," 48 HARV. L. REV. 1281 (1935).

⁷ 39 COL. L. REV. 460 (1939).

⁸ Proceedings of the Seventh Tax Clinic of the American Bar Assn., 16 TAX. MAN. 663 (1938).

⁹ Reiling, "The Function of the Taxpayer's Ethics in Income Tax Liability," 12 TAX. MAN. 294 (1934).

¹⁰ 295 U.S. 247, 55 S. Ct. 695 (1935).

The court allowed the taxpayer the benefit of the barred claim, relying on the doctrine of recoupment, and the idea that "such a defense is never barred by the statute of limitations so long as the main action itself is timely."¹¹ The lower courts followed the rule of this case, giving the language used a broad interpretation and allowing recoupment despite the fact that different items were concerned. The requirement was that the party benefiting by the bar be the initiating party, and that the items be related.¹² The case of *McEachern v. Rose*, however, greatly lessened the value of the doctrine.¹³ Here the court refused to apply recoupment, upholding the bar of the statute of limitations. Though distinguishable on their facts, the cases are difficult to reconcile. "That the lower courts have been quite generally confused by the two holdings is evidenced by the fact that some cases have accepted the recoupment theory in the *Bull* case, while in others, the *McEachern* doctrine is deemed controlling."¹⁴ At best, recoupment seems to be a makeshift solution applicable to a limited class of cases. Courts still insist that an equitable remedy cannot nullify the statute of limitations.¹⁵ On this point the principal case is emphatic. "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."¹⁶ The need for remedial legislation to supplement or replace judicial methods has been widely admitted. Section 3801 was added to the Internal Revenue Code to mitigate the effect of the statute of limitations and other provisions in income tax cases.¹⁷ In general, the section operates only when there has been a determination in a particular year, which is adverse to either the taxpayer or commissioner, and is inconsistent with the position adopted in an earlier year by the party in whose favor the determination operates.¹⁸ The one taking the inconsistent position must lose out when restitution is made in the

¹¹ "Recoupment is in the nature of a defense arising out of some feature of the transaction upon which the plaintiff's action is grounded." *Id.* at 262.

¹² See 52 HARV. L. REV. 300 at 301 (1938) for cases. *Stone v. White*, 301 U.S. 532, 57 S. Ct. 851 (1937), also gave support to the rule of the *Bull* case. Here trustees sought to recover tax paid by the trust on income which should have been taxed to the beneficiary. Since recovery by the trustees would inure to the benefit of beneficiaries and collection of the deficiency was barred, the court allowed application of the equitable defense.

¹³ 302 U.S. 56, 58 S. Ct. 84 (1937). The government relied upon a barred deficiency of income tax for the year of decedent's death to deny refund of overpayments made by administrator for subsequent years. Both taxes were levied on the same item of income.

¹⁴ Zimet, "Tax Refund Claims and the Statute of Limitations," 1 TAX'L. REV. 45 at 53, (1945); see also McConnell, "The Doctrine of Recoupment in Federal Taxation," 28 VA. L. REV. 577 (1942). For cases following each see *American Light & Traction Co. v. Harrison*, (C.C.A. 7th, 1944) 142 F. (2d) 639 at 644; 52 HARV. L. REV. 496 at 501, note 37 (1939); note 11, *supra*.

¹⁵ 39 COL. L. REV. 460 (1939).

¹⁶ Principal case at 303.

¹⁷ Revenue Act of 1938, § 820.

¹⁸ Kent, "Mitigation of the Statute of Limitations in Federal Tax Cases," 27 CAL. L. REV. 109 (1939). The inconsistent position may have been adopted by a related taxpayer.

right year, so that a party cannot volunteer an inconsistent position in order to get a refund.¹⁹ The adoption of this section has many advantages over the judicial methods. The law allows real adjustment, so that the taxpayer pays the correct tax on the transaction and no more, instead of freezing the error or allowing only reduction of the present claim. The section has been much criticised, mainly because of its omissions.²⁰ However, the solution lies in sensible amendment of the law.²¹ The doctrine of estoppel and recoupment, as limited by the courts, are still available in those situations which are beyond the present scope of section 3801.

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¹⁹ Seidman, "Section 820 of the Revenue Act of 1938," 17 TAXES 341 (1939). Five classes of cases are affected by the section.

1. Double inclusion of an item in gross income.
2. Double allowance of a deduction or credit.
3. Double exclusion of an item of gross income when tax has been paid on the second exclusion.
4. Correlative deductions and inclusions specified in § 162(b) and (c).
5. Determination of basis of property where there has been erroneous treatment of a transaction upon which such basis depends. For analysis of these classes see Maguire, Surrey and Traynor, "Section 820 of the Revenue Act of 1938," 48 YALE L. J. 509, 719 (1939). See also 2 MERTENS, LAW OF FEDERAL INCOME TAXATION, c. 14 (1942).

²⁰ The chief objection is to the omission of double disallowance from section 3801. No way has been found to include this situation without defeating the substance of the statutes of limitations. See Bayly and Dickson, "Bad Debts and Section 3801: A Proposal," 18 TAXES 599 (1940), for proposed amendments.

²¹ Proceedings of the Seventh Tax Clinic of the American Bar Assn., 16 TAX MAN. 663 (1938).