Income Tax Statute of Limitations: Sixty Years of Mitigation--Enough, Already

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INCOME TAX STATUTE OF LIMITATIONS:
SIXTY YEARS OF MITIGATION—ENOUGH, ALREADY!!

JOHN A. LYNCH, JR.*

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I. INTRODUCTION

The struggle between simplicity and fairness in the income tax that has taken place in the last decade and a half, and which has reached an astonishing crescendo in serious consideration of some form of simplified tax,\(^1\) is not entirely new. A similar struggle was waged long ago, albeit on a smaller scale (though it did not seem so then), over the statute of limitations. In its simplest form the issue was this: could a taxpayer who erroneously enjoyed a tax benefit

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1. It is astonishing to recall in this sour age that public officials once extolled payment of taxes in general and the civic virtues promoted by our progressive tax in particular. See, e.g., Compañía de Tabacos v. Collector, 275 U.S. 87, 100 (1927) (Holmes, J., dissenting) (opining that "[t]axes are what we pay for civilized society . . ."). According to Franklin D. Roosevelt, "taxation according to income is the most effective instrument yet devised to obtain just contribution from those best able to bear it and to avoid placing onerous burdens upon the mass of our people." A Message to the Congress on Tax Revision (June 19, 1935), in 4 THE PUBLIC PAPERS AND ADDRESSES OF FRANKLIN D. ROOSEVELT 270, 271 (1938).

In sharp contrast, and reflecting frustration with the perceived onerousness of federal taxation, is the incitement of popular discontent embodied in a recent statement by Representative Bill Archer of Texas, Chairman of the House Committee on Ways and Means: "I am convinced that the overwhelming majority of Americans will realize that simply fixing the I.R.S. is not enough, but the true answer lies in uprooting today's oppressive and unfair tax." David E. Rosenbaum, Internal Audit Confirms Abusive I.R.S. Practices, N.Y. TIMES, Jan. 14, 1998, at A15.
(i.e., non-reporting of income) in an earlier tax year, again enjoy such a benefit because the year in which it was enjoyed was now barred by the statute of limitations?2 Conversely, could a taxpayer who had erroneously paid (or had been required to pay) a tax in an earlier year, or had sustained some other detrimental tax consequence, be required to suffer the same burden again because it was legally sustainable in the year at issue rather than the (now barred) earlier year?3

One response might have been to accept the notion that the existence of a

2. From the government perspective the problem was described in 1938 by Aubrey R. Marrs, head of the Technical Staff of the Bureau of Revenue:

In the early twenties the Bureau men were set back on their heels by this practical situation:—A taxpayer would come in for a particular year, contending that an item was deductible (and my argument applies equally well to the Commissioner sometimes). We listened to him. He argued strenuously that it was deductible in such-and-such a year. . . . Sometimes in a close question he brought in other forms of persuasion like National Committeemen and Senators, and so forth. And after listening to the taxpayer very patiently we said, "All right! We'll agree with you; it is an allowable deduction in this year and you are relieved of the deficiency, or you are entitled to the refund." And then, to our amazement, after that year became closed by the statute of limitations, in came that same taxpayer for another year, usually with a different lawyer, saying: "We are terribly sorry. An error has been committed. It's too bad. We regret it just as much as you do. But taxes must be determined according to the law and the law is that this was an allowable deduction in another year which is now open and we demand that our case be closed in accordance with law."


3. The government, through no less than the person of Robert H. Jackson, then Assistant General Counsel of the Bureau of Revenue, was remarkably up-front about hedging its bets:

A statute is passed, a question raised. Often the Supreme Court will not hear it unless and until there is a conflict of decision in Circuit Courts. Meanwhile, we guess at what the law will be, but we do not trust our guess. . . . [P]ending decision you may be shocked to know that we sometimes take both positions. That is, we take opposite sides of the same question, whichever will be to the advantage of the revenues. I was shocked at the apparent dishonesty of that policy when it first came to my attention. But I can find no way to avoid it.

income tax statute of limitations

statute of limitations will always make uncorrectable a certain amount of injustice and to balance that against the benefits of repose conferred by limitations. Another factor that counseled acquiescence in the ostensible inequities permitted by that statute of limitations was the annual accounting rule, a corollary of which is that events in one taxable year generally do not determine taxable income in other taxable years. Viewing inequities caused by the statute of limitations for what they are often requires viewing as a whole transactions spanning more than one taxable year, something that is generally anathema under the regime of annual accounting.

Notwithstanding the benefits of repose from the statute of limitations and to the flow of revenues from strict annual accounting, the first two decades of the income tax law produced stark inequities that public policy could not abide. As early as 1933 the Treasury Department recognized the need for a legislative solution. Thus, in that year, Acting Secretary of the Treasury, Henry Jackson

4. I.R.C. § 441(a) (1994) (providing that "[t]axable income shall be computed on the basis of the taxpayer’s taxable year.").
6. Robert H. Jackson observes: A strict annual basis for the computation of the tax has been followed in this country . . . . We . . . take a gradual process like the recognition that a debt has become a loss, or that a stock has become worthless and insist that a moment be fixed when it passed from one class to the other.

Jackson, supra note 3, at 645.

In reality, of course, the annual accounting principle has never been a strict bar to the determination of taxation in one year by reference to another. See, e.g., Arrowsmith v. Commissioner, 344 U.S. 6, 8-9 (1952) (holding that a payment which would have been a capital transaction in a prior year is not transformed into an ordinary business transaction simply because the transaction actually took place in a later year). An exception to the annual accounting principle that has a remarkably sweeping potential scope is the tax benefit rule, one significant aspect of which allows the government to hold taxpayers accountable for tax benefits enjoyed in long-barred years. See Hillsboro Nat’l Bank v. Commissioner, 460 U.S. 370, 377 (1983). This rule is bottomed on preventing taxpayers from enjoying tax benefits in different years that are “fundamentally inconsistent.” Id. at 383. In Part V, infra, the methodology of the tax benefit rule will be promoted as a better method of assessing when to allow an adjustment concerning a barred year than the present structure of the mitigation provisions.

7. A leading example, which is highlighted in Arthur H. Kent, Mitigation of the Statute of Limitations in Federal Tax Cases, 27 CAL. L. REV. 109, 110-11 (1939), occurred in Bigelow v. Bowers, 68 F.2d 839 (2d Cir. 1934). In 1916 taxpayer received a stock dividend the value of which he reported as income. Bigelow, 68 F.2d at 839-40. In 1918 he sold this stock using a basis that reflected his treatment of the stock dividend as taxable (i.e., taxpayer increased his basis by the amount of gain recognized). Id. at 840. In 1920 the Supreme Court held in Eisner v. Macomber, 252 U.S. 189 (1920), that stock dividends such as Bigelow's were not taxable. Bigelow, 68 F.2d at 840. In 1923, after the time in which taxpayer could have claimed a refund for 1916 had expired, the government redetermined taxpayer's income for 1918, denying him the basis increase attributable to the 1916 tax paid on the stock dividend. Id.

The dissent anguished: “If what the [government] has contended for here prevails, it results in the evil of double taxation . . . . We can attribute to Congress no such intention unless the statute expressly so provides.” Id. at 843.
Morgenthau, stated: "The Treasury strongly endorses the proposal to amend the statute of limitations to insure that, in cases of disputes as to the proper year in which income or deductions should be reported, such items shall be taken into account once and only once." Nonetheless, no statutory solution came forward until 1938 because of the "many formidable technical difficulties which even a partial legislative solution of the problem involve[.]"

The courts did not always sit idly by until the legislative response in 1938. In a number of cases the courts applied the equitable principle of estoppel, which prevents a taxpayer from obtaining a benefit that is factually inconsistent with a result obtained in an earlier year barred by limitations. Courts also applied the principle of recoupment, which requires a taxpayer or the government to reduce a claimed benefit (or tax) if such benefit or tax has been obtained with respect to the same transaction in an earlier year presently barred by the statute of limitations. Unfortunately, these remedies offered unsatisfactory relief from unfair exploitation of the statute of limitations. Estoppel was inadequate because of its inflexibility, conceptual limitations, and one-sidedness. It is now available to the taxpayer only under limited circumstances. Similarly, the doctrine of equitable recoupment did not develop as a satisfactory remedy for multiyear inequities. For reasons that will

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9. Kent, supra note 7, at 118.
10. For example, in R. H. Stearns Co. v. United States, 291 U.S. 54 (1934), the taxpayer and the government had a dispute about the taxpayer's tax for 1917. They executed two waivers of the statute of limitations for 1917, but the second one was not signed by the government. The taxpayer claimed overpayments for tax years 1918 through 1921 and asked that such overpayments be applied against a claimed deficiency for 1917. The government agreed. Id. at 56-58.

The taxpayer later contended that the waiver for 1917 was invalid and that the credit against the 1917 liability was invalid as against a barred deficiency under § 609 of the Revenue Act of 1928 (current version at I.R.C. § 6514). The taxpayer sued to recover the amount credited against the 1917 deficiency. Id. at 59-60.

In denying the taxpayer's recovery the Court rejected the taxpayer's attempt to renounce the consequences of its attempted waiver. Justice Cardozo stated for the Court: "[I]t is 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. at 61-62.

11. See, e.g., Bull v. United States, 295 U.S. 247 (1935) (allowing the taxpayer, under a recoupment theory, to have an overpayment of estate tax credited against a deficiency of income tax, even though the statute of limitations had run).
14. See S. Rep. No. 75-1567, at 49 (1938) (stating recoupment and other judicial principles are not effective in preventing misuse of the statute of limitations). Two leading commentators on the state of the law prior to the adoption of mitigation referred to the
be explored in Part IV, the history of equitable recoupment has involved progressively stronger restrictions on its use by the Supreme Court.\textsuperscript{15}

In response to the ineffectiveness of estoppel and recoupment, Congress concluded in 1938 that legislation was 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."\textsuperscript{16}

The legislative response was to enact the first mitigation provisions of the Code.\textsuperscript{17} In amended form these provisions still appear in the Code today.\textsuperscript{18} The provisions allow the government to reopen, or the taxpayer in certain circumstances to seek to reopen, a year barred by limitations when tax treatment of an item in an open year is inconsistent with treatment of the same or a related item in the barred year. Whether such reopening is ultimately allowed is decided in a judicial forum, as though it were an adjudication of a deficiency or claim for refund.\textsuperscript{19}

Unlike estoppel and recoupment, mitigation involves reopening a barred year. In one sense, it represents a simple solution to inequitable exploitation of the statute of limitations. It operates only in specified circumstances.\textsuperscript{20} The limited scope of the mitigation power is intended to accommodate the largely conflicting aims of keeping intact the statute of limitations and preventing limitations from being exploited inequitably.\textsuperscript{21} Mitigation is purportedly simple in that it creates no sweeping power in the courts to address anomalous and inequitable invocations of limitations. It is purportedly fair because it allows substantial exactness in adjusting the barred year to reflect inconsistent treatment of an item in an open year.\textsuperscript{22}

Despite these purported benefits, this Article contends that the present mitigation provisions, in attempting to reconcile the advantages of the statute of limitations with the prevention of inequitable exploitation from its use, have struck the balance too far in favor of the former. The closed-ended approach of the mitigation provisions has unnecessarily exalted limitations over equity and, far from promoting simplicity and predictability, has created statutory provisions which, in nearly six decades of practice, have proven monstrously


15. This development reached its culmination in United States v. Dalm, 494 U.S. 596, 608 (1990), where the Court clearly indicated that the scope of equitable recoupment was narrow.

complex.  

This Article will advocate that the mitigation provisions be repealed and replaced with a proposed statute that functions similarly to equitable recoupment. Part II of this Article will describe the mitigation provisions. Part III will explore several problems that have arisen in six decades of experience with the provisions. Part IV will explore equitable recoupment and examine why it has not been given a greater role in redressing multiyear anomalies in tax law. Part V will set out a statutory proposal that embodies recoupment, will explain how it works and will argue that it is preferable to the current mitigation provisions.

II. THE MITIGATION PROVISIONS

Mitigation, or a corrective adjustment, is permitted under I.R.C. § 1311(a) if a determination brings about any of the inequitable results described in I.R.C. § 1312. The “determination” that creates the inequity may be (1) a decision of the Tax Court or other competent court “which has become final”, (2) a closing agreement under I.R.C. § 7121, (3) a final disposition by the IRS of a claim for refund, or (4) an agreement which serves as a determination.


And a sampling of the scholarship: "Few areas within the tax field enjoy less understanding and generate more uncertainty than do Sections 1311 through 1315 of the Internal Revenue Code, which deal with mitigation of limitations." Irving Bell, Recent Developments Amid the Mysteries of Mitigation, 17 UCLA L. REV. 542, 542 (1970); "Who can blame the lawyer or judge who, occasionally, instead of reading the law, merely guesses at what it says?" Daniel Candee Knickerbocker, Jr., Mysteries of Mitigation: The Opening of Barred Years in Income Tax Cases, 30 FORDHAM L. REV. 225, 229 (1961).


26. I.R.C. § 1313(a)(2) (1994). Under Treas. Reg. § 1.1313(a)-2 (1999) a closing agreement may relate to the total tax liability of the taxpayer for a particular year or years or to one or more separate items affecting such liability. Under this provision of the regulations a closing agreement becomes final for purposes of mitigation on the date of its approval by the Commissioner. Id.

27. I.R.C. § 1313(a)(3) (1994). In some circumstances the disposition of a refund claim is final when it is allowed or when notification of disallowance is mailed. I.R.C. § 1313(a)(3)(A) (1994). This rule applies, according to Treas. Reg. § 1.1313(a)-3(b)(1) (1999), if:

(i) The taxpayer's claim for refund is unqualifiedly allowed; or
(ii) The taxpayer's contention with respect to an item
These requirements were intended to limit operation of the mitigation provisions to instances in which the inconsistency has been set in stone and both years are closed.  

A. The Circumstances of Adjustment

The centerpiece of legislative timidity concerning corrective adjustment is I.R.C. § 1312. This provision limits mitigation to seven "[c]ircumstances of adjustment." Each of these circumstances is discussed below.

is sustained and with respect to other items is denied, so that the net result is an allowance of refund or credit; or
(iii) The taxpayer's contention with respect to an item is sustained, but the Commissioner applies other items to offset the amount of the alleged overpayment and the items so applied do not completely offset such amount but merely reduce it so that the net result is an allowance of refund or credit.

In each of these instances the taxpayer prevails as to the item that is the subject of the determination and obtains at least some refund or credit of tax. See Michael I. Saltzman, IRS Practice and Procedure ¶ 5.07[3][c] (2d ed. 1991).

Under Treas. Reg. 1.1313(a)-3(b)(1) (1999) if the taxpayer is sustained as to the item at issue but receives no refund or credit of tax, the final disposition is date of mailing. Practically speaking, this indicium of finality controls when the IRS may seek a corrective adjustment. Under the circumstances enumerated in I.R.C. § 1313(a)(3)(B) (1994), a refund claim is finally disposed of when the time for filing suit on such claim expires unless suit is filed before such time expires, in which case a determination may come about with the result of such suit. This rule applies, according to Treas. Reg. § 1.1313(a)-3(c) (1999), if:

(1) The taxpayer's claim for refund is unqualifiedly disallowed; or
(2) The taxpayer's contention with respect to an item is denied and with respect to other items is sustained so that the net result is an allowance of refund or credit; or
(3) The taxpayer's contention with respect to an item is sustained in part and denied in part.

Likewise, under Treas. Reg. § 1.1313(a)-3(d) (1999), if the IRS reduces a claimed refund by the amount of an item, resulting in a net refund or credit, the disposition of the item so applied becomes final upon the expiration of the time for instituting suit under I.R.C. § 6532, unless suit is filed prior to the expiration of such period.

Under Treas. Reg. § 1.1313(a)-3(e) (1999) the taxpayer may eliminate the two year waiting period until the time for filing suit for refund expires by reaching a closing agreement or, under Treas. Reg. § 1.1313(a)-4 (1999), an agreement to a determination.

28. I.R.C. § 1313(a)(4) (1994). Such an agreement, which must state the amount of tax determined in the open year and describe the error in the closed year and the manner in which the error was treated in computing the tax in the open year, constitutes authorization for assessment of the agreed deficiency or refund of the agreed overpayment. J. Robert Coleman, Mitigation of the Statute of Limitations—Sections 1311-1315, 2 N.Y.U. Thirty-First Annual Institute on Federal Taxation 1575, 1583-84 (1973).


1. **Erroneous Inclusion of Income**

The first circumstance of adjustment occurs when a determination requires a taxpayer to report as gross income "an item which was erroneously included in the gross income of the taxpayer for another taxable year or in the gross income of a related taxpayer."\(^{31}\) For example, assume that a cash basis taxpayer's last paycheck from his employer for 1995 is lost in the mail. The taxpayer receives a replacement in March 1996, after she has received her W-2 statement of wages for 1995. The W-2 statement was promptly sent to her accountant in 1995 without telling the accountant of her failure to receive the lost check that year. The taxpayer's return for 1995 thus includes an amount that she did not receive and which has thus been erroneously reported. When the taxpayer files her own return for 1996, she does not report the amount of the replacement check for 1995. Because the check was received in 1996, however, it is income for 1996. Her failure to report this amount is discovered by the IRS before April 15, 2000—a timely discovery as to 1996,\(^ {32}\) but too late for the taxpayer to file a claim for a refund of the same amount reported in 1995.\(^ {33}\) Once there has been a determination of the inconsistent tax treatment of the same item in two different tax years, the taxpayer has one year to seek a reopening of 1995 to claim a refund for the amount of tax she erroneously overpaid.\(^ {34}\)

2. **Prior Allowance of Credit or Deduction**

The second circumstance in which a corrective adjustment is permitted under the mitigation provisions is when a determination allows the taxpayer a deduction or credit that she has already enjoyed in a previous year that is barred in the year of determination.\(^ {35}\) For example, consider a taxpayer who deducts a bad business debt in 1995. The same taxpayer, in 1999, has second thoughts about whether such debt was worthless in taxable year 1995 and decides to deduct it in 1999.\(^ {36}\) The IRS challenges this deduction, but the Tax Court upholds the taxpayer in 2003, long after any adjustment for 1995 is barred. Within one year of the Tax Court's decision, the IRS may send a notice of deficiency to the taxpayer for 1995.\(^ {37}\)

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31. I.R.C. § 1312(1). "Related taxpayer" is defined in I.R.C. § 1313(c) (1994) and will be addressed below. See infra notes 68-73 and accompanying text.
33. Id. Here the deadline for filing a claim for a refund would ordinarily be April 15, 1999. See I.R.C. § 6511(a) (1994).
34. See I.R.C. § 1314(b) (1994). The manner in which the adjustment is computed and allowed is described below. See infra notes 88-90 and accompanying text.
35. I.R.C. § 1312(2).
36. Under I.R.C. § 166(a) (1994), a bad debt is deductible in the taxable year in which it becomes worthless.
37. I.R.C. § 1314(b).
3. Erroneous Exclusion of Income

The third circumstance in which a corrective adjustment is permitted is when a determination requires exclusion from income of an item that was erroneously excluded by the taxpayer for another year or by a related taxpayer for the same or another taxable year.\textsuperscript{38} The statute distinguishes between instances in which the determination requires exclusion of an item the taxpayer has included in a return she has filed\textsuperscript{39} and instances in which the determination requires exclusion of an item the taxpayer has not included in a return but that is includible in the taxpayer's gross income or in the income of a related taxpayer for another year.\textsuperscript{40}

The former circumstance is governed by I.R.C. § 1312(3)(A). As an example, consider a partnership made up of father and son, each entitled to one half of partnership items. For the 1995 partnership taxable year, father reports the entire income of the partnership and son reports no partnership income. Shortly before expiration of the time for claiming a refund for the taxable year in which the father has reported the partnership income,\textsuperscript{41} the father files a claim for refund for the portion of partnership income properly reportable by son. The claim is allowed by the IRS after the time has expired for asserting a deficiency against the son. A corrective adjustment would be permitted with respect to the son for his share of the 1995 partnership income.\textsuperscript{42}

Exclusion of an item that has not been included in income in another year by the taxpayer or by a related taxpayer is described in I.R.C. § 1312(3)(B). An adjustment is not permitted in such cases unless assessment of a deficiency was not barred either "for the taxable year in which the item is includible or against the related taxpayer" at the time the IRS first maintained that the item must be included in the taxpayer's gross income for the taxable year to which the determination relates.\textsuperscript{43} In circumstances described by I.R.C. § 1312(3)(B) it is not necessary that the taxpayer maintain, in connection with the determination, a position inconsistent with erroneous exclusion of the item in the other taxable year.\textsuperscript{44}

\textsuperscript{38} I.R.C. § 1312(3).
\textsuperscript{39} I.R.C. § 1312(3)(A).
\textsuperscript{40} I.R.C. § 1312(3)(B).
\textsuperscript{41} Under I.R.C. § 706(a) (1994), a partner reports partnership items for any partnership taxable year ending within his or her own taxable year.
\textsuperscript{42} This example is patterned on example 2 under Treas. Reg. § 1.1312-3(a)(2) (1999).
\textsuperscript{43} I.R.C. § 1311(b)(2)(A). This rule is discussed in more detail in connection with the inconsistency requirement of I.R.C. § 1311(b). See infra notes 74-86 and accompanying text.
\textsuperscript{44} I.R.C. § 1311(b)(1) (1994). The requirement of the inconsistent position is discussed infra at notes 74-86 and accompanying text.
4. Disallowance of Deduction or Credit

The fourth circumstance in which a corrective adjustment is permitted is when a "determination disallows a deduction or credit which should have been allowed to, but was not allowed to, the taxpayer for another year, or to a related taxpayer." 45 This is the other circumstance in which the party seeking the determination (in this case the IRS) need not maintain, in connection with the determination, a position inconsistent with earlier exclusion of the item. 46 It is necessary, however, that the deduction or credit sought by the taxpayer in the determination not have been barred at the time the taxpayer first maintained "that he was entitled to such deduction or credit for the taxable year to which the determination relates." 47 As an example of this circumstance, consider a taxpayer who deducts a bad debt on his 1995 calendar year return at a time when a deficiency for 1994 is not barred. 48 The IRS denies this deduction for 1995 on the basis that the debt became worthless in 1994. 49 In 1998, after any refund for 1994 is barred, 50 the Tax Court upholds the IRS. In this situation an adjustment would be permitted to allow the deduction for 1994.

5. Correlative Deductions and Inclusions for Trusts, Estates, Legatees, Beneficiaries or Heirs

The fifth circumstance in which a corrective adjustment is allowed involves "[c]orrelative deductions and inclusions for trusts or estates and legatees, beneficiaries, or heirs." 51 In the Internal Revenue Code there are instances in which a trust or estate may deduct distributions to a beneficiary 52 or legatee. 53 The Code contains correlative provisions requiring distributees to include such distributions in income. 54 A determination obtained by or against a trust or estate that its treatment of an item of income or deduction was erroneous may upset the correlative treatment contemplated by the Code. For example, a determination establishing that an amount of undistributed trust income was not required under the trust terms to be distributed, contrary to reporting of such item by the trust, would indicate correlative treatment of that same item as income by the beneficiary was erroneous. 55 The mitigation

45. I.R.C. § 1312(4).
46. I.R.C. § 1311(b)(1).
47. I.R.C. § 1311(b)(2)(B). This rule is discussed in more detail in connection with the inconsistency requirement of § 1311(b). See infra notes 74-86 and accompanying text.
49. See I.R.C. § 166(a) (1994).
50. See I.R.C. § 6501(a).
52. I.R.C. § 651(a) (1994).
55. See I.R.C. § 662(a).
provisions permit an adjustment allowing a deduction to the beneficiary if the determination against the trust occurs when the taxable year in which the beneficiary reported the item is otherwise barred.\footnote{\textit{I.R.C.} § 1312(5).}

6. \textit{Correlative Deductions and Credits for Corporations in an Affiliated Group}

The sixth circumstance allowing a corrective adjustment involves correlative deductions and credits for corporations which are members of an affiliated group.\footnote{\textit{I.R.C.} § 1312(6). A member of an "affiliated group" of corporations, as defined in \textit{I.R.C.} § 1504(a) (1994), is categorized as a "related taxpayer" under \textit{I.R.C.} § 1313(c)(7) (1994).} The regulation pertaining to this circumstance presents a good example similar to the following:\footnote{Treas. Reg. § 1.1312-6(b) example 1 (1999).} \textit{X} Corporation, a wholly-owned subsidiary of \textit{Y} Corporation, pays $5,000 to \textit{Y} in 1990 and deducts this amount on its 1990 tax return as an interest expense. \textit{Y} correspondingly reports the same amount as interest income on its 1990 taxable year. In 1995 the Tax Court determines that the $5,000 payment from \textit{X} to \textit{Y} was a dividend to \textit{X} and denies \textit{X} its interest deduction. If \textit{Y}'s 1990 taxable year is otherwise barred, \textit{Y} is permitted an adjustment allowing \textit{Y} to deduct the payment from \textit{X} as dividend qualifying for the dividends received deduction.\footnote{\textit{Id.; see also} \textit{I.R.C.} § 243 (1994) (addressing the deductibility of dividends received by corporations).}

7. \textit{Erroneous Treatment of Basis}

Finally, \textit{I.R.C.} § 1312 allows a corrective adjustment when a "determination determines the basis of property, and in respect of any transaction on which such basis depends, or in respect of any transaction which was erroneously treated as affecting such basis, there occurred," any of three types of errors affecting the following classes of taxpayers:\footnote{\textit{I.R.C.} § 1312(7)(A).}

(i) the taxpayer with respect to whom the determination is made,
(ii) a taxpayer who acquired title to the property in the transaction and from whom, mediately or immediately, the taxpayer with respect to whom the determination is made derived title, or
(iii) a taxpayer who had title to the property at the time of the transaction and from whom, mediately or immediately, the taxpayer with respect to whom the determination is made derived title, if the basis of the
property in the hands of the taxpayer with respect to whom the determination is made is determined under section 1015(a) (relating to the basis of property acquired by gift). 61

To be in the second class of taxpayers listed above, a taxpayer must have "acquired title to the property in the erroneously treated transaction," been "a predecessor in title to the taxpayer with respect to whom the determination is made, and" been one "through whom the latter derived a carry-over basis for the property." 62

The following hypothetical, based on the regulations, 63 presents an example of this class of taxpayer: Taxpayer A makes a gift of preferred stock in Z Corporation to taxpayer B, who is not related to A. A received such stock in 1990 in a distribution from Z Corporation. A treated the distribution as nontaxable. When B sells the stock in 1995 she treats her basis as $1000, the fair market value of the stock when it was distributed to A. Assume that a closing agreement with B upholds this treatment in 1998. An adjustment is permitted as to A for 1990 because the determination of basis in the closing agreement indicates that A's treatment of the distribution to him as nontaxable was erroneous. 64

As an example of the third class of taxpayer, assume that A in his 1990 taxable year acquires stock in X Corporation in exchange for property in a transaction that A believes is not taxable because of I.R.C. § 351. 65 A makes a gift of this stock to B. In 1995, B sells it. B reports a gain that reflects that the exchange in which A acquired the stock was a taxable transaction. 66 The Tax Court sustains B's position in 1999, long after A's taxable year 1990 is barred. In this instance an adjustment would be allowed against A.

The following three types of erroneous treatment may serve as grounds for an adjustment as a result of a determination of basis:

(i) an erroneous inclusion in, or omission from, gross income,
(ii) an erroneous recognition, or nonrecognition, of gain or loss, or
(iii) an erroneous deduction of an item properly chargeable to capital account or an erroneous charge to capital account of an item properly deductible. 67

62. See Coleman, supra note 28, at 1611.
63. Treas. Reg. § 1.1312-7(c) example 2(i) (1999).
64. Id.
65. Under I.R.C. § 351(a) (1994), no gain or loss is recognized on transfer of property to a corporation in exchange for its stock if after such transfer the transferor or transferors control the corporation as defined in I.R.C. § 368(c).
66. B's assumption might be that the 80% control requirement of I.R.C. § 368(a) was not met in the transaction in which A acquired the stock. I.R.C. § 368(c) (1994).
B. Adjustments Involving Related Taxpayers

The first four circumstances of adjustment discussed above permit adjustment as to barred years in favor of and against “related” taxpayers (i.e., taxpayers that are not involved in the proceeding which gives rise to the determination). The relationships between taxpayers that serve as the bases for such adjustments are relationships in which one might anticipate difficulty in allocating income and deductions. They include the following: "(1) husband and wife, (2) grantor and fiduciary, (3) grantor and beneficiary, (4) fiduciary and beneficiary, legatee, or heir, (5) decedent and decedent’s estate, (6) partner, or (7) member of an affiliated group of corporations. . ." Such a relationship to "the taxpayer with respect to whom a determination is made" must have existed at some time in the taxable year in which the erroneous tax treatment occurred. Further, if it is the IRS that seeks an adjustment against a related taxpayer, the relationship with the taxpayer with respect to whom the determination is made must, with one exception, exist at the time the taxpayer first maintains the position upheld in the determination or at the time of the determination.

C. An Inconsistent Position

The paramount condition in most circumstances of adjustment is the requirement that the party who "wins" the determination must have previously sung a different tune about the erroneous, inconsistent treatment of the item involved in the determination. If the determination would provide the basis for an adjustment against the taxpayer for another year or against a related taxpayer, the taxpayer must have maintained in connection with the determination a position inconsistent with the erroneous treatment of the item by the taxpayer in another year or by the related taxpayer. On the other hand, if the determination provides the basis for an adjustment creating an overpayment by the taxpayer for another year or for a related taxpayer, the IRS must have maintained a position inconsistent with the erroneous treatment of

68. I.R.C. § 1312(1)-(4); see also I.R.C. § 1313(c) (1994) (defining related taxpayers).
69. SALTMAN, supra note 27, ¶ 5.07[4], at 5-61.
70. I.R.C. § 1313(c).
71. Id.
72. I.R.C. § 1311(b)(3) (1994). This exception applies when, under § 1312(3)(B), the determination requires the exclusion from income of an item the taxpayer has not included on his return. In such a circumstance it is not necessary, as a condition of allowing an adjustment in favor of the IRS, that the taxpayers maintained inconsistent positions in connection with the determination and the inconsistent erroneous treatment of the item involved in the determination.
73. I.R.C. § 1311(b)(3).
the item by the taxpayer in another year or by another taxpayer.\textsuperscript{75}

Notwithstanding the fact that a statute of limitations often creates circumstances of ostensible injustice, it works a form of justice of its own because it effects repose. Thus exceptions to the statute of limitations should be administered sparingly. In the mitigation provisions Congress has used the inconsistency requirement to limit corrective adjustments to instances in which either the government or a taxpayer seeks to enjoy some benefit a second time because correction of the first time is barred by the statute of limitations. Congress said the following about this requirement:

To preserve unimpaired the essential function of the statute of limitations, corrective adjustments should (a) never modify the application of the statute except when the party or parties in whose favor it applies shall have justified such modification by active inconsistency, and (b) under no circumstances affect the tax save with respect to the influence of particular items involved in the adjustment.\textsuperscript{76}

The rationale for this extraordinary sidestepping of the statute of limitations was perhaps stated most succinctly as follows: \textquote{He who seeks repose should practice it by letting sleeping dogs lie.}\textsuperscript{77}

As previously noted, the inconsistency requirement is inapplicable to two circumstances of adjustment.\textsuperscript{78} The first instance is when \textquote{the determination requires the exclusion from gross income of an item not included} in income \textquote{by the taxpayer and with respect to which the tax was not paid but which is includible in the gross income of the taxpayer for another taxable year or in the gross income of a related taxpayer.}\textsuperscript{79} The second instance is when \textquote{the determination disallows a deduction or credit which should have been allowed to, but was not allowed to, the taxpayer for another taxable year, or to a related taxpayer.}\textsuperscript{80} These two circumstances of adjustment were not part of the original 1938 statute; they were added in 1953.\textsuperscript{81}

Although it is not necessary in these two circumstances for the party who benefits from the determination to have maintained a position inconsistent with erroneous treatment of the item in another year or by a related taxpayer, the

\textsuperscript{75} I.R.C. § 1311(b)(1)(A). This inconsistency may simply arise from the IRS's adoption of a position in connection with the determination that is inconsistent with its acquiescence in erroneous treatment of the item in the closed year. Such acquiescence would be implicit in the IRS's acceptance of the return containing such erroneous treatment. SALTZMAN, supra note 27, ¶ 5.07[2][a], at 5-48 to 5-50.

\textsuperscript{76} S. Rep. No. 75-1567, at 49 (1938).

\textsuperscript{77} Maguire, supra note 12, at 518.

\textsuperscript{78} I.R.C. § 1311(b)(1) (1994).

\textsuperscript{79} I.R.C. § 1312(3)(B) (1994).

\textsuperscript{80} I.R.C. § 1312(4).

\textsuperscript{81} Technical Changes Act of 1953, ch. 512, sec. 211(a) § 3801(b), 67 Stat. 615, 625.
party seeking a corrective adjustment must meet a different condition. If the determination entitles the taxpayer to exclude an item she has excluded in another year, or that another taxpayer has excluded, the prior year of the taxpayer or related taxpayer must not have been barred by the statute of limitations at the time the IRS first maintained that the item should be included in the taxpayer’s income.\textsuperscript{82} By the same token, if the determination disallows a deduction which should have been allowed to the taxpayer for another taxable year or to a related taxpayer, an adjustment is permitted only if the year in which such deduction should have been allowed was not barred by the statute of limitations “at the time the taxpayer first maintained . . . that he was entitled to such deduction or credit for the taxable year to which the determination relates.”\textsuperscript{83}

In these two circumstances of adjustment, the requirement of an inconsistent position might perversely allow the IRS or a taxpayer to open up a closed year by maneuvering the opponent into a position inconsistent with treatment of an item in a barred year.

For example, consider taxpayer $A$, who suffered in his 1991 taxable year what he thought to be a partially worthless bad business debt.\textsuperscript{84} He deducted the worthless portion in 1991. In 1993, on audit, the IRS demanded an explanation and then accepted $A$’s return. In 1995, after the running of the statute of limitations for the 1991 tax year, $A$ concluded that the debt was wholly worthless in 1991.\textsuperscript{85} Nevertheless, $A$ deducts the remaining portion of the debt for tax year 1995. On audit, the IRS denies the remaining portion of the debt, concluding also that the entire debt was worthless in 1991.

Should the IRS position become the basis of a determination, its inconsistent position would provide a lever for the taxpayer to reopen 1991.\textsuperscript{86} This is not permitted, however, unless 1991 was open at the time $A$ first maintains in writing before the IRS the entitlement to the deduction of the portion of the debt not deducted in 1991. $A$ cannot benefit from a later determination unless the issue was raised before the running of the statute of limitations; the IRS’s inconsistent position is irrelevant to the issue of whether an adjustment is allowed.

\textbf{D. Method of Adjustment}

The amount of the adjustment under I.R.C. § 1311 is computed under I.R.C. § 1314. Under I.R.C. § 1314(a) the amount of the adjustment is the difference between the tax as previously computed in the year the error was

\textsuperscript{82} I.R.C. § 1311(b)(2)(A).
\textsuperscript{83} I.R.C. § 1311(b)(2)(B).
\textsuperscript{84} See I.R.C. § 166(a)(2) (1994).
\textsuperscript{85} See I.R.C. § 166(a)(1).
\textsuperscript{86} See I.R.C. § 1312(4) (1994).
made and the tax as computed with the item correctly treated. The tax for the year adjusted is not otherwise changed. Adjustments may be made to other taxable years if the adjustment of the year in which the error occurred effects a carryback or carryover of a net operating loss or capital loss.

If the determination permits an adjustment, such adjustment must occur within one year of the determination. If the adjustment entails an increase in tax, the IRS must issue a notice of deficiency to the taxpayer. Although the determination that permits the adjustment may be a judicial decision involving the same taxpayer, the taxpayer as to whom the adjustment is sought "may contest the deficiency before the Tax Court . . . or may pay the deficiency," file a claim for refund and then file a refund suit in a district court or in the Court of Federal Claims. If the adjustment indicates that the taxpayer has overpaid tax in the year in which the error was made, the taxpayer must file a claim for refund. If the IRS denies the refund claim, the taxpayer must file a suit for refund. The manner in which the statute functions sometimes requires two adjudications of the same anomaly: one to establish an inconsistency and a second to establish that the inconsistency is the sort that warrants relief from the statute of limitations, or, worse still, that the "determination" is the sort that invokes mitigation.

III. SHORTCOMINGS OF THE MITIGATION PROVISIONS

The judicial reluctance to provide a means to address inequities caused by the statute of limitations is addressed in Part IV. The preceding explanation of the mitigation provisions demonstrates a highly qualified approach to multiyear anomalies. There is no inherent reason that Congress needed to embrace the judiciary's timidity; nevertheless, it did.

If a solution as crabbed as the mitigation provisions had yielded a mechanism which (1) might be applied simply and predictably, and (2) paid sufficient homage to the advantages of the statute of limitations and annual accounting principle, it would be unwise to question Congress's wisdom in embracing it.

Six decades of experience has demonstrated, however, that the mitigation

87. I.R.C. § 1314(a) (1994); Coleman, supra note 28, at 1615.
88. Coleman, supra note 28, at 1615.
91. I.R.C. § 1314(b).
93. Id.
94. See, e.g., Yagoda v. Commissioner, 331 F.2d 485, 491-92 (2d Cir. 1964).
95. Commissioner v. Estate of Weinreich, 316 F.2d 97, 104-05 (9th Cir. 1963).
provisions, in structure and administration, have proved a morass of complexity, unpredictability, and sometimes indisputable injustice.\footnote{97} This section addresses the following four flaws of the mitigation provisions: A. Limitation of applicability of the mitigation provisions to a narrow catalogue of errors.  
B. Limited capacity of the mitigation provisions to address the consequences of basis errors.  
C. Confusion about what constitutes an inconsistency that invokes the mitigation provisions.  
D. The tendency of the determination requirement to spawn redundant litigation.

The author does not claim to have been the first to identify any of these flaws, but time and judicial construction has not cured them.

A. \textit{Limitation of Applicability of the Mitigation Provisions to a Narrow Catalogue of Errors}

Mitigation operates only in the circumstances of adjustment identified in I.R.C. § 1312.\footnote{98} This restriction is a genuflection to the statute of limitations\footnote{99} and no doubt bespeaks a fear of resort to any form of equitable discretion to remedy inequitable exploitation of limitations.\footnote{100} Thus, mitigation sidesteps limitations only in precisely defined instances.

Mitigation also serves as an escape valve from the rigors of the annual accounting principle, which has been aptly described as "obviously directed to taxable years rather than transactions or events."\footnote{101} Although mitigation is only one of many safety valves from the rigors of annual accounting, among other legislative\footnote{102} and judicial\footnote{103} escape hatches, mitigation is ordinarily construed

\footnotesize{
97. Ironically, a major advantage of mitigation touted by its supporters at its inception was that its highly detailed structure would be the approach to multiyear anomalies that would entail the least litigation. \textit{See} Kent, supra note 7, at 156; Maguire, supra note 12, at 775-76.  
99. See Maguire, supra note 12, at 516-17.  
100. As the Assistant General Counsel of the Bureau of Revenue stated in 1935: "The occasions when courts exercise the powers to do equity are rare and not likely to be very much extended. Meanwhile, the old adage that 'hard cases make bad law' is frequently exemplified in tax decisions." Jackson, supra note 3, at 642.  
103. \textit{See, e.g.,} Arrowsmith v. Commissioner, 344 U.S. 6, 8-9 (1952) (characterizing loss in a tax year as having been determined by circumstances in an earlier year); Dobson v. Commissioner, 320 U.S. 489, 493 (1943) (deciding that the extent of income inclusion in a tax year was to be determined by circumstances in an earlier year); R. H. Stearns Co. \textit{v.} United States, 291 U.S. 54, 60-62 (1934) (holding that the consistent treatment of a transaction was
}
parsimoniously. The narrowness with which the mitigation provisions have been written and generally construed has exacerbated the tendency of annual accounting to bring about inequity. A number of cases demonstrate this.

First and foremost is the 1975 decision of the Tax Court in B. C. Cook & Sons, Inc. v. Commissioner (Cook II). In that case the taxpayer, which was engaged in the business of acquiring citrus fruit for distribution to processing plants, was the victim of embezzlement by its bookkeeper for tax years ending in 1958 through 1965. The culprit wrote checks to a fictitious payee for whom he maintained a bank account. These checks were treated by the bookkeeper as purchases of fruit, thus increasing the taxpayer’s cost of goods sold and lowering its taxable income in the years involved. The taxpayer discovered the embezzlement in 1965, obtained some reimbursement from the bookkeeper, and deducted a theft loss of $605,116.52 that year. The IRS denied these deductions to the extent that embezzlements in years 1958 through 1962 were reflected in taxpayer’s cost of goods sold. The taxpayer contested this denial in the Tax Court, which upheld the taxpayer.

The Tax Court noted in Cook II that its earlier decision in the 1972 Cook

required notwithstanding the running of the statute of limitations); Lewis v. Reynolds, 284 U.S. 281, 283 (1932) (holding that although assessment and collection were barred by statute of limitations, the government could still retain and apply overpayments to amounts “which might [otherwise] have been properly assessed and demanded”).

104. The complex statutory scheme of mitigation has been viewed as inhibiting the liberal application of mitigation: “Incorporating rough justice or equitable principles into the elaborate scheme of the mitigation provisions would add inestimable mischief to the rigorous statutory scheme.” Fruit of the Loom, Inc. v. Commissioner, 68 T.C.M. (CCH) 867, 874 (1994), aff’d, 72 F.3d 1338 (7th Cir. 1996). See also O’Donnell v. Belcher, 414 F.2d 833, 844 (5th Cir. 1969) (stating that the court would not interpret the mitigation statutes as liberally as the service had requested). This rigidity has been viewed as even-handedly presenting occasional hardships to both taxpayers and the government. See Olin Mathieson Chem. Corp. v. United States, 265 F.2d 293, 296 (7th Cir. 1959).

Compounding the work of interpreting these complex mitigation provisions is a “recessive” strain of judicial thought which holds that as a relief provision, mitigation should be construed liberally. See Note, Sections 1311-15 of the Internal Revenue Code: Some Problems in Administration, 72 Harv. L. Rev. 1536, 1543 (1959) (quoting Gooch Milling & Elevator Co. v. United States, 78 F. Supp. 94, 100 (Ct. Cl. 1948)).

105. 65 T.C. 422 (1975) [hereinafter Cook II].
106. Id. at 422-23.
107. Id. at 424. This deduction resulted in a net operating loss which the taxpayer carried back to tax years 1962, 1963 and 1964. Id. at 424-25.
108. Id. at 425.
109. B. C. Cook & Sons, Inc. v. Commissioner, 59 T.C. 516 (1972) [hereinafter Cook I]. In Cook I the Commissioner argued that allowing the theft loss for 1965 would constitute an impermissible double deduction. Id. at 520. The court held the prohibition against double deductions of the same item in different years applies only when the earlier deduction is proper. Id. at 521-22. The court stated that the remedy for a deduction incorrectly taken in one year is to take it out of the year in which it was deducted. Id. at 521. The court hinted that the appropriate remedy for this situation was mitigation. Id. at 521-22. The determination that “expenses for fruit” were in reality losses from theft established the requisite erroneous treatment of such amounts in the earlier years.
I case represented a determination within the meaning of I.R.C. § 1313(a)(1),\textsuperscript{110} and thus an occasion for the Commissioner to invoke mitigation. The Commissioner ultimately failed in this effort.

The Commissioner relied on I.R.C. § 1312(2), stating that the prior determination in \textit{Cook I} entailed double allowance of a deduction in that the taxpayer received overlapping deductions for embezzlement losses and purchases of fruit, the latter increasing its cost of goods sold. The Commissioner urged that double allowance of a deduction or credit should include “any position taken by a taxpayer which would result in a double reduction of tax.”\textsuperscript{111} The Commissioner urged that such a construction of the circumstance of adjustment was “necessary to effectuate the purpose of the mitigation provisions.”\textsuperscript{112}

There is much to commend in the position of the IRS in \textit{Cook II}. The first paragraph of the Senate Report concerning the mitigation provision stated: “This section of the bill provides an equitable solution of certain classes of income-tax problems, now very numerous, which have caused much hardship to taxpayers and great difficulty to the Commissioner, the Board of Tax Appeals, and the courts.”\textsuperscript{113}

The Tax Court perceived Congress’s remedy to be somewhat narrower. It quoted the House Report to the effect that, notwithstanding its statement of general principles, Congress acted to correct only “some of the inequities under the income-tax laws caused by the statute of limitation and other provisions which now prevent equitable adjustment of various income-tax hardships.”\textsuperscript{114} The court concluded that “Congress intended to preclude the possibility of a double tax benefit only in the specific circumstances set forth in section 1312,”\textsuperscript{115} and construed the double deduction circumstance in that spirit.

The \textit{Cook II} court conceded that \textit{Cook I} had allowed the taxpayer a theft loss deduction for 1965 but stated that it was not “a deduction ‘which was erroneously allowed to the taxpayer for another taxable year.’”\textsuperscript{116} The court viewed the error the Commissioner tried to correct, the overstatement of cost

\textsuperscript{110} \textit{Cook II}, 65 T.C. at 422, 425 (1975).

\textsuperscript{111} \textit{Id.} at 427.

\textsuperscript{112} \textit{Id.} The IRS cited the Senate Report that accompanied the original version of the mitigation statute to support its contention that it was Congress’s intent that “disputes as to the year in which income or deductions belong, or as to the person who should have the tax burden of income or the tax benefit of deductions, should never result in a double tax or double reduction of tax, or an inequitable avoidance of tax.” \textit{Cook II}, 65 T.C. at 427 (quoting S. Rep. No. 75-1567, at 49-50 (1938)).

\textsuperscript{113} S. Rep. No. 75-1567, at 48.

\textsuperscript{114} \textit{Cook II}, 65 T.C. at 428 (quoting H.R. Rep. No. 75-2330, at 56 (1938)) (emphasis added by the court).

\textsuperscript{115} \textit{Cook II}, 65 T.C. 422, 428 (1975).

\textsuperscript{116} \textit{Id.} (quoting I.R.C. § 1312(2) (1994)).
of goods sold in the amount of the embezzled funds, as simply an offset in the computation of gross income.\textsuperscript{117} The court also noted that the term "deduction" is not used in I.R.C. § 1312 in connection with errors in gross income, but rather, the statute uses the terms "inclusion," "exclusion," and "omission" with respect to such errors.\textsuperscript{118}

The distinction drawn by the court between deduction and offset for the purpose of denying mitigation is not implausible.\textsuperscript{119} In support of its hypertechnical approach to construing the scope of the circumstances of adjustment the court relied upon \textit{Brennen v. Commissioner},\textsuperscript{120} which is addressed immediately below. The court in \textit{Cook II} assumed that Congress, in enacting the mitigation provisions, was cognizant of the "fundamental differences therein between the tax treatment of either basis or cost of goods sold and itemized deductions,"\textsuperscript{121} and that Congress included only the latter within the ambit of I.R.C. § 1312(2).\textsuperscript{122}

Despite the distinction, the result was terrible! The taxpayer benefitted twice from the amounts represented by embezzled funds, a result which seemed to trouble most members of the Tax Court.\textsuperscript{123} Such a result, however,

\begin{itemize}
\item \textsuperscript{117} \textit{Id.} (citing I.R.C. § 1001(a) (1954); Treas. Reg. § 1.61-3(a) (1957)).
\item \textsuperscript{118} \textit{Id.} at 430 (citing I.R.C. § 1312(2) (1994)).
\item \textsuperscript{119} The court cited a number of decisions in support of its distinction, including Curtis Gallery & Library, Inc. v. United States, 388 F.2d 358 (9th Cir. 1967); Bridges v. Commissioner, 64 T.C. 968 (1975); Estate of Dorn v. Commissioner, 54 T.C. 1651 (1970); Estate of Bray v. Commissioner, 46 T.C. 577 (1966), aff'd, 396 F.2d 452 (6th Cir. 1968). \textit{Cook II}, 65 T.C. at 428-30.
\item \textsuperscript{120} 20 T.C. 495 (1953).
\item \textsuperscript{121} \textit{Cook II}, 65 T.C. 422, 431 (1975).
\item \textsuperscript{122} \textit{Id.} at 431-32.
\item \textsuperscript{123} Judge Sterrett, who wrote for the majority, stated:
\begin{quote}
It may be fairly said that [the taxpayer] has not turned the appropriate square corner with its Government. It has availed itself of a situation which slips between the statutory cracks to gain an unwarranted tax advantage. Nonetheless, it is entitled to our unprejudiced interpretation of the law in issue.
\end{quote}
\textit{Id.} at 432.
\end{itemize}

Chief Judge Dawson, agreeing with the result from a technical standpoint in \textit{Cook II}, lamented that he now believed he had erred in \textit{Cook I}. He stated: "This time I have simply decided to go along with the majority so that we can avoid producing more bad law in this already bad case." \textit{Id.} (Dawson, C.J., concurring).

Both Judges Drennen and Wilbur, in separate dissents, criticized the restricted construction given to "deduction" by the majority. Significantly, however, Judge Drennen made what was very nearly an argument based on equitable recoupment. He stated:
\begin{quote}
I would agree that the mitigation provisions were probably not intended to cure all abuses of the statute of limitations but I think the circumstances of this case qualify for the benefits thereof. Congress was concerned with double deductions and credits which produced tax avoidance, not with the fine distinctions between deductions from gross income and
\end{quote}
is a predictable by-product of a scheme so fixated on deference to the statute of limitations.

A similarly inequitable result occasioned by the restrictiveness of the circumstances of adjustment may be seen in the Tax Court's decision in *Brennen v. Commissioner.* In that case the taxpayer took a deduction in 1944 for an amortizable bond premium under section 125 of the 1939 Internal Revenue Code. In 1945 the taxpayer sold the bonds to which the premium he had deducted pertained. He reduced his basis in the bonds by the amount of the bond premium he had deducted the previous year.

In 1946 the government audited the taxpayer's 1944 and 1945 returns. It denied deduction for the bond premium for 1944 and correspondingly decreased the taxpayer's gain on the sale of the bonds in 1945. The taxpayer cashed a refund check for 1945 but continued to litigate denial of the 1944 deduction in the Tax Court.

The Tax Court disposition of that matter was held in abeyance pending the Supreme Court's resolution of the deductibility of amortizable bond premium issue in another similar case. The Supreme Court's decision in that case vindicated the taxpayer's deduction for 1944. Since the statute of limitations on 1945 had run by time the Tax Court upheld the taxpayer's deduction for 1944, the government relied on mitigation to disgorge the taxpayer's 1945 refund. It relied in vain.

The Commissioner asserted the applicability of § 3801(b)(2) and (b)(5) of the 1939 Code. These correspond to § 1312(2) (double allowance of deduction) and § 1312(7) (error relating to a determination of basis) in the 1986 Code. The court rejected applicability of both circumstances of adjustment reductions of gross income. This is particularly true here where the very same actions or transactions of the embezzler gave rise to both the reductions in gross income in the years 1958-61 and the loss deduction this Court allowed for 1965.

*Id.* at 434-35.

As noted below, the essence of equitable recoupment is to prevent an inconsistent double benefit, or tax, on the basis of the same transaction. The assessment of whether such a double benefit is sought may entail consideration of different tax years. See *infra* notes 458-507 and accompanying text.

124. 20 T.C. at 495.
126. 20 T.C. at 497.
127. *Id.* at 497-98.
128. *Id.* at 498 (citing Commissioner v. Korell, 339 U.S. 619 (1950)).
129. *Id.* at 498-99 (referring to Korell, 339 U.S. at 628).
130. *Id.* at 500.
131. Although the language of the corresponding provisions of the 1939 and 1986 Codes is not identical, the provisions are not different from each other in any way material to the discussion herein.
under the facts of the case.132

Much in the manner that it did in *Cook II*, the court in *Brennen* held that the error in 1945 was not a deduction. Instead, the court viewed the transaction in 1945 as an adjustment to basis, something not covered by I.R.C. § 3801(b)(2).133 The court rejected the applicability of subsection (b)(5) because it held that its determination with respect to 1944 was not a determination of basis, as that subsection requires, but rather of the propriety of a deduction (albeit one which affected basis).134

As in *Cook II*, the *Brennen* court’s restrictive view of the scope of mitigation permitted the taxpayer to enjoy a double benefit from the same item. Judge Turner dissented, focusing on I.R.C. § 3801(b)(5),135 the provision concerning errors in connection with basis, which shall be addressed in more detail below.136 He argued that the bond premium issue determined earlier by the Tax Court was *de facto* part of the taxpayer’s basis.137 Notwithstanding his criticism, however, the decision in *Brennen* and its egregious result may be seen as faithful to congressional intent for mitigation to provide only restrictive safe harbors from manipulation of the statute of limitations.138

*Cook II* and *Brennen* are hardly the only examples in which the “list” of circumstances of adjustment, as construed restrictively, was too short to address patent inequity.139 Nevertheless, the large number of tribunals engaged in

132. 20 T.C. at 500-01.
133. *Id.* at 500.
134. *Id.*
135. *Id.* at 502 (Turner, J., dissenting).
136. *See infra* notes 153-218 and accompanying text.
138. It must be conceded that in most cases both taxpayers and the government may protect themselves from litigation. *See*, e.g., I.R.C. § 6501(c)(4) (1994) (providing that the government may obtain a waiver from the taxpayer of limitation on assessment for a taxable year); Kellogg-Citizens Nat’l Bank of Green Bay v. United States, 330 F.2d 635, 639 (Ct. Cl. 1964) (noting that a taxpayer may file a protective claim for refund).

That limitations may be avoided in such ways raises two policy questions: (1) If one accepts as appropriate the restrictive nature of mitigation, is this purpose served if limitations may be readily avoided? (2) Is it appropriate that the greatest flexibility in correcting errors may be obtained only by the procedurally agile? The author’s view is that the scope of relief from the statute of limitations to remedy inequity would be better placed in the hands of tribunals with broader remedial powers than mitigation now permits.

139. For example, see *Evans Trust v. United States*, 462 F.2d 521 (Ct. Cl. 1972). In 1967 the estate of Cora Evans, which included a beneficiary trust established to hold assets from the estate of Arthur Evans, Cora’s husband, was required to include a substantial asset representing income in respect of a decedent. The trust claimed a deduction for estate tax paid by Cora’s estate for 1961, 1962, 1963, and 1964. The IRS allowed such a deduction only for 1964, which was not then barred. The trust sought relief through the mitigation provision for correlative items for trusts, estates, and beneficiaries under I.R.C. § 1312(5). *Id.* at 523.

In much the same spirit as the Tax Court in *Cook II* and *Brennen*, the Court of Claims held mitigation inapplicable. Among other reasons, it noted that the statute refers to deductions or inclusions in computing taxable income of an estate or beneficiary. It also noted that the determination as to which the taxpayer sought mitigation entailed inclusion of an *asset* in the estate of Cora. *Id.* at 524.
deciding tax cases makes it inevitable that not all will follow the restrictive approach to construing the scope of the circumstances of adjustment. In *Cocchiara v. United States* 140 for example, the Fifth Circuit construed the scope of I.R.C. § 1312(1)—the section dealing with the double inclusion of an item of gross income—in a manner that is probably inconsistent with the congressional purpose of mitigation (and certainly with how the courts have generally construed this purpose). Coincidentally, the court averted a significant injustice.

In *Cocchiara* the taxpayers sold two mineral leases in 1959 for approximately $2,000,000. They reported the gain from this sale on the installment basis in their tax years from 1959 to 1965. The IRS and the taxpayers agreed to hold these years open for assessment until 1972. The IRS denied the taxpayers the benefit of installment reporting, requiring the entire amount of gain to be reported for 1959. This caused a deficiency for that year but also created overpayments for tax years 1960 through 1965. These overpayments were credited against deficiencies in those years. 141

The taxpayers sued for a refund in the United States District Court for the Eastern District of Louisiana. 142 The court upheld the IRS denial of installment treatment in 1959 but held that the IRS, through its adjustments in 1960 through 1965, had received $511,878.03 more in taxes than it should have. The court held, however, that over half of this amount was barred by limitations. 143 The taxpayers' recovery was reduced still further by the Fifth Circuit. 144 Subsequently, the taxpayers, dependent upon mitigation for relief, filed a refund action in the United States District Court for the Eastern District of Louisiana. 145

A master found that the taxpayers had paid a double tax on the same item of income, the sale of the mineral leases in 1959, for which they had never received a refund or credit against taxes legitimately owed. 146 The important question was whether this constituted a double inclusion of income within the meaning of I.R.C. § 1312(1).

The IRS argued that it was not and the district court agreed, finding that the taxpayers were “taxed once on the mineral lease sale and once on other items of income, albeit erroneously.” 147 This surely provides a cogent explanation as to why the taxpayers literally did not qualify for mitigation. Crediting

140. 779 F.2d 1108 (5th Cir. 1986).
141. Id. at 1109.
143. Republic Petroleum Corp. v. United States, 613 F.2d 518, 521-22 (5th Cir. 1980) (describing the district court's findings).
144. Id. at 527.
146. Roussel, 676 F. Supp. at 122.
147. Cocchiara, 779 F.2d at 1111 (describing the district court's findings).
overpayments of tax attributable to installment payments for 1960 through
1965 against other taxes for those years that proved to be erroneous literally did
not entail double reporting of income from the 1959 sale.

The appellate court, in reversing the district court, remarkably agreed that
the determination did not require the taxpayers to include the income from the
mineral lease sale in both 1959 and the years from 1960 to 1965. The court
stated, however, that "it is the taxes due on the items of gross income, not the
double inclusion of the gross income itself, that the statute by implication refers
to." Later the court concluded that "[t]hese statutes are essentially equitable
in nature. They relieve the parties from the disabilities imposed by the pertinent
statute of limitations under the Internal Revenue Code."

The court's approach in Cocchiara essentially analyzes the net tax result
of a transaction to see whether it has been taxed twice. As such, it resembles
equitable recoupment. Since it is used offensively—that is, as the basis of a
separate refund action for a year as to which limitations has expired—it would
probably be impermissible under United States v. Dalm, the Supreme Court's
last word on recoupment. While mitigation was thought to be an antidote to the
inadequacies of equitable recoupment, the majority of courts applying
mitigation have not been as inclined to "do equity" as the court in Cocchiara.
For the Cocchiara court's approach to be the norm, it would be necessary to
replace the mechanics and spirit of mitigation with those of equitable
recoupment.

B. Limited Ability of the Mitigation Provisions to Address the
Consequences of Basis Errors

Section 1312(7) allows an adjustment when a "determination determines
the basis of property, and in respect of any transaction on which such basis
depends," the determination establishes that any of three types of error
occurred. These errors are (1) "an erroneous inclusion in, or omission from,
gross income," (2) "erroneous recognition, or nonrecognition, of gain or loss,"
and (3) "an erroneous deduction of an item properly chargeable to capital
account or an erroneous charge to the capital account of an item properly
deductible." As previously discussed, this adjustment may be made to the income of
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(i) the taxpayer with respect to whom the determination is made,
(ii) a taxpayer who acquired title to the property in the transaction [in which error occurred] and from whom, mediately or immediately, the taxpayer with respect to whom the determination is made derived title, or
(iii) a taxpayer who had title to the property at the time of the transaction [in which error occurred] and from whom, mediately or immediately, the taxpayer with respect to whom the determination is made derived title, if the basis of the property in the hands of the taxpayer with respect to whom the determination is made is determined under I.R.C. § 1015(a). . . .

The opacity of the mitigation provisions probably reaches its zenith with this circumstance of adjustment. The provision’s history in the courts demonstrates, for the most part, that the complex terms have been used as a course of hurdles that have often thwarted mitigation’s overall purpose—to take the profit out of inconsistency. This has been particularly true with respect to the requirements that a determination “determine[] the basis of property” and that the determination also determine that an error has occurred “in respect of any transaction on which such basis depends.” Failure to meet either of these requirements of the statute prevents a mitigation adjustment even when an adjustment would ostensibly be compelled by the circumstances.

Perhaps the best way to demonstrate the harshness with which the basis provision has been construed is to look first at an instance in which it was applied liberally. Such an instance is provided in United States v. Rosenberger. In that case the taxpayer held stock and debentures in a corporation. From 1932 to 1942 she received from the corporation payments she treated as distributions in reduction of the principal of her debentures. In tax years 1946 and 1947 the taxpayer received two large distributions that liquidated the principal of her debentures. She reported capital gain on these distributions, having reduced her basis by earlier distributions.

In 1950 the taxpayer filed a timely claim for refund for 1947. She contended that her treatment of earlier distributions as reducing her basis was

156. S. REP. NO. 75-1567, at 49 (1938).
158. Of the type specified in § 1312(7)(C).
161. 235 F.2d 69 (8th Cir. 1956).
162. Id. at 71.
erroneous, and that these distributions were in fact dividends. The district court agreed with the taxpayer that the distributions between 1932 and 1942 were dividends that should not have reduced the taxpayer’s basis prior to the liquidating distributions in 1946 and 1947. The court, however, permitted the government to offset taxes on the dividends between 1932 and 1942 against the taxpayer’s refund. The taxpayer then filed a claim for refund with respect to 1946, which was barred by limitations. The taxpayer’s argument for application of mitigation was that since she had been required for 1947 to report distributions between 1932 and 1942 as dividends, such distributions should not have reduced her basis. Since these distributions were so employed in calculating her basis with respect to the 1946 distribution, her gain was overstated.

The district court agreed with the taxpayer that mitigation was appropriate under the statutory antecedent of I.R.C. § 1312(7). The government argued on appeal that the district court erred because there had not been, in the litigation of the 1947 tax year, a determination of basis of the debentures. It also argued that there was no erroneous tax treatment of an item in respect of a transaction on which basis depends.

The court brushed aside the government objections with little explanation. It noted that while one relying on the mitigation provisions must prove the existence of the prerequisites to its applicability,

[t]hat . . . does not mean that the statute should be so strictly or narrowly interpreted as to defeat its apparent purpose, which it has been said was “to provide a fair and workable formula under which taxpayers and the Government would be given relief from the unfair and unjust results occasioned by corrections . . . of errors . . . in connection with proper treatment of items affecting taxable income and tax liability in more than one year.”

163. Id. In a proceeding involving the corporation which made the distributions, Broadway Corp. v. Commissioner, 4 T.C. 1158 (1945), the Tax Court denied the corporation's interest deductions pertaining to the debentures involved in Rosenberger. The 1432 Broadway court found the “debentures” more analogous to preferred stock than evidences of indebtedness.” Rosenberger, 235 F.2d at 71 (citing and summarizing 1432 Broadway, 4 T.C. at 1166).


165. Rosenberger, 235 F.2d at 72 (summarizing the district court’s findings in Bauman).

166. Id.

167. Id.

168. Id. (citing I.R.C. § 3801(b)(5) (1939)).

169. Id. at 73.

170. Id. (quoting Gooch Milling & Elevator Co. v. United States, 78 F. Supp. 94, 100 (Ct. Cl. 1948)).
The court’s conclusion was consistent with its overarching statement that the statute should not be parsimoniously interpreted to the point of frustrating its purpose. In deciding that the taxpayer reported too much capital gain income in 1947, the court had to determine her basis.\footnote{See I.R.C. § 1001 (1994).} In determining that distributions from 1932 to 1942 did not reduce her basis, the district court had determined that these distributions should have been taxed as dividends and it thus allowed the government to reduce her refund to collect such tax.\footnote{\textit{Rosenberger}, 235 F.2d at 72.} This action resulted in double taxation of a portion of these distributions for the 1946 tax year. Some of the amount by which the taxpayer had reduced her basis to reflect these distributions was taxed as capital gain in that year. The error in 1946 was traceable to transactions the tax treatment of which was the subject of the refund suit for 1947 and which affected taxpayer’s basis. Notwithstanding the clear appropriateness of the result, there is ample support in the caselaw under I.R.C. § 1312(7) for a different result on account of failure to satisfy the requirements of a determination of basis and that such determination conclude that an error occurred “in respect of [a] transaction on which basis depends.”\footnote{I.R.C. § 1312(7)(A) (1994).}  

1. \textit{Determination of Basis}  

That it may plausibly be argued that the facts of \textit{Rosenberger} lacked the essential determination of basis may be seen in \textit{Sherover v. United States},\footnote{137 F. Supp. 778 (S.D.N.Y. 1956), aff’d, 239 F.2d 766 (2d Cir. 1956).} a case which bears significant factual similarities to \textit{Rosenberger}. In \textit{Sherover} the taxpayer was a participant in a joint venture that owned a ship. In 1941 certain repairs to the ship were capitalized. In 1946, in a consolidated proceeding involving the venture, the Tax Court determined that half of the amount capitalized in 1941 should have been deducted as expenses.\footnote{Id. at 779-80 (citing \textit{Worth S.S. Corp. v. Commissioner}, 7 T.C. 654 (1946)).} The ship had been destroyed in 1942 and the owners received an insurance payment for the loss.\footnote{\textit{Worth}, 7 T.C. at 662-63. \textit{The Leslie} was sunk by a German submarine. \textit{Id.}}  

In 1947, following an audit of the taxpayer’s 1942 return, the government assessed additional tax against the taxpayer for that year. It did so by lowering the taxpayer’s basis by the proportional amount of expenses that the venture should have deducted.\footnote{\textit{Sherover}, 137 F. Supp. at 780.} The taxpayer paid the tax and then sought, through mitigation, to obtain a refund based on the amounts in 1941 that events proved should have been deducted.\footnote{Id. at 780.} In rejecting the applicability of mitigation, the court determined, \textit{inter alia}, that there had been no determination of basis under
what is now I.R.C. § 1312(7). The court stated that the earlier Tax Court determination of the joint venture’s taxable income for 1942 simply determined the propriety of the tax treatment of repair expenses and not the taxpayer’s basis.

Although this conclusion is defensible, it seems harsh under the circumstances. The determination had the effect of creating a capital gain as to an open year of the taxpayer, 1942, by reducing the taxpayer’s basis; indeed, no unreported gain could have been found unless the determination presented a basis lower than the taxpayer’s amount realized.

The court in Rosenberger might just as plausibly have held that the determination therein concerning 1947, strictly speaking, did not determine the basis but rather required inclusion of distributions in earlier years as dividend income. The Rosenberger court did not take that approach and thus the taxpayer was able to avoid double taxation on capital gain in 1946. In Sherover the court divorced a decision pertaining to an item that clearly affected the basis of property from the overpayment of tax in a closed year. The taxpayer was compelled to pay a double tax with respect to 1941. Again, the result is logically defensible, but harsh. Sherover’s restrictive view regarding what constitutes a determination of basis, however, is consistent with the weight of authority.

179. Id. at 781. At issue in Sherover was I.R.C. § 3801(b)(5) (1939), the predecessor of I.R.C. § 1312 (1994).
181. Treas. Reg. § 1.1312-7(a) (1999) (stating that I.R.C. § 1312(7) applies if, among other things, a “determination establishes the basis of property”). In Sherover, the “determination” of basis was implicit; the case actually determined a capital gain owed by the taxpayer. All but one of the examples in the regulations providing examples of determinations of basis involve determinations in closing agreements, which may be fashioned by the parties to address issues specifically (particularly in the imagination of a regulation author). Example 5, however, like Sherover, involves a determination by the Tax Court of an additional capital gain occasioned by an earlier error. The example appears to recognize that there may be an implicit determination of basis in the explicit determination of additional capital gain against a taxpayer. Treas. Reg. § 1.1312-7(e) example 5 (1999) (as amended in 1962).
182. In Fong v. Commissioner, 75 T.C.M. (CCH) 2299 (1998), the Tax Court ruled that language in a stipulation not adopted by the court in its decision could not be regarded as determining basis. This stipulation allowed taxpayer deductions for depreciation that indicated that the taxpayer should have reported a higher capital gain when such asset was distributed to her. Since there was no determination of basis, however, mitigation was inapplicable. Id. at 2303.
183. This head-in-the-sand approach has cut egregiously against both taxpayers and the government. For example, in Central Hanover Bank & Trust Co. v. United States, 163 F.2d 60 (2d Cir. 1947), the personal representative of an estate sought a mitigation adjustment concerning the sale of a block of stock in 1936. The decedent had treated the basis of the stock, which represented only a part of her holdings in the company, on an average per share. The decedent taxpayer had reported a sale in 1935, of her holdings in the same company the same
The examples in the Treasury Regulations reflect the prevailing narrow judicial construction of determination of basis. It appears that to qualify as a determination of basis, the determination must simply resolve the question of basis of property for purposes of comparing basis with the amount realized in order to calculate the amount of gain or loss in the year to which the determination applies. The regulations surely are a strong indication of the appropriateness of the narrow judicial interpretation of the statute, but so construed, the statute is a weak bulwark against multiyear inequity.

A decision that contrasts remarkably with this limited construction about what constitutes a determination of basis is Gooding v. United States. In this case the taxpayers transferred to a corporation assets of a business they had operated as a partnership in exchange for stock, assumption of partnership debt, and notes of the corporation. The taxpayers treated the notes as boot, and hence

way. The government required an adjustment for 1935, contending that basis must be calculated first in, first out. This increased the taxpayer's gain for 1935 but necessarily indicated that the taxpayer's basis in calculating her loss for 1936 was too low. Id. at 61. Nevertheless, the court denied the taxpayer's adjustment with respect to the barred year, 1936.

The court held, inter alia, that the determination with respect to 1935 did not determine basis of the property at issue in 1936, but instead only determined the basis of the stock sold in 1935. Id. at 62. This was an extraordinary holding because the government's insistence that the taxpayer shift from average cost to first-in-first-out necessarily "pours" basis from the year at issue to other years when other portions of the block of stock are sold. Consequently, the taxpayer was deprived of full use of its cost basis against sale proceeds—surely a close relative of double taxation.

Such hypertechnicality has also served the cause of inappropriate tax avoidance. This may be seen in American Foundation Co. v. Commissioner, 2 T.C. 502 (1943). Taxpayer had treated receipt of stock in 1931 as a nonrecognition transaction. The government contested this in an earlier case, but the taxpayer was upheld by the Ninth Circuit. Id. at 505-06. See American Found. Co. v. United States, 120 F.2d 807 (9th Cir. 1941).

However, in 1934, 1936, and 1937 the taxpayer sold portions of the stock received in 1931. As its basis in these sales it used the stock's fair market value in 1931, which was inconsistent with treating receipt of the stock as a nonrecognition transaction. 2 T.C. at 506-07. When litigation concerning 1931 was completed, the government sought mitigation adjustments for 1934, 1936 and 1937. Id. at 507.

The Tax Court held, inter alia, that the determination with respect to 1931 did not determine the basis of the stock sold in the years for which adjustment was sought, but instead only whether gain or loss should have been recognized in 1931. 2 T.C. at 508. While that, speaking very strictly, may be true, the determination that the 1931 transaction was not taxable inescapably affected the basis of the property obtained and, thus, later dispositions of such stock. Pretending that it did not permitted the taxpayer a double inconsistent exclusion of gain with respect to the stock at issue. The Tax Court, a few years later, allowed another taxpayer a similar windfall under somewhat analogous circumstances. See Brennen v. Commissioner, 20 T.C. 495 (1953).

185. See, e.g., Lykes v. United States, 343 U.S. 118, 127 (1952) (noting that Treasury regulations are "entitled to substantial weight").
186. 326 F.2d 988 (Ct. Cl. 1964).
treated the transaction as capital gain to that extent.187

As the corporation paid the notes the taxpayers treated the payments as tax free return of capital. The government disagreed. It regarded the transfer to the corporation as nontaxable and payments on the notes as dividends.188 The Tax Court sustained the Commissioner.189

Shortly thereafter, the taxpayers filed claims for refund of the capital gains tax paid in the year of the exchange of the partnership assets to the corporation. Since that year was then barred, the taxpayers relied on the mitigation provisions in their refund action.190 In finding for the taxpayers, the court relied on I.R.C. § 1312(7). Somewhat surprisingly it found that the Tax Court, in holding that payments on the notes were dividends, had determined basis as required by I.R.C. § 1312(7)(A). The court stated that by treating the exchange as tax free, the Tax Court determined that the notes and other assets shared a common basis. As the notes were repaid, any basis allocable to them was reallocated to other assets.191 The court concluded that a decision that had "such a direct, immediate, and drastic impact on the basis of the notes" was a determination of basis for purposes of I.R.C. § 1312(7).192

This is a sensibly broad interpretation of I.R.C. § 1312(7), but it is at variance with the approaches of Sherover, Central Hanover Trust,193 American Foundation,194 and Brennen. It could be just as plausibly argued that the Tax Court determination at issue in Gooding simply resolved the question of whether payments excluded by the taxpayer were taxable dividends, and that any effect on basis was incidental. The fact that either approach is plausible, however, undercuts the supposed advantages of a narrowly crafted statute: certainty of application and maximum protection for the statute of limitations.

2. In Respect of a Transaction on Which Such Basis Depends

In Rosenberger195 the taxpayer obtained a mitigation adjustment with respect to capital gain she overpaid in 1946. This was triggered by a setoff against her refund claim for 1947 of dividends between 1932 and 1942 that taxpayer had treated as distributions in reduction of her basis. The setoff as to the 1947 refund meant that the amounts thereby taxed as dividends were taxed twice to the extent that they reduced the basis used to calculate gain on the

187. Id. at 989-90 (citing I.R.C. § 112(c) (1939) (current version at I.R.C. § 351(b) (1994))).
188. Id. at 990.
190. Gooding, 326 F.2d at 990.
191. Id. at 992.
192. Id.
193. See supra note 183 and accompanying text.
194. See supra note 183 and accompanying text.
195. United States v. Rosenberger, 235 F.2d 69 (8th Cir. 1956).
distribution to taxpayer in 1946. It could plausibly be argued, however, that the taxpayer's erroneous double taxation with respect to 1946 did not occur "in respect of" any transaction upon which the basis of property depended, at least in the sense that this statutory requirement has been construed by some courts.

In *American Foundation Co. v. Commissioner*, for example, the taxpayer treated a 1931 acquisition of stock as a nonrecognition transaction. The government disputed this treatment, but the taxpayer ultimately prevailed. The taxpayer had inconsistently reported subsequent sales of the stock received in the 1931 transaction as if it had recognized gain on the 1931 transaction. The court rejected the government's attempt to obtain a mitigation adjustment. In addition to holding that the determination did not determine basis, the court also held that the erroneous understatement of capital gain in subsequent sales did not occur in respect of a transaction on which basis depended—that is, the acquisition of the stock in 1931—but rather in respect of the three transactions in later years in which the stock was sold. While this is logically defensible, it overlooks the reality that the determination with respect to the 1931 transaction established the erroneous treatment of the later transactions in closed years.

Another hypertechnical construction of the requirement that the error be "in respect of" the transaction determining basis may be seen in *O'Brien v. United States*. In this case the taxpayer's father was the sole shareholder of a close corporation. The father made gifts of stock during his lifetime, but they were brought back into his estate as "gifts made in contemplation of death." The estate valued the stock at $215.7796 per share. The IRS disputed this valuation. While that matter was pending, the corporation was liquidated and the taxpayer reported his gain on the liquidation using a valuation of $215.7796. Later the Tax Court established the valuation of the stock at $280.10 per share. This determination also indicated that the taxpayer's basis in calculating his gain on the liquidation had been too low and that he had paid too much income tax. The tax he paid was incompatible with the estate tax paid

196. See supra notes 168-74 and accompanying text. For a fuller discussion of *American Foundation, see supra note 183.*


198. 2 T.C. 502 (1943).

199. *American Found., 2 T.C.* at 508.

200. *Id.*

201. 766 F.2d 1038 (7th Cir. 1985).

202. *Id.* at 1040 (citing I.R.C. § 2035 (1954)).

203. *Id.*

204. *Id.; see also* I.R.C. § 1014 (1994) (addressing the "[b]asis of property acquired from a decedent").

205. 766 F.2d at 1040.
by the estate on the stock.206

The IRS denied the taxpayer's claim for a refund as untimely.207 Subsequently the taxpayer sued for a refund on the basis of the mitigation provisions and prevailed.208 The appellate court reversed, holding, inter alia, that the taxpayer's erroneous reporting of excessive capital gain did not occur "in respect of" the transmission of the stock by the father through his estate, which was at issue in the Tax Court proceeding in which basis was determined.209 The error occurred "in respect of" the liquidation of the corporation.210

Again, this construction of "in respect of" is not illogical and fosters a restrictive scope of the I.R.C. § 1312(7) circumstance of adjustment. However, it overlooks the inescapable link between the basis determination in the Tax Court and the amount of the taxpayer's gain on the corporate liquidation. The limitation of the scope of transactions "in respect of" the basis determination to the estate tax valuation proceeding seems highly artificial.

A third case that demonstrates the harshness of a narrow scope of transactions "in respect of" a transaction affecting basis is presented in Koss v. United States.211 In Koss the taxpayer was a lawyer who agreed to perform legal services in exchange for stock in a corporation. He received such stock in 1974 and valued it at $4,400. In 1977 the stock became worthless, although the taxpayer did not claim a deduction for such worthlessness in his return for that year. In 1980 the IRS determined a deficiency of $44,788.05 against the taxpayer for 1974 on the basis of valuing the stock at $110,000.212 Koss petitioned the Tax Court, which upheld the IRS, and the appellate court upheld that decision.213 Following the sustaining of the deficiency for 1974, the taxpayer sought a mitigation adjustment for 1977 under I.R.C. § 1312(7).214

Notwithstanding his failure to claim the loss in 1977 for the worthless stock, the assertion by the taxpayer of the applicability of I.R.C. § 1312(7) was not farfetched. The determination of the amount of income recognized by the taxpayer on receipt of the stock necessarily determined the taxpayer's basis in the stock. Taking an approach similar to the court in O'Brien,215 the court held

206. Mitigation could be rejected as a threshold matter if, as Steven J. Willis strenuously contends, mitigation does not apply to inequitable inconsistencies between income and estate taxes. Steven J. Willis, Some Limits of Equitable Recoupment, Tax Mitigation, and Res Judicata: Reflections Prompted by Chertkof v. United States, 38 TAX L. 625, 626 (1985).
207. O'Brien v. United States, 766 F.2d 1038, 1040 (7th Cir. 1985).
210. Id.
211. 69 F.3d 705 (3d Cir. 1995).
212. Id. at 706-07.
213. Id. at 707 (citing Koss v. Commissioner, 57 T.C.M. (CCH) 882 (1989), aff'd, 908 F.2d 962 (3d Cir. 1990)).
214. Id. at 709.
215. Indeed, the Koss court relied on O'Brien. Koss, 69 F.3d at 710 (citing O'Brien v. United States, 766 F.2d 1038, 1043).
the erroneous failure to take a deduction for the worthless stock in 1977 was not "in respect of" the acquisition of the stock in 1974.\footnote{216}

\textit{Koss} concededly does not present as compelling an example of the harshness of the "in respect of" requirement as \textit{American Foundation} or \textit{O'Brien}.\footnote{217} The taxpayer in \textit{Koss} was simply attempting to avail himself of the fortuity of the later worthlessness of the stock in order to offset the effects of his failure to report properly its value in the year of receipt. On the other hand, the government reaped what was essentially a windfall because it had to reckon with only one end of a continuum pertaining to the stock at issue. The determination of its value on receipt logically determined the magnitude of the taxpayer's loss on the worthlessness of the stock.

The construction of the requirement that the error occur "in respect of" a transaction on which basis depends has caused courts to disregard windfalls logically related to determinations that have affected basis. This approach would likely have yielded a different result in \textit{Rosenberger}. The offset therein of dividends against the taxpayer's refund for 1947 recouped erroneous exclusions of the dividends in years long closed. The taxpayer's mitigation claim for 1946 related to the effect that retroactive characterization of these amounts as dividends had on her basis.\footnote{218} Under the reasoning of \textit{American Foundation} or \textit{O'Brien} it could be argued that the erroneous basis reductions, not the erroneous mischaracterizations of dividends, resulted in erroneous reporting of income in 1946. Thus the erroneous amount of gain for 1946 would not be "in respect of" the mischaracterization of dividends, the transactions on which basis depended.

The basis portion of the mitigation provisions is, of course, intended to be narrow. Unfortunately, this narrowness thwarts adjustments for anomalies that warrant correction. Cases such as \textit{Rosenberger} and \textit{Gooding} indicate that this narrow construction has not been applied with complete consistency, but consistency would probably be too much to expect for a provision as complex as the basis provision.

\section*{C. Confusion About What Constitutes an Inconsistency That Invokes the Mitigation Provisions}

Most of the circumstances of adjustment require that the party against whom a mitigation adjustment is sought must have acted inconsistently (1) in connection with the original erroneous tax treatment of an item and (2) in

\footnotesize

\begin{itemize}
\item \footnote{216} Koss, 69 F.3d at 710-11.
\item \footnote{217} Certainly taxpayers in the circumstances of Koss may file a protective claim for refund as to the later year. There is no guarantee that taking such action will not result ultimately in two different suits, one to determine the value of the stock in the year of receipt and one to determine whether the stock became worthless in the later year in which taxpayer seeks a deduction.
\item \footnote{218} United States v. Rosenberger, 235 F.2d 69, 72 (8th Cir. 1956).
\end{itemize}
connection with the determination that establishes such treatment as error. 219
This restriction ostensibly serves an overriding congressional objective that
mitigation provide only a narrow exception to limitations—that it serve only
to correct inequitable attempts to use the statute of limitations as a shield.

A construction of the term "inconsistency" that requires active and
deliberate inconsistent conduct, if applied uniformly, would indeed serve the
policy of supporting the statute of limitations and engender predictable results
in mitigation cases. The Senate Finance Committee long ago made clear the
appropriateness of such a construction of the inconsistency requirement. "To
preserve unimpaired the essential function of the statute of limitations,
corrective adjustments should . . . never modify the application of the statute
except when the party or parties in whose favor it applies shall have justified
such modification by active inconsistency." 220

Unfortunately, at least with respect to the objective of "check[ing] the
growing volume of litigation," the Senate report also aims mitigation at
inconsistency "whether fortuitous or the result of design." 221Although this may
be logically taken to mean simply that active inconsistency need not be part of
a prearranged scheme, hatched at the time of the original error, this is not the
only sensible interpretation of the statement. The statement may also be taken
to mean that a benefit derived by acquiescence in inconsistent treatment of a
transaction may result in a mitigation adjustment. This interpretation is tenuous
in light of the general tone of the history, legislative and otherwise, of the
mitigation provisions, but some courts have embraced it. 222 The split of judicial
authority on this point has compromised the benefits that a restrictively drawn
statute is supposed to achieve.

A relatively recent example of the restrictive view of the inconsistency
requirement is F.W. Boelter Co. v. United States. 223 In that case the taxpayer,
in 1982, discovered an error in the manner in which it had computed the value
of its inventory for taxable years 1975 through 1981. These errors resulted in
overstatement of income for those years. The taxpayer filed amended returns
claiming refunds for tax years 1979 through 1981. 224 In 1983 the IRS allowed
refunds in accordance with the amended returns. The taxpayer then filed
amended returns claiming refunds for tax years 1975 through 1978. These

219. Maintenance of an inconsistent position is not required when an adjustment is
sought on account of double exclusion of an item of gross income under I.R.C. § 1312(3)(B) and
220. S. Rep. No. 75-1567, at 49 (1938). Some insight into what the Committee meant
by "active" inconsistency may be gleaned from language earlier in the same paragraph which
excoriates active exploitation of opportunities available only by "assum[ing] a position
diametrically opposed to that taken prior to the running of the statute." Id.
221. Id.
222. See F.W. Boelter Co. v. United States, 12 Cl. Ct. 120, 125 (1987).
223. Id.
224. Id. at 121.
adjustments were denied on the basis of the statute of limitations. Although the court agreed with the taxpayer that there had been a double inclusion of income, it held in favor of the IRS on the basis that the agency had maintained no active inconsistency in connection with the purported items of adjustment.

The taxpayer's arguments that the IRS was chargeable with the requisite inconsistency were somewhat creative. In particular, the taxpayer relied on *Moultrie Cotton Mills v. United States,* which also involved inventory valuations. The taxpayer in *Moultrie* had been required to recompute inventory values for past taxable years by Treasury regulations. The government allowed refunds for these recomputations only in open years, not closed years. The court held that denial of refunds as to closed years in the face of allowance of refunds for open years constituted the inconsistency the mitigation provisions required.

In *F.W. Boelter* the court rejected application of *Moultrie* in part because the case at hand, unlike *Moultrie,* did not involve recomputations mandated by the IRS. More importantly, the court rejected application of *Moultrie* because any inconsistency between IRS acquiescence to adjustments for open years and its refusal to allow adjustments in the closed years was not active inconsistency. The IRS, in allowing refunds for open years, simply acquiesced to a position taken by the taxpayer. Although this position was inconsistent with the taxpayer's earlier reporting of similar transactions in

225. *Id.* at 122. Initially the IRS agent erroneously allowed a refund for 1977, which the IRS successfully sought to recover through a counterclaim. The taxpayer had recovered a settlement from its former accounting firm equal to the tax overpayments the IRS had not refunded, and had treated this recovery as income. *Id.*

226. *Id.* at 125.

227. 151 F. Supp. 482 (Ct. Cl. 1957).

228. *Id.* at 483.

229. *Id.* at 485. Although the court in *F.W. Boelter* did not address the point, the stated reasoning of the court in *Moultrie* regarding the inconsistency is specious. Mitigation is not based on any general requirement that similar items must be treated the same in different years. See, e.g., First Nat'l Bank of Philadelphia v. Commissioner, 18 T.C. 899, 903 (1952), *aff'd,* 205 F.2d 82 (3d Cir. 1953). For mitigation there must be an inconsistency between tax treatment of an item established in a determination and treatment of the item in an earlier year. Unless correction with respect to the earlier year affects another taxable year, see I.R.C. § 1314(a), other taxable years are unaffected. In *Moultrie,* while similar mistakes were made in several years, they were not causally related to each other through shifting of income or deduction from year to year.

230. *F.W. Boelter Co.,* 12 Cl. Ct. at 125. The court stated:

To require that inventories be valued correctly and consistently is no different than requiring that they be reported properly and without mistake in the first instance. The same requirement applies to all items reported on federal tax returns. If an error is made, it can be corrected unless the year is closed by the statute of limitations.

231. *Id.*
closed years—to which the IRS acquiesced by accepting the returns—such a change of heart, at the behest of the taxpayer, was not the sort of active inconsistency contemplated by the mitigation provisions. As the court stated, the plaintiff "cannot originate and actively assert an inconsistent position and then use that position to extricate [itself] from the defense of the statute of limitations merely because the Commissioner passively accedes to plaintiff[’]s assertions."\(^{222}\)

If one accepts the notion that any exception to the statute of limitations should be narrow, the active inconsistency gloss to the inconsistent position requirement of I.R.C. § 1311(b) is sensible. This notion has been applied by courts other than the former Court of Claims.\(^{223}\) Unfortunately, as discussed below, a number of courts have not insisted on active inconsistency as a condition of a mitigation adjustment.

A stark rejection of the active inconsistency construction may be seen in *Chertkof v. Commissioner*.\(^{224}\) In that case the taxpayer, in 1965, agreed to a redemption of his stock in a corporation that owned a shopping center in exchange for one third of the corporation’s assets. The surrender of stock and receipt of assets did not occur until 1966. The taxpayer reported capital gain for that year. In 1969 the IRS audited the taxpayer’s 1965 tax return and determined that the transaction reported as capital gain in 1966 was actually a dividend in 1965. At the same time, the IRS determined that the taxpayer’s reporting of the capital gain for 1966 resulted in an overpayment. The taxpayer paid the deficiency for 1965 and filed a suit for refund. The taxpayer also accepted the refund from the IRS voluntarily made for 1966.\(^{225}\)

The district court, in the refund action, had upheld the taxpayer’s contention that the taxable transaction occurred in 1966, not 1965.\(^{226}\) The taxpayer’s contention in connection with the determination was consistent with his initial reporting of the transaction, though, of course, the taxpayer accepted the refund by the IRS of tax he paid for 1966. Because the statute of limitations had run with respect to the taxpayer’s 1966 return at the time of the district court’s determination regarding 1965, the IRS had to rely on mitigation to extricate itself from the consequences of its error concerning 1965.\(^{227}\)

The court squarely rejected the taxpayer’s contention that mitigation was not permitted under the circumstances because the *taxpayer* had not maintained inconsistent positions in reporting the transaction initially and then in the

\(^{222}\) *F.W. Boelter Co.*, 12 Cl. Ct. at 125 (quoting Glatt v. United States, 470 F.2d 596, 601 (Cl. Ct. 1972)).

\(^{223}\) *See Commissioner v. Estate of Weinreich*, 316 F.2d 97, 105 (9th Cir. 1963); *Sherover v. United States*, 137 F. Supp. 778, 781 (S.D.N.Y. 1956), *aff’d per curiam*, 239 F.2d 766 (2d Cir. 1956); *Estate of SoRelle v. Commissioner*, 31 T.C. 272, 275 (1958).

\(^{224}\) 649 F.2d 264 (4th Cir. 1981).

\(^{225}\) *Id.* at 265-66.


\(^{227}\) *Chertkof*, 649 F.2d at 266.
district court suit.\textsuperscript{238} The court looked at the statutory language and legislative history to conclude:

\begin{quote}
[T]here is no requirement that the party who benefits from the application of the statute of limitations must have maintained a position inconsistent with that which it initially advanced. It is only necessary that the position adopted in the determination be inconsistent with the exclusion or deduction in another year.\textsuperscript{239}
\end{quote}

Thus the court required the taxpayer to report the transaction for 1966, something the taxpayer had attempted to do before the statute of limitations had run for that year but which the IRS error thwarted.\textsuperscript{240}

There is much to commend about the result in \textit{Chertkof}. The taxpayer executed a taxable transaction that was reported and taxed before the statute of limitations ran. Fairness commands that a taxpayer report such a transaction in \textit{some} year. Nevertheless, the legislative history of the mitigation provisions evinces its unambiguous goal to "take the profit out of inconsistency."\textsuperscript{241} \textit{Chertkof} served no such purpose.

The taxpayer’s position in the district court was consistent with its reporting of the transaction. The only inconsistency involved was that between the result sought by the IRS in district court and the result obtained. The court in \textit{Chertkof} permitted this "inconsistency" to allow the IRS to invoke mitigation to attempt to tax the transaction in another year when it could have preserved its right to do so through diligence before limitations ran.\textsuperscript{242}

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\textsuperscript{238} \textit{Id.}
\textsuperscript{239} \textit{Id.} at 267-68.
\textsuperscript{240} To add insult to injury, the court held that the transaction, as a dividend, was taxable as ordinary income, substantially increasing the taxpayer’s tax. \textit{Id.} at 270.
\textsuperscript{241} S. REP. NO. 75-1567, at 49 (1938).

The Tenth Circuit refused to take a similarly indulgent view toward the government under somewhat analogous circumstances in \textit{Kent Homes, Inc. v. Commissioner}, 455 F.2d 316 (10th Cir. 1972). In this case the taxpayer received condemnation proceeds with respect to housing it had constructed on land owned by the United States Army. The taxpayer’s 1958 tax year ended January 31, 1958. The agreement carrying out the condemnation was executed in March 1958, which was in the taxpayer’s 1959 year. The taxpayer contended that the transaction should have been reported in 1963, when all legal proceedings among parties to the transaction were concluded. Reporting in 1963 would have resulted in no tax. \textit{Id.} at 317-18.

The IRS issued a deficiency for 1958. The district court, on the basis that condemnation documents were not executed until March 1958, held that gain was reportable by taxpayer for 1959. \textit{Id.} at 660. The court held the IRS action was based on a misreading of the facts in documents the IRS had before it. The Tenth Circuit refused to allow a mitigation adjustment when the IRS attempted to open 1959 after losing in the district court with respect to 1958. The court found no inconsistency on the part of the taxpayer, which consistently asserted that 1963 was the proper year to report the transaction. \textit{Id.} at 318-20.
it may serve equity, the approach of Chertkof is contrary to the protection of the statute of limitations supposedly served by a narrow scope of mitigation. Nevertheless, this approach to the requirement of I.R.C. § 1311(b) of an inconsistent position has been embraced by a number of courts at least comparable to the number of courts that have embraced the "active inconsistency" view.\textsuperscript{243} In light of the split of authority concerning how the inconsistent position requirement should be construed, this writer contends that the current mitigation provisions fail significantly to obtain their objective of providing a clear and limited exception to the statute of limitations.

D. The Tendency of the Determination Requirement to Spawn Redundant Litigation

In order to obtain a mitigation adjustment the taxpayer or the government must be able to point to a determination involving some tax treatment in one year that contrasts inequitably with tax treatment of the same item or transaction in a different closed year.\textsuperscript{244} Such a determination may be a court order,\textsuperscript{245} a closing agreement,\textsuperscript{246} a final disposition of a claim for refund,\textsuperscript{247} or an agreement pertaining to a person's tax liability for any taxable period.\textsuperscript{248} The determination requirement is intended to give "authoritative sanction to the inconsistent action."\textsuperscript{249} In the words of one commentator, the determination

\begin{quote}
The approach of Chertkof, if applied in Kent Homes, might have yielded a different result. The result in the district court—that 1959 was the proper year to report the transaction—was inconsistent with taxpayer's reporting of the transaction. The court noted, however, that "there is no evidence of actual inconsistent positions by the taxpayer, nor is there evidence that the taxpayer used any devious means to avoid the mitigation section with knowledge withheld from the government." \textit{Id.} at 320. The court required that the inconsistency be in the conduct of the taxpayer.
\end{quote}

\textsuperscript{243} See Yagoda v. Commissioner, 331 F.2d 485 (2d Cir. 1964); United States v. Rushlight, 291 F.2d 508 (9th Cir. 1961); H.T. Hackney Co. v. United States, 78 F. Supp. 101 (Cl. Ct. 1948); Albert W. Priest Trust v. Commissioner, 6 T.C. 221 (1946).

\textsuperscript{244} I.R.C. § 1311 (1994).

\textsuperscript{245} I.R.C. § 1313(a)(1) (1994).

\textsuperscript{246} I.R.C. § 1313(a)(2).

\textsuperscript{247} I.R.C. § 1313(a)(3).

\textsuperscript{248} I.R.C. § 1313(a)(4). The usefulness of this procedure, as described in the regulations, would appear to be quite limited. The agreement pertains to the tax consequences of the closed year and does not become determinative as to such consequences until the tax liability of the open year becomes final. Treas. Reg. § 1.1313(a)-4(d) (1999). Either the taxpayer or the IRS may pursue positions as to the open year at variance with what they pursued as to the closed year; if such position prevails the agreement as to the closed year is revoked. \textit{Id. See also} Treas. Reg. § 1.1314(b)-1(d) (1999) (providing that if revocation occurs, "any overpayment or deficiency resulting from such redetermination shall be refunded or credited, or assessed and collected.").

It would seem that the only circumstance in which such an agreement might be used efficaciously is when the taxpayer and the government make an agreement as to the closed year in coordination with a closing agreement as to the open year.

\textsuperscript{249} S. Rep. No. 75-1567, at 50 (1938).
consolidate claims and issues to avoid multiple litigation. The mitigation provisions were adopted before much of this development, and were amended to skirt the doctrine of res judicata. In much of the world outside the maze of the mitigation provisions, if a party is aware that a right or interest may be affected in a proceeding she must bring this awareness to the fore or suffer the consequences of her failure to do so.

256. See, for example, FLEMING JAMES, JR., ET AL., CIVIL PROCEDURE § 11.2 (4th ed. 1992), which states:

As the rules of litigation have changed in the evolution of modern procedure, so have the rules of res judicata. The changes in the joinder and discovery rules have come about through statutes and rules of court. The corresponding changes in the rules of res judicata have been developed almost entirely through decisional law that evolved in the wake of these legislative reforms. . . . As the rules of procedure have expanded the scope of the initial opportunity to litigate, they have invited a corresponding expansion of the extent to which that opportunity forecloses a subsequent opportunity.

Id.

257. I.R.C. § 1311(a) (1994) (permitting a mitigation adjustment notwithstanding res judicata by stating "correction of the effect of the error . . . is prevented by the operation of any law or rule of law").

In United Mine Workers v. Gibbs, 383 U.S. 715, 722-24 (1966), the Supreme Court, in addressing pendent jurisdiction, discussed the scope of the unit of litigation before the adoption of the Federal Rules of Civil Procedure in 1938—the same year in which Congress enacted the mitigation provisions. The Court used as an example the case of Baltimore Steamship Co. v. Phillips, 274 U.S. 316 (1927), which described a cause of action as "the violation of but one right by a single legal wrong." Id. at 321. The federal rules have generally expanded res judicata so that it applies the "same transaction or occurrence" requirement on a broader scope. See JACK H. FRIEDENTHAL, ET AL., CIVIL PROCEDURE § 14.4 (2d ed. 1993).

258. An exquisitely harsh demonstration of the willingness of the federal courts to apply this rule may be seen in Federated Department Stores, Inc. v. Moitie, 452 U.S. 394 (1981). The Court in that case prohibited a party from sharing in his co-parties' success on appeal because the party failed to appeal an unsuccessful result below. Justice Rehnquist professed no remorse at the result:

The Court of Appeals also rested its opinion in part on what it viewed as "simple justice." But we do not see the grave injustice which would be done by the application of accepted principles of res judicata. "Simple justice" is achieved when a complex body of law developed over a period of years is evenhandedly applied. The doctrine of res judicata serves vital public interests beyond any individual judge's ad hoc determination of the equities in a particular case. There is simply "no principle of law or equity which sanctions the rejection by a federal court of the salutary principle of res judicata."

Id. at 401 (quoting Heiser v. Woodruff, 327 U.S. 726, 733 (1946)).
"definitely establishes the correct treatment of an item or transaction in the open year and, by so doing, the existence of an error in the treatment of the same item or relevant transaction in another year." The determination starts running the one-year clock for seeking a mitigation adjustment.

The determination requirement makes sense only if one decides to address problems of inequitably inconsistent tax treatment only after such treatment has been set in stone, leaving the "victim" of such inconsistency to seek redress in a later, sometimes judicial and sometimes duplicative, procedure. Although a party to a proceeding in which a determination occurs may often possess knowledge that the determination will create a result incompatible with some other year, and may often take steps to prevent such consequences, such a party may also save his ammunition for a later affray—that is, he may allow an open year to become closed and then seek mitigation.

The circumstances of adjustment in which mitigation is permitted under I.R.C. § 1312 effectively require a close transactional or factual relationship between the matter resolved in the determination and the matter in which one seeks a mitigation adjustment. This transactional or factual relationship is not unlike the relationship between a claim and a compulsory counterclaim under Rule 13(a) of the Federal Rules of Civil Procedure. Under that rule, if the defendant has a compulsory counterclaim against the plaintiff, one that arises out of the same transaction or occurrence as the plaintiff's claim, the defendant must assert the counterclaim or it is thereafter barred. Liberal joinder rules, some of them mandatory, have marched hand-in-hand with an ever-expanding scope of the doctrines of former adjudication, namely res judicata and collateral estoppel, to encourage and sometimes compel litigants to

250. SALTZMAN, supra note 27, ¶ 5.07[3].
252. Although the Tax Court may determine the tax consequences only with respect to years as to which the IRS has determined a deficiency, see NINA J. CRIMM, TAX COURT LITIGATION—PRACTICE AND PROCEDURE ¶ 2.2[2][a][iv] (1996), it may consider facts with relation to taxes for other years to determine correctly the amount of such deficiency. I.R.C. § 6214(b) (1994).

As to open years, the IRS may assert new deficiencies and the taxpayer may file claims for refund, even if only of a protective nature. See Kellogg-Citizens Nat'l Bank of Green Bay v. United States, 330 F.2d 635, 639 (Cl. Cl. 1964); see also SALTZMAN, supra note 27, ¶ 11.08[3] (stating that "[a] claim for refund may be filed to protect a potential right to receive a refund contingent on the occurrence of a future event").

253. Coleman, supra note 28, at 1592-93.
254. CHARLES ALAN WRIGHT, FEDERAL COURTS 564 (5th ed. 1994).
255. Rule 13(a) of the Federal Rules of Civil Procedure, as noted above, effectively requires the defendant to assert a compulsory counterclaim against the plaintiff. FED. R. CIV. P. 13(a). Rule 14(a) similarly requires a plaintiff, under some circumstances, to assert a claim against a third-party defendant. FED. R. CIV. P. 14(a). The Supreme Court has held that if a party wishes to bind strangers to a suit by its result, she must join such persons under Rule 19. See Martin v. Wilks, 490 U.S. 755, 763-65 (1989).
It is doubtful that there have been many situations involving mitigation, particularly when it is sought by the taxpayer, in which the party seeking mitigation was unaware of the inequitable inconsistency that a determination would bring about before such determination occurred. Yet a party is under no obligation to inform the tribunal or adversary of the possibility that a determination may result in more related litigation. In many cases, of course, the tribunal under current law would not be able to do anything about closed years.

The modern trend with respect to res judicata is embodied in the Restatement (Second) of Judgments, which provides that a judgment extinguishes "all rights of the plaintiff to remedies against the defendant with respect to all or any part of the transaction, or series of connected transactions, out of which the action arose."259 In determining what facts comprise a transaction, the Restatement looks to whether facts are "related in time, space, origin, or motivation, whether they form a convenient trial unit, and whether their treatment as a unit conforms to the parties' expectations or business understanding or usage."260

Such a grouping neatly describes the relationship of transactions to which mitigation applies. Although any two transactions in different years that yield an inequitable inconsistency may not represent one "cause of action" as that term was understood in former times, they nonetheless involve separate tax liabilities in separate years, thus triggering the temporal and motivational relationships of the Restatement test.

For example, assume a taxpayer wishes to deduct fully a bad debt pursuant to I.R.C. § 166. She is unsure whether it became worthless in 1992 or 1993. She chooses 1993. After the statute of limitations has expired on 1992, the IRS denies the deduction for 1993 contending that it became worthless in 1992. Surely an inquiry as to whether the deduction is proper for 1992 or 1993 would "form a convenient trial unit" in the parlance of the Restatement.261 A tribunal, in considering the propriety of the deduction for 1993, may not really pick one year or the other because the tribunal may not award a deduction for 1992 if it invalidates the deduction for 1993. Under mitigation, only another tribunal may do so.

Concededly, instances may arise in which an inquiry involving transactions may not involve a simple choosing of the proper year for a deduction. A complete trial may have to be held about a transaction in one year. Alternative treatment of the same item in another year may be governed by the result of such trial. The approach of modern rules of procedure is to adjudicate

260. Restatement (Second) of Judgments § 24(2) (1982).
261. Id.
contingent but related claims in separate trials,\textsuperscript{262} not separate lawsuits. Although the determination requirement reflects Congress's desire in 1938 to require solemn establishment of error with respect to a closed year before it may be reopened, now is the time to assess whether the mechanism for reopening a closed year should reflect six decades of new learning about res judicata and judicial economy. The determination requirement runs contrary to such learning. This requirement has allowed taxpayers and the government, by design or inattention, to concoct unnecessary litigation or has necessitated such litigation even for attentive parties.

Several cases demonstrate this. For example, in \textit{Olin Mathieson Chemical Corp. v. United States},\textsuperscript{263} the taxpayer sought a mitigation adjustment to deduct a capital loss for tax year 1945. The taxpayer had previously deducted the same loss as an ordinary loss in tax year 1944. The government disallowed it as an ordinary loss, declaring it to be a long-term capital loss instead. The district court upheld the decision in a refund suit by the taxpayer. When that judgment became final in 1956, the taxpayer sought to carryover the capital loss to 1945. The government defended by way of the statute of limitations.\textsuperscript{264}

In the taxpayer's second suit for refund the court allowed the taxpayer to use the mitigation provisions to carryover the loss to 1945.\textsuperscript{265} Although the second decision cured an inequity, the court may have exerted unnecessary effort. At the time of the first judgment in 1956, the taxpayer was probably aware that if its 1944 ordinary loss was recharacterized as a capital loss, the taxpayer did not have enough capital gains against which to offset the loss advantageously.\textsuperscript{266} In this case it is apparent that if the taxpayer were unsuccessful as to characterization of the loss then it would need to carry the loss back or forward to some other year. In 1956 this prior year might well have been barred by limitations. It would have been more efficient to permit the district court in 1956 to address the consequences of its recharacterization of the taxpayer's 1944 loss than to have the parties, and perhaps another court, revisit the matter in 1959.

Unfortunately, the mitigation rules do not always promote such efficiency. If the capital loss for the 1945 tax year was barred at the time of the first district court suit in 1956, the determination requirement of I.R.C. § 1311 would have

\textsuperscript{262} See Fed. R. Civ. P. 42(b); see also Friedenthal et al., supra note 257, § 6.6, at 347 (noting that "[m]odern rules also authorize the joinder of prospective claims, even when, had the claims been prosecuted separately, rendition of a favorable judgment on one of them would have been required before litigation could proceed on the other").

\textsuperscript{263} 265 F.2d 293 (7th Cir. 1959).

\textsuperscript{264} Id. at 296. The government resisted mitigation on the basis that since the capital loss deduction was allowed for 1944, albeit without tax effect, no double disallowance of a deduction had occurred (the circumstance of adjustment upon which the taxpayer relied). Id.; see I.R.C. § 1312(4) (1994). The court rejected this argument.

\textsuperscript{265} Id. at 297.

\textsuperscript{266} See I.R.C. § 1211(a) (1994), which like its predecessor, I.R.C. § 117(d) (1939), limits deduction of capital losses for corporations.
made the parties spin their wheels again. Although litigants in other circumstances are generally required by the ever-expanding doctrines of res judicata and collateral estoppel to be attentive to preclusive effects of judgments, the determination requirement at times virtually mandates just the opposite—duplicative litigation.

Had the mitigation rules permitted the taxpayer in Olin Mathieson to assert both its contentions about deduction of the ordinary loss for 1944 and the same loss as a capital loss carryover to 1945, the latter would be asserted only if the former were unsuccessful. Common law would not have permitted simultaneous assertion of such alternative bases of recovery. Although modern pleading rules do allow a party to hedge her bets by pleading alternatively, the ability to assert alternative claims does not generally permit a party to assert usefully a barred claim as an alternative claim. Mitigation, however, is the obvious exception. The notion that the policy underlying the statute of limitations would be unduly compromised by permitting a party who has a barred contingent claim to call it to the attention of the court for whatever value comparing the open and barred claims may have, and perhaps then to adjudicate it, seems quite far-fetched. This situation flies in the face of how litigation is otherwise conducted at the close of the twentieth century.

The futility of requiring a second tribunal to address what is essentially the same controversy may also be seen in Benenson v. United States. Benenson involved one of the remarkable artifices taxpayers employed to manufacture interest deductions in the era of the 91% marginal tax rate. In 1955 taxpayers "borrowed" $2 million to purchase 1.875% Treasury notes. The taxpayers paid and deducted $67,550 in interest in 1955. In 1956 the taxpayers "sold" the bonds to the broker who had "purchased" them for his account and received a check which was $7,550 more than the "interest" he had paid in 1955. The taxpayers reported a capital gain for 1956 in that amount.

In 1959, on audit, the IRS disallowed the 1955 interest deduction. The court agreed with the IRS that the loan transaction lacked substance. As an alternative position the taxpayers sought to deduct their out-of-pocket cost of the transaction in 1956, the year in which it was closed. Since 1956 was barred by the statute of limitations, and since the taxpayer in the district court was litigating the validity of the 1955 deduction (which the court was simultaneously rejecting), the taxpayers were unable to avail themselves of

267. 265 F.2d at 293.
268. FRIEDENTHAL ET AL., supra note 257, § 5.12, at 266.
271. For 1955 the maximum marginal tax rate was 91%. I.R.C. § 1 (1954).
272. 257 F. Supp. at 104-05.
273. Id. at 107. The broker from whom the taxpayers supposedly borrowed the purchase price of the bonds did not have funds sufficient to make such a loan. The broker had purchased the bonds short; thus, the bonds were never delivered to or on behalf of the taxpayers. Id. at 104-05.
beneficial tax treatment flowing from rejection of their primary objective. The taxpayers could only avail themselves of any tax benefit for 1956 through mitigation. Since at the time the 1955 deduction was itself at issue, there was no determination for that year.\footnote{274}

The \textit{Benenson} court noted that the taxpayers were offered a chance by the IRS to execute a closing agreement concerning 1955 that would have enabled them to seek an adjustment concerning 1956.\footnote{275} However, such an agreement, which under I.R.C. § 1313(a)(2) would have provided the determination required for a mitigation adjustment, would have conceded the primary basis of the taxpayers’ attack on the treatment of the multiyear transaction—probably too high of a price for the taxpayer to pay for judicial economy. Thus it seems that delaying a taxpayer’s alternative quest for “half a loaf” may require another tribunal to address the same transaction.

The decision in \textit{Prentis v. United States}\footnote{276} also demonstrates how the determination requirement may engender redundant litigation. In this case the elderly principals of a corporation engaged in construction and civil engineering wished to transfer the business to younger persons. They organized a new corporation, to be controlled by younger employees of the old corporation, and “sold” the equipment of the old corporation to the new. The old corporation paid tax on this sale.\footnote{277}

In the next tax year, the new corporation took depreciation on the equipment it had “bought” from the old corporation at its market value at the time of sale. In rejecting depreciation deductions on that basis,\footnote{278} the government contended that transfer of assets to the new entity constituted a tax-free reorganization,\footnote{279} thus requiring depreciation of assets under the old company’s lower basis.\footnote{280}

The court upheld the government’s contention concerning the asset basis. The taxpayer sought to recover the payment of tax on the purported sale of assets by the old company, which would not have been imposed in a transfer pursuant to a reorganization. Although the Second Circuit stated in an earlier consideration of the transaction that such payment of tax was erroneous and urged that the taxpayers be permitted to so contend on remand,\footnote{281} the trial court refused to entertain this issue because of the determination requirement.\footnote{282}

\footnotesize
\begin{itemize}
\item \footnote{274. Berensen v. United States, 257 F. Supp. 101, 112-13 (S.D.N.Y. 1966), aff’d, 385 F.2d 26 (2d Cir. 1967).}
\item \footnote{275. Id. at 112.}
\item \footnote{276. 273 F. Supp. 460 (S.D.N.Y. 1967).}
\item \footnote{277. Id. at 465-68.}
\item \footnote{278. Prentis v. United States, 273 F. Supp. 449, 456 (S.D.N.Y. 1964); see also Turner Constr. Co. v. United States, 364 F.2d 525, 531 (2d Cir. 1966) (remanding an earlier decision of the district court in the same case).}
\item \footnote{279. See I.R.C. § 112(b)(4) (1939). The current version of this statute is located at I.R.C. § 368(a)(1)(D) (1994).}
\item \footnote{280. Prentis, 273 F. Supp. at 476-77.}
\item \footnote{281. Turner Constr. Co., 364 F.2d at 538-39.}
\item \footnote{282. Prentis, 273 F. Supp. at 479.}
\end{itemize}
The remarkable extent to which the determination requirement may frustrate efficient and equitable resolution of disputes pertaining to a multiyear transaction may be seen in O'Donnell v. Belcher.\textsuperscript{283} In this case the taxpayers were partners in a venture that sold a tract of land in 1950. The partnership reacquired the land in a foreclosure sale in 1953, realizing a capital gain that the partners did not report as income. The 1950 purchaser transferred its right of redemption to the partnership in 1954.\textsuperscript{284} In 1959 the IRS issued deficiency notices to the taxpayers for 1953. Taxpayers contested these notices in consolidated cases in the Tax Court, which the court decided on January 8, 1965. The Tax Court held that there was no gain for 1953.\textsuperscript{285} One of the partners proceeded in the district court with other issues, and that court in 1963 decided the reacquisition of the tract resulted in a taxable gain in 1954 for the taxpayer.\textsuperscript{286} The IRS issued deficiency notices to all of the partners for 1954 on January 22, 1964. These deficiencies were paid by the taxpayers on August 20, 1964. Taxpayers filed claims for refund on February 25, 1965, asserting that the assessments they paid had been barred by limitations. On May 16, 1966 the government amended its answer in the taxpayers' refund suit to assert its entitlement to a mitigation adjustment for 1954. The government did not issue another deficiency notice to the taxpayers within one year after the finality of the Tax Court's decision on April 8, 1965, as required by I.R.C. § 1314(b).\textsuperscript{287}

Before that time the IRS had asserted that it was entitled to tax for 1954 if it was not so entitled for 1953. However, it had asserted deficiencies for 1954 in January, 1964 before the final April, 1965 Tax Court decision, which would have been the determination upon which a mitigation adjustment might have been based. It is not surprising that the IRS failed to issue new deficiency notices after finality of the Tax Court decision, because by that time the taxpayers had already filed claims for refund that raised precisely the same issue, tax liability for 1954. These claims were the subject of a refund suit. The court held that a deficiency notice before the determination was not sufficient to permit mitigation.\textsuperscript{288}

The predicament in which the government found itself was at least in part a product of the reliance of the mitigation scheme on setting an inequity in stone before allowing a corrective adjustment. Particularly following the 1963 district court decision, which involved one of the partners, it should have been apparent that if partnership gain on the foreclosure was not taxable in 1953, the issue in the Tax Court proceeding, it must have been taxable in 1954. Since

\textsuperscript{283} 414 F.2d 833 (5th Cir. 1969).
\textsuperscript{284} Id. at 834.
\textsuperscript{285} This judgment became final on April 8, 1965. O'Donnell, 414 F.2d at 840. See Belcher v. Commissioner, 24 T.C.M. (CCH) 1, 13 (1965).
\textsuperscript{286} Abernathy v. Patterson, 63-2 U.S. Tax Cas. (CCH) ¶ 9678 (N.D. Ala. 1963). The court offset tax on such gain against refunds otherwise due the taxpayers for 1952, 1954, and 1955. Id.
\textsuperscript{287} O'Donnell, 414 F.2d at 836, 844.
\textsuperscript{288} Id. at 841-42.
1954 was otherwise barred while the Tax Court proceeding was pending, the IRS could not really have urged the Tax Court to resolve the question of the appropriate year to report the income. The government had to abide by the result in Tax Court. Unfortunately for the government, the IRS acted prematurely.

O'Donnell is unusual only in that the redundant proceedings were commenced before the determination. O'Donnell has been analyzed before, with the analysis essentially viewing the unfortunate result as a matter of poorly timed strategy on the part of the government. Though this analysis may be correct, it is contended herein that the current determination requirement, in necessitating the creation of an inequity before it may be corrected, fosters unnecessary litigation. Litigation is unnecessary, as are other administrative proceedings to resolve inequities, because inequities occasioned by an earlier determination might have been resolved more efficiently in the course of those earlier proceedings that resulted in the determination.

IV. RECOUPMENT: THE ROAD LESS TRAVELED

A. Development of Recoupment in the Supreme Court

Before Congress created the mitigation provisions, the primary method of correcting injustices wrought by limitations was recoupment, first applied by the Supreme Court to the modern revenue law in Bull v. United States. Courts now refer to this method as equitable recoupment. Courts choosing to fashion some sort of remedy for some inequitable circumstances is certainly understandable. Nevertheless, judicial application of equitable recoupment historically evinces a strong desire to keep the equity genie in the bottle because a genie who possesses equitable powers threatens values dear to the law of taxation and, indeed, the entire federal system. These threatened values include the annual accounting principle, limitation of actions, and its esteemed relative, sovereign immunity. Thus, in the absence of any statutory sanction for judicial employment of recoupment, the courts have more often rejected its application. This judicial restrictiveness has resulted to some degree from a mistaken assumption that recoupment is necessarily equitable in character. This Article contends that most legitimate qualms about recoupment

289. See Bell, supra note 23, at 565-71.
290. Id. at 570.
in tax cases would be alleviated by legislative authorization of a carefully
detailed form of recoupment in tax cases.

1. *What is Recoupment?*

The short and obvious answer to this question portends trouble: recoupment, before the notion of counterclaim came into fashion under modern rules of procedure, was one method by which parties who had mutual claims avoided a multiplicity of actions. The trouble portended is that understanding recoupment entails understanding a procedure that has limited application in contemporary litigation. It is awkward to explain, and even more so to defend, modern application of a procedure that has generally been long supplanted. No doubt adaptation of an old doctrine to contemporary litigation breeds confusion.

The leading treatise on former practice concerning mutual claims describes recoupment as follows:

A defense by way of recoupment denies the validity of the plaintiff's cause of action to so large an amount as he alleges he is entitled to. It is not an independent cross claim like a separate and distinct debt or item of account due from the plaintiff; but is confined to matters arising out of, or connected with, the contract or transaction which forms the basis of the plaintiff's claim.

One may glean the following three points from this definition: (1)

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294. *See, e.g., 24 RULING CASE LAW Set-off and Counterclaim § 3 (William M. McKinney et al. eds., 1929); JAMES ET AL., supra note 256, § 9.9.
295. *See FRIEDENTHAL ET AL., supra note 257, § 6.7. The authors discuss how modern counterclaim practice is quite different from former practice, when recoupment and the related doctrine of setoff held sway, and note that modern counterclaim practice reflects expanded notions of joinder and res judicata.*
296. *The same is true of recoupment's procedural relative, setoff, which has also been conscripted to fill a contemporary role in federal taxation—a role that does not very closely resemble the role it played before the adoption of counterclaim rules. See Lewis v. Reynolds, 284 U.S. 281 (1932). Professor Steven J. Willis, no doubt the leading contemporary authority on multiyear anomalies in taxation, has confessed a temptation to describe the Supreme Court's distinction between setoff and recoupment in the tax context as "laughable." See Willis, supra note 206, at 633 n.63.*

While the distinctions may be unclear today, setoff and recoupment in their former contexts had clearly defined roles. At common law recoupment was available only to defeat or diminish a plaintiff's recovery, and such a claim had to arise out of the same transaction as that to which plaintiff's claim related. A setoff allowed affirmative recovery and might entail assertion of claims unrelated to the transaction on which plaintiff's claim was based. *See FRIEDENTHAL ET AL., supra note 257, § 6.7, at 349.*
297. *THOMAS W. WATERMAN, A TREATISE ON THE LAW OF SET-OFF, RECOUPMENT, AND COUNTER-CLAIM § 424, at 471 (1869) (footnote omitted).*
recoupment is asserted defensively, (2) recoupment serves only to reduce the claim of the plaintiff, and (3) recoupment must relate to the basis of the plaintiff’s claim. These elements have largely been carried over to modern definitions of recoupment for purposes of internal revenue taxation. An undercurrent to recoupment has been deftly, if somewhat polemically,

298. A number of scholars have defined equitable recoupment for tax purposes. For example, Professor Camilla E. Watson defines recoupment 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.” Camilla E. Watson, *Equitable Recoupment: Revisiting an Old and Inconsistent Remedy*, 65 *Fordham L. Rev.* 691, 713 (1996) (footnote omitted).

Like most scholars of recoupment, Professor Watson “defines” recoupment functionally, as a list of elements:

- Based on 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 a single unit. A third element has emerged from the subsequent lower court cases—two different taxes . . . .

*Id.* at 734-35.

Professor James E. Tierney states that “[e]quitable recoupment allows a party to use a tax related claim, barred by the statute of limitations, as a defense to another party’s timely tax-related claim, where the two claims arise out of the same transaction or taxable event.” 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, 101-02 (1991) (footnote omitted).

Professor Arthur W. Andrews’s description of equitable recoupment is tied closely to case law development:

- Usually, equitable recoupment is potentially available as a remedy where two different types of taxes are implicated, at least one of which is not an income tax. These two tax cases may usefully be further divided into two different categories or models. The first category is where an item of receipt, expenditure or other transaction is potentially subject to one of two taxes, but not both . . . . The other category is one in which two taxes operate, in a given situation, independently in the sense that a determination that there is, for example, a deficiency in one tax pretty much automatically means that there is an overpayment of the other tax.


David N. McConnell defines recoupment more traditionally, stating that “[t]he word ‘recoupment’ is derived from the French ‘recouper’—‘to cut again.’ It signifies the right or act of making a reduction, defalcation, or discount by the defendant to the claim of the plaintiff.” David N. McConnell, *The Doctrine of Recoupment In Federal Taxation*, 28 *Va. L. Rev.* 577, 577-78 (1942). Unlike others who define this doctrine, Mr. McConnell disputes that its nature is equitable. *Id.* at 580-81.
identified by Professor Steven J. Willis:

The theory begins with the premise that two wrongs can make a right. Recoupment, rather than extending the statute of limitations to correct a perceived injustice, permits a wronged party to recoup the loss against a sum still open to litigation. This does not correct the wrong, as does the mitigation statute, but instead causes a later matter to be equally wrong in the opposite direction.299

The present author concedes Professor Willis’s point that application of recoupment in tax cases violates the universal parental admonition—two wrongs don’t make a right. What is intrinsically wise and good on the playground, however, may be less so in the field of taxation, particularly when the correction method that purports to make both wrongs right, mitigation, has proved over six decades to be so cumbersome. The Supreme Court, in its most recent discussion of recoupment, summed up its jurisprudence by providing “that a party litigating a tax claim in a timely proceeding may, in that proceeding, seek recoupment of a related, and inconsistent, but now time-barred tax claim relating to the same transaction.”300 The important elements of this statement are the defensive nature of recoupment and that it must be sought with respect to a particular transaction by a party to such transaction.301

2. How the Supreme Court has Come to View Recoupment from such a Jaundiced Perspective

Analysis of Supreme Court decisions addressing recoupment reveals the development of a gradual uneasiness with its application in tax matters. This uneasiness is largely because application of recoupment has come to be viewed as the exercise of equity jurisdiction as equity jurisdiction was understood before the merger of law and equity in modern court systems.302 Equity powers are construed broadly, giving a court free-wheeling discretion to remedy injustice.303 However, viewing the allowance of recoupment in tax matters as

299. Willis, supra note 206, at 633.
301. The Supreme Court itself has actually held that recoupment may be applied against a party who, while not formally a party to the barred claim, has an identity of interest with one of the parties to such claim. Stone v. White, 301 U.S. 532, 537 (1937).
302. This merger occurred in the federal court system with the adoption of the Federal Rules of Civil Procedure in 1938. Fed. R. Civ. P. 2 advisory committee’s note. See also Wright, supra note 254, § 67 (discussing the Supreme Court’s move to “one form of action”).
303. This discretion was described by Professor Dobbs:
Discretion of equity courts is long established. It makes possible decisions that are flexible, intuitive, and tailored to the particular case. It also makes possible decisions that are unaanalyzed, unexplained,
akin to such powers has overlooked the limited character of the remedy, as well as its common law heritage.

The Court's first application of recoupment in a tax case, *Bull v. United States*, involved no such misconceptions. In *Bull* a member of a calendar-year partnership that involved no invested capital died on February 13, 1920. With the concurrence of the decedent's personal representative, the business of the partnership continued until December 31, 1920. The decedent's share of the profits of the business to the date of his death was $24,124.20. Under the partnership agreement, the estate was paid $200,117.99 in 1920 and $12,601.70 in 1921, these payments representing profits of the business from the decedent's death until the end of the year.

In valuing the decedent's estate, the Commissioner included both the right to the amount of profits accrued to the decedent's death and payments attributable to the remainder of the year, resulting in an estate tax of $41,517.45. This estate tax was paid in June and August of 1921.

In April 1921 the estate filed an income tax return that did not report as income the partnership profits paid following the decedent's death, $200,117.99. In July 1925 the Commissioner determined that the $200,117.99 represented taxable income for the estate for 1920. The estate appealed this determination to the Board of Tax Appeals, which upheld the Commissioner. The estate paid the tax in April 1928.

In July 1928 the estate filed a claim for refund contending that the postdeath profits represented corpus of the estate and had previously been determined as such by the Commissioner. The Commissioner denied the claim. The estate then sued in the Court of Claims seeking alternatively either a refund of income tax predicated on the Commissioner's contention that postdeath profits represented income to the estate or credit of the estate tax allocable to such profits that had been paid by the estate. The Court of Claims

and un-thoughtful. The precise role for discretion of judges has not been worked out. Discretion of the chancellor originated in a society where authority counted for more than democracy, and the wishes of the powerful for more than their explanations.

**DAN B. DOBBS, 1 LAW OF REMEDIES § 2.4(1), at 92 (2d ed. 1993).**

*304. 295 U.S. 247 (1935).*

*305. Id. at 251.*

*306. Id. at 255.*

*307. Id. at 252.*

*308. Id.*

*309. Id. at 252-53.*


*311. Id.*

With respect to the year at issue, there was no direct judicial review of decisions of the Board of Tax Appeals. A taxpayer dissatisfied with a decision of that body was relegated to a refund suit in the Court of Claims or the district court. CRIMM, supra note 252, at ¶ 2.2[1]. This rule was changed in the Revenue Act of 1926, which provided for judicial review in federal circuit courts. Revenue Act of 1926, ch. 22, 44 Stat. 2019 (current version at I.R.C. § 7482 (1994 & Supp. III 1997)).
agreed with the Commissioner that postdeath profits were properly taxable as income, but deemed itself unable to consider the estate’s contention concerning overpayment of estate tax because the suit had not been timely filed for that purpose.\(^\text{312}\)

On certiorari the Supreme Court agreed with the Court of Claims that sums paid to the estate representing profits after the death of the decedent were not corpus of the estate but rather income to the estate.\(^\text{313}\) Nevertheless, the Court stated:

A serious and difficult issue is raised by the claim that the same receipt has been made [on] the basis of both income and estate tax, although the item cannot in the circumstances be both income and corpus; and that the alternative prayer of the petition required the court to render a judgment which would redress the illegality and injustice resulting from the erroneous inclusion of the sum in the gross estate for estate tax.\(^\text{314}\)

As to the substance of the estate’s contention that "[t]he identical money,—not a right to receive the amount, on the one hand, and actual receipt resulting from that right on the other,—was the basis of two assessments,"\(^\text{315}\) the Court agreed with the taxpayer.\(^\text{316}\) More to the point for present purposes, however, the Court rejected the government’s contention that the statute of limitations barred correction of the government’s error in using profits accruing to the estate to compute the estate tax.\(^\text{317}\)

Conceding that it was too late for the estate to file a claim for the erroneously assessed estate tax when, in 1928, the Board of Tax Appeals upheld the imposition of income tax for the estate on postdeath profits, the Court stated that the "[i]nability to obtain a refund or credit, or to sue the United States, did not, however, alter the fact that if the Government should insist on payment of the full deficiency of income tax, it would be in possession of some $41,000 in excess of the sum to which it was justly entitled."\(^\text{318}\) Although noting that limitations had expired on the estate tax and that the income tax sought after overpayment of the estate tax was legitimately due, the Court acknowledged the process by which the government generally collects

\(^{312}\) Bull v. United States, 6 F. Supp. 141, 141 (Ct. Cl. 1934).
\(^{313}\) 295 U.S. at 254.
\(^{314}\) Id. at 255.
\(^{315}\) Id. at 256.
\(^{316}\) Id. at 257. Nevertheless, the Court limited its analysis of tax liability of particular rights to receive income for both estate and income tax purposes to the circumstances of the decedent and his estate. Id. at 256-57.
\(^{317}\) Id. at 258-59.
\(^{318}\) Id. at 258.
taxes. Because "taxes are the life-blood of government,"319 the Court indicated, "the usual procedure for the recovery of debts is reversed."320 The government does not generally have to maintain suit to collect the taxpayer's debt; the administrative assessment is akin to a judgment and the taxpayer must resort to a judicial proceeding "to have mistakes rectified."321 If, after accepting the excess estate tax, the government had done nothing further, the estate would have had no redress with respect to such tax after expiration of limitations. The government sought income tax with respect to the same transaction. If the government had been required to maintain an action at law to collect this new tax, the estate would have been able to demand recoupment of the amount mistakenly collected against the government's claim.322

In discussing this right of recoupment in claims by the government, the Court cited three nineteenth century cases: 323 United States v. Macdaniel,324 United States v. Ringgold,325 and The Siren.326 In each of these cases the defendant was permitted, under a 1797 act,327 to offset claims by the United States with claims against the United States. This right of a defendant to assert a claim defensively against the government was referred to by the statute and the courts as setoff rather than recoupment.328 This characterization was appropriate in light of the nineteenth century procedural conception that the claim asserted defensively did not need to be related to the same transaction as that sued upon by the government.329 This right of setoff was particularly important before the adoption of the Tucker Act in 1855,330 since before that time there was generally no right to sue the United States.331

Although in Bull the Court relied upon decisions involving setoff in applying the related doctrine of recoupment to federal taxation, the remedy it

320. Id. at 260.
321. Id.
322. Id. at 261.
323. Id. at 261-62.
324. 32 U.S. (7 Pet.) 1 (1833).
325. 33 U.S. (8 Pet.) 150 (1834).
326. 74 U.S. (7 Wall.) 152 (1868).
327. Act of March 3, 1797, provided that when the United States filed an action, it should obtain judgment at the next term "unless the defendant shall, in open court . . . make oath or affirmation, that he is equitably entitled to credits which had been, previous to the commencement of the suit, submitted to the consideration of the accounting officers of the treasury, and rejected." Act of March 3, 1797, ch. 368, § 3 (incorporated as tit. 13, R.S. 957 (1875); codified as amended at 28 U.S.C. § 2407 (1994)).
328. See, e.g., Watkins v. United States, 76 U.S. (9 Wall.) 759, 764-65 (1869) (stating that claims for a credit against the government will only be allowed if proper as setoffs).
329. See WATERMAN, supra note 297, § 2, at 4.
331. Siren, 74 U.S. (7 Wall.) at 154. As the statute indicates, one could not use a claim against the government as a setoff unless one had previously made such claim to the Treasury and such claim had been rejected. Tucker Act, ch. 122, 10 Stat. 612 (1855).
fashioned more closely resembled common law recoupment because the claim for which deduction was sought had to arise out of the transaction upon which the main claim was based. The 1797 act referred to a defendant’s oath in asserting a claim for setoff that he is “equitably entitled to credits;” however, this language did not imply that allowance of such setoff entailed the exercise of equitable jurisdiction. Indeed, a claim for setoff could be submitted to a jury, which strongly indicates that it does not entail administration of an equitable remedy.

In Bull the Court simply adapted to modern revenue law an old procedural means of preventing the government from recovering an amount greater than that to which it was entitled—a means freely utilized before the adoption of the modern tax law. The most significant modification allowed use of recoupment in instances in which the party with the recoupment claim instituted the judicial proceedings. The recoupment device adapted to the tax law in Bull hardly conjured up the spectre that the Supreme Court and some lower courts have since sought to curtail. In Bull the Court did not even describe recoupment as equitable recoupment.

The Supreme Court first described recoupment as equitable recoupment in Stone v. White, a characterization appropriate in that case. In Stone a testator left property in a testamentary trust with his widow as sole beneficiary. The widow elected to take this benefit rather than her dower interest or statutory share. In conformity with the decisions of several appellate courts, the widow

332. Bull v United States, 295 U.S. 247, 262 (1935). The setoff permitted against the government under the 1797 act was akin to recoupment in that no affirmative recovery was allowed against the government. Siren, 74 U.S. (7 Wall.) at 154. It was different from recoupment in that it allowed a defendant to assert claims unrelated transactionally to the government claims. United States v. Ringgold, 33 U.S. (8 Pet.) 150, 163-64 (1834).

333. Waterman states that “[t]he courts have frequently allowed claims as setoff against the government, which were not strictly legal, provided they were due, ex aequo et bono.” WATERMAN, supra note 297, § 32, at 35-36. The phrase ex aequo et bono implies fairness in a more colloquial sense, rather than, strictly speaking, the exercise of equitable jurisdiction. See BLACK’S LAW DICTIONARY 557 (6th ed. 1990).


335. This was succinctly stated by Professor Dobbs: “Equity courts did not grant jury trials; law courts did.” DOBBS, supra note 303, at 149 (footnote omitted).

336. For example, BLACK’S LAW DICTIONARY defines equitable recoupment as the following:

Rule of the law which diminishes the right of a party invoking legal process to recover a debt, to the extent that he holds money or property of his debtor, to which he has no moral right, and it is ordinarily a defensive remedy going only to mitigation of damages.


337. 301 U.S. 532, 539 (1937).

338. Id. at 533 (citing Allen v. Brandeis, 29 F.2d 363, 364 (8th Cir. 1928); United States v. Bolster, 26 F.2d 760, 762 (1st Cir. 1928); Warner v. Walsh, 15 F.2d 367, 368 (2d Cir. 1926)).
did not report distributions from the trust as income.\textsuperscript{339} The Commissioner assessed a deficiency against the trustees for such income, which they paid under protest.\textsuperscript{340} Before the time for a refund suit by the trustees expired, but after the permitted time for assessment of tax against the widow for 1928, the Supreme Court held, in a case involving another taxpayer, that in the trustees’ and widow’s circumstances income is taxable to the beneficiary rather than the trust.\textsuperscript{341} Thereafter the trustees sued for refund of the tax they paid for 1928.\textsuperscript{342}

In defense to the trustees’ suit in \textit{Stone}, the Commissioner asserted that the tax that should have been paid by the beneficiary, and which could not now be collected from the beneficiary, exceeded the tax paid by the trustees. Because any recovery would inure entirely to the widow, the sole beneficiary of the trust, the government argued that it should be permitted to offset the beneficiary’s unpaid tax against the trustees’ refund.\textsuperscript{343}

In asserting this right to use a barred claim defensively, the government confronted a problem not encountered by the plaintiff’s estate in \textit{Bull}. The government sought benefit of recoupment against one taxpayer, the trust, of a barred claim against another taxpayer, the beneficiary. Of course, the need to look beyond legal formalities to untangle beneficial rights and obligations was one of the main reasons for the development and endurance of equitable jurisprudence.\textsuperscript{344} In preventing the beneficiary from escaping a tax because the government first collected it from the wrong party, the Court asserted a breathtaking scope of judicial power to correct inequity—a scope not at all consonant with tax jurisprudence generally.\textsuperscript{345}

The Court characterized the suit for refund by a taxpayer as “equitable in its function . . . the lineal successor of the common count in \textit{indebitatus assumpsit} for money had and received.”\textsuperscript{346} This characterization is odd when applied to the realm of tax refund litigation\textsuperscript{347} and appears to have been recently

\textsuperscript{339} Her contention was that distributions received from the trust were not income until they exceeded the value of her dower interest. \textit{Stone}, 301 U.S. at 533.

\textsuperscript{340} \textit{Id.}

\textsuperscript{341} Helvering v. Butterworth, 290 U.S. 365, 369 (1933).

\textsuperscript{342} \textit{Stone}, 301 U.S. at 533.

\textsuperscript{343} \textit{Id.} at 534.

\textsuperscript{344} \textit{See} Dobb's, supra note 303, § 2.3(1)-(3), at 74-81.

\textsuperscript{345} The Court recently stated in rejecting use of equitable tolling by taxpayers against the government that “[t]ax law, after all, is not normally characterized by case-specific exceptions reflecting individualized equities.” United States v. Brockamp, 519 U.S. 347, 352 (1997).

\textsuperscript{346} 301 U.S. at 534.

\textsuperscript{347} The common count of \textit{indebitatus assumpsit} developed judicially as a means of avoiding unjust enrichment in the absence of express assumpsit. Its pedigree is unquestionably legal. \textit{See} J.B. Ames, \textit{The History of Assumpsit}, 2 Harv. L. Rev. 53 (1888). A tax refund suit entails a statutory waiver of sovereign immunity, and the courts have been most resistant to take liberties with the statute. In \textit{Commissioner v. Lundy} the Court stated that “[w]e are bound by the language of the statute as it is written, and even if the rule [the taxpayer] advocates might ‘accor[d] with good policy,’ we are not at liberty ‘to rewrite [the] statute because [we] might deem its effects susceptible of improvement.’” 516 U.S. 235, 252 (1996) (quoting Badaracco v.
rejected by the Court.\textsuperscript{348}

At any rate, this characterization of the tax refund as equitable was a step toward the sweeping proposition that in tax refund suits, "the plaintiff must recover by virtue of a right measured by equitable standards . . . ."\textsuperscript{349} Because the plaintiff's recovery is so dependent upon such standards, "it is open to the defendant to show any state of facts which, according to those standards, would deny the right . . . ."\textsuperscript{350}

The Court's infusion of an equitable character into tax refund actions far exceeded the needs of the case—to treat the widow as the true party in the trustee suit. When a court allows recoupment to a defendant on account of a claim against someone other than the plaintiff, particularly in the absence of any statutory guidance, it is unquestionably exercising an equitable function.\textsuperscript{351}

In support of its characterization of a tax refund suit as subject to equitable principles, the only authority cited by the Court concerning modern federal tax law was \textit{United States v. Jefferson Electric Manufacturing Co.,}\textsuperscript{352} a case in which adjudication of a taxpayer's claim for refund entailed consideration of circumstances involving parties not before the Court.\textsuperscript{353} The Court then made a detailed analysis of the relationship between trustee and beneficiary, the end result of which was the Court's denial of recovery to the trustees because they acted for the benefit of the beneficiary. The Court stated:

\begin{quote}
[W]henever the trustee brings suit in a court which is free to consider equitable rights and duties, his right to maintain the suit may be enlarged or diminished by reference to the fact that the suit, though maintained in the name of the trustee alone, is for the benefit and in the equitable interest of the cestui.\textsuperscript{354}
\end{quote}

Although \textit{Stone}, like \textit{Jefferson Electric}, involved judicial adaptation of recoupment to a three-party situation, the Court in \textit{Stone} stated (or overstated)

\begin{quotation}
348. \textit{Brockamp}, 519 U.S. at 352.
350. \textit{Id.} (citations omitted).
351. It was thus not necessary to attribute equitable characteristics in \textit{Stone}, nor is it necessary to exercise equitable functions in tax litigation generally.
353. \textit{Jefferson Electric} involved suits by manufacturers for taxes on the sales of products that the plaintiffs contended were improperly imposed on such products. \textit{Id.} at 389-90. The plaintiffs attacked qualifications under section 424(a)(2) of the Revenue Act of 1928, 45 Stat. 791, 866 (repealed 1939) which conditioned recovery on a showing that the tax was not collected directly or indirectly from the purchaser. 291 U.S. at 391. In upholding such a condition on a refund action, the Court adverted to a tax refund action as equitable in character. \textit{Id.} at 401-02. This characterization justified the Court in examining whether the plaintiff is a nominal party or the real party in interest. \textit{Id.} at 407.
\end{quotation}
a much broader equitable maxim for federal taxation: "It is in the public interest that no one should be permitted to avoid his just share of the tax burden except by positive command of law, which is lacking here." Did this dictum portend a free-wheeling power to deny refund claims on equitable grounds unless the statute explicitly stood in the way? Or should such equitable power in refund actions exist only for the narrower purpose of examining interests of parties and qualifying the right to recover on the basis of such analysis, a narrower scope for the role of equity? Whatever the Court may have intended, its peroration married the terms "equitable" and "recoupment":

The government, by retaining the tax paid by the trustees, is not reviving a stale claim. Its defense, which inheres in the cause of action, is comparable to an equitable recoupment or diminution of petitioners' right to recover. "Such a defense is never barred by the statute of limitations so long as the main action itself is timely."

In the handful of decisions pertaining to recoupment since Stone, the Court has not seen fit to divorce the terms, leading to a general constriction of the application of recoupment.

The next opportunity the Court took to consider recoupment was in McEachern v. Rose. As in Stone, the Court's opinion was written by Justice Stone. The Court did not permit recoupment, but the reasoning for the two decisions appears to at least fit Justice Stone's framework for application of the doctrine.

In McEachern the decedent sold five hundred shares of corporate stock for $300,000 in 1924. The purchaser paid ten percent of the purchase price at the time of sale and was to pay installments of ten percent in each of the nine succeeding years. The decedent elected to report his gain on the installment method. After the decedent's death in 1928, his administrator, for the calendar tax years 1928 through 1931, continued to report gain from the transaction pursuant to the decedent's election. This reporting was erroneous because under section 44(d) of the 1928 Revenue Act, the capital gain for remaining installments was taxable to the decedent in the year of his death. Since the capital gain was due in 1928, the administrator sued in district court for overpayments for the years 1929 through 1931.

The government contended in district court that, on equitable principles, the taxpayer was not entitled to recover the overpayments for 1929 through 1931 because they amounted to less than the tax that should have been assessed.

355. Id. at 537.
356. Id. at 539 (quoting Bull v. United States, 295 U.S. 247, 262 (1935)).
357. 302 U.S. 56 (1937).
358. Id. at 57.
359. Id. at 57-58.
for 1928, which was then barred. The district court rejected the government’s contention.\textsuperscript{360} The Fifth Circuit reversed, holding that the administrator could not in equity and good conscience recover overpayments that, because of taxpayer’s failure to pay the 1928 tax, resulted in no unjust enrichment to the government.\textsuperscript{361}

The Supreme Court reversed the Fifth Circuit.\textsuperscript{362} It assumed that equitable principles might prevent the administrator’s recovery in the absence of a statutory prohibition, but found such a prohibition in I.R.C. §§ 607 and 609.\textsuperscript{363} Section 607 treated payment of a tax after expiration of limitations as an overpayment,\textsuperscript{364} and I.R.C. § 609 forbade crediting by the government of overpayments against liabilities barred by limitations.\textsuperscript{365} The Court viewed the following provisions as applicable:

The similar treatment accorded by the statutes to credit against an overdue tax, and to payment of it; the prohibition of credit of an overpayment of one year against a barred deficiency for another; and the requirement that payment of a barred deficiency shall be refunded, are controlling evidences of the Congressional purpose by the enactment of §§ 607 and 609 to require refund to the taxpayer of an overpayment, even though he has failed to pay taxes for other periods, whenever their collection is barred by limitation.\textsuperscript{366}

And what of \textit{Bull} and \textit{Stone}? Reconciling these decisions has provided a lot of work for commentators.\textsuperscript{367} Justice Stone’s final paragraph, in which \textit{Stone} is distinguished, is stunning in its opacity. Nevertheless, it appears that the critical distinction between the two cases is that the party in \textit{Stone} against whom recoupment was applied, the trustees, were litigating a year not barred

\begin{itemize}
  \item \textsuperscript{360} Rose v. McEachern, 86 F.2d 231, 231 (5th Cir. 1936).
  \item \textsuperscript{361} Id. at 233. The language of the Fifth Circuit is remarkable in that it bespeaks a belief that a taxpayer is not entitled to recover in a refund action unless the government is unjustly enriched. The more appropriate inquiry would be whether the tax is valid under the tax statute.
  \item \textsuperscript{362} McEachern, 302 U.S. at 63.
  \item \textsuperscript{363} Id. at 59-60.
  \item \textsuperscript{364} Revenue Act of 1928, ch. 852, § 607, 45 Stat. 874 (current version at I.R.C. § 6401(a) (1994)).
  \item \textsuperscript{365} Id. § 609, 45 Stat. 875 (current version at I.R.C. § 6514(b) (1994)).
  \item \textsuperscript{366} McEachern, 302 U.S. at 62.
  \item \textsuperscript{367} Professor Andrews commented that \textit{McEachern} appears to rule out recoupment in the situation in which it would most ordinarily arise (\textit{i.e.}, cases involving the same taxpayer and two tax periods where there is a deficiency in one period and an overpayment in the other). Therefore, \textit{McEachern} appears to overrule \textit{Bull}. See Andrews, supra note 296, at 605-06.
  Professor Watson ultimately distinguishes the government’s obtaining recoupment in \textit{Stone} with its failure to do so in \textit{McEachern} on the basis of the government’s lack of diligence in \textit{McEachern}. The latter presented no compelling equities. See Watson, supra note 298, at 730.
\end{itemize}
by the statute of limitations, at least as to them. The statute of limitations barred collection of the tax from the beneficiary, but recoupment involved no attempt to collect a barred tax from the beneficiary; thus, it was not precluded by I.R.C. §§ 607 and 609. Justice Stone’s final two sentences highlighted his understanding of recoupment in Stone as involving the exercise of equitable jurisdiction: "Equitable considerations not within the reach of the statutes denied a recovery. 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."  

Such a view of recoupment may be viewed alternatively as alarmingly broad or highly restrictive. On one hand, it posits that courts may, in the context of refund suits, exercise broad power to avoid unjust enrichment. This theory is not consonant with tax jurisprudence, at least in terms of avoiding unjust enrichment of the government. On the other hand, when only one taxpayer is involved in a transaction and recoupment is sought against the taxpayer, then I.R.C. §§ 607 and 609 and their descendants would generally prevent its application. In such situations, whether defending a deficiency or resisting a refund, the government would be attempting, in essence, to force payment of barred taxes. Recoupment would thus not be permissible against taxpayers in the more common “one taxpayer” situations.

The highly restrictive view of McEachern has prevailed. Recoupment has been viewed as equitable in character, although that viewpoint has caused its exercise to be restricted. McEachern was thus just a small step in the restriction of recoupment.

The adverse effect of this equitable characterization on the availability of recoupment was evident when the Supreme Court next addressed recoupment in Commissioner v. Gooch Milling & Elevator Co. In Gooch Milling a 1938 audit of the taxpayer’s books disclosed an erroneous valuation of inventory as of June 30, 1935, the close of taxpayer’s 1935 fiscal year. This error resulted in an overpayment by the taxpayer for 1935, which was not subject to refund because of the statute of limitations. The adjustment caused a corresponding deficiency for 1936, however, which was less than the overpayment for 1935. In its petition before the Board of Tax Appeals, the taxpayer sought to recoup

368. McEachern, 302 U.S. at 62-63. In McEachern the tax liability involved was that of the administrator of the decedent. The issue was whether it arose in the year of the death of the decedent or in later years.
369. Id. at 63.
371. I.R.C. §§ 6401(a), 6415(b) (1994).
372. Professor Willis has contended that McEachern and Bull, because both involve one taxpayer, are perhaps inconsistent. See Willis, supra note 206, at 637-38.
373. 320 U.S. 418 (1943).
The barred 1935 overpayment against the 1936 deficiency. The Board of Tax Appeals refused such recoupment for jurisdictional reasons, and the Eighth Circuit reversed. The Supreme Court reversed the Eighth Circuit.

The Court addressed both the Board’s jurisdictional provision and the nature of recoupment. The latter was unnecessary to the result and perpetrated what may be shown to have been a 50-year heresy—that the Tax Court could not exercise recoupment.

The Court first looked to I.R.C. § 272(g) which provided that the Board, in redetermining a deficiency in the taxable year before it, “shall consider such facts with relation to the taxes for other taxable years.” However, the section also provided that the Board had “no jurisdiction to determine whether or not the tax for any other taxable year has been overpaid or underpaid.” The Court found that in determining a deficiency for 1936, it was unnecessary to consider any facts relating to the 1935 taxable year. Whether it was necessary to look to 1935 in determining taxes for 1936 was really beside the point. Even if the Board needed to do so, the statute provided that it could not adjust the taxes for 1935. This determination would be the case regardless of what sort of jurisdiction, legal or equitable, the allowance of recoupment entailed.

The Court was quite correct in stating that allowing recoupment of the 1935 overpayment would involve a redetermination of the 1935 liability in

375. Id.
376. Gooch Milling & Elevator Co. v. Commissioner, 133 F.2d 131, 138 (8th Cir. 1943).
380. This limitation was rejected by the Tax Court in Estate of Mueller v. Commissioner, 101 T.C. 551, 561 (1993), but the question has not clearly been resolved. In a later decision involving the same controversy, Estate of Mueller v. Commissioner, 107 T.C. 189, 199 (1996), the Tax Court actually considered application of recoupment to the facts and found it inapplicable. The Sixth Circuit affirmed this result in Estate of Mueller v. Commissioner, 153 F.3d 302, 303, 306-07 (6th Cir. 1998), cert. denied, 119 S. Ct. 1031 (1999), but held that the Tax Court lacked jurisdiction to apply equitable recoupment. Prior to the Sixth Circuit’s decision, however, the Tax Court reaffirmed its recoupment power in Estate of Bartels v. Commissioner, 105 T.C. 430, 433 (1996). Bartels involved an Illinois taxpayer and would not have been appealable to the Sixth Circuit. See I.R.C. § 7482(b)(1)(A) (1994). Consequently, the decision of the Tax Court in Bartels would not necessarily be disturbed by the decision of the Sixth Circuit in Estate of Mueller. See Stacey Mfg. Co. v. Commissioner, 237 F.2d 605, 606 (6th Cir. 1956).
381. Gooch Milling, 320 U.S. at 420 (quoting I.R.C. § 272(g) (1939)).
382. Id. This determination is true only in an attenuated sense. The crucial fact in establishing a deficiency for 1936 was the revaluation (lowering) of the opening inventory. Such inventory revaluation coincidently lowered the ending inventory for 1935. Truly, however, it was not necessary to look to an identical fact for the 1935 year to determine the tax effect of a corresponding element of taxpayer’s 1936 taxes.
contravention of the statute; thus, there was no need for its characterization of such an action as giving effect to an "equitable defense."383 However, the Court's motive for doing so was transparent.

The Court clearly wanted to avoid a spillover of its holding to the applicability of recoupment in other forums.384 Its discussion of the Board of Tax Appeal's jurisdiction was remarkable:

The Internal Revenue Code, not general equitable principles, is the mainspring of the Board's jurisdiction. Until Congress deems it advisable to allow the Board to determine the overpayment or underpayment in any taxable year other than the one for which a deficiency has been assessed, the Board must remain impotent when the plea of equitable recoupment is based upon an overpayment or underpayment in such other year.385

While the Court purported not to address the powers of tribunals other than the Board of Tax Appeals, its implication that the Board was limited by the Code suggested that either other forums might not be or that equitable powers might enable them to act outside the realm of the Code in tax cases.386 However, such a conception of recoupment would ultimately not comport with the Court's juridical notions of taxation. This fact may be seen in the Court's remaining two cases pertaining to recoupment: Rothensies v. Electric Storage Battery Co,387 and United States v. Dalm.388

In Electric Storage Battery, the taxpayer had, from 1919 to 1926, paid excise taxes on sales of storage batteries on the assumption that such sales were subject to tax. In 1926 the taxpayer sought a refund of such taxes paid between 1922 and 1926. Taxes paid before 1922 were then barred by the statute of limitations. The taxpayer sued for a refund of the 1922 through 1926 taxes and prevailed in the refund suit. The government paid the taxpayer's refund in

383. Id. at 421.
384. It stated: "We are not called upon to determine the scope of equitable recoupment when it is asserted in a suit for refund of taxes in tribunals possessing general equity jurisdiction." Id.
385. Id. at 422.
386. The implication that tribunals other than the Board are not bound by the Code is puzzling unless it may be understood as stating that the Board is more restricted to the letter, or explicit language, of the Code. In truth, Article III tribunals have, on some famous occasions, applied the Code without punctilious attention to its text. See, e.g., Corn Products Ref. Co. v. Commissioner, 350 U.S. 46 (1955) (applying narrowly the statutory definition of "capital asset" for capital gains purposes); Helvering v. Clifford, 309 U.S. 331 (1940) (interpreting "gross income" broadly for income tax purposes).
On such occasions, however, the courts never view themselves as exercising free-wheeling Article III equity powers to "do right," but rather to carry out the intent of Congress.
1935. However, because the taxpayer had deducted such excise taxes in the years in which it had paid them, the government treated the collection of the refund by the taxpayer as income in 1935. The taxpayer paid the deficiency, filed a claim for refund, and then sued for a refund. 389

The trial court allowed the taxpayer to recoup the excise taxes paid from 1919 to 1921 against tax on income attributable to recovery of taxes paid from 1922 to 1926, 390 and the Third Circuit affirmed. 391 The Supreme Court reversed. 392

The Court held that recoupment did not permit offsetting one transaction against another. 393 This application of a long-established element of recoupment, the requirement that the offsetting claims arise out of the same transaction, 394 was sensible under the circumstances. Taxes that the taxpayer in *Electric Storage Battery* sought to recoup against the government were imposed upon transactions that were merely identical, not common. The insistence that recoupment applies only to a single transaction was the only point needed to reject the taxpayer’s claim. But the Court had more work to do.

The Court appeared to accept the government’s contention that the lower courts erred in approving the use of recoupment in a situation other than those sanctioned in *Bull* and *Stone*. 395 As the Court noted: “Whatever may have been said indicating a broader scope to the doctrine of recoupment, these facts are the only ones in which it has been applied by this Court in tax cases.” 396

As justification for such a limitation, the Court highlighted the policy behind the statute of limitations: the avoidance of a “system under which there never would come a day of final settlement and which require[s] 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.” 397

Perhaps most significantly, the Court took cognizance of the egregious situations wrought by limitations, those which create hardships for both taxpayers and the government, and noted: “They tempt the equity-minded judge to seek for ways of relief in individual cases.” 398 In short, “lead us no[ ] longer] into temptation!” 399 The Court emphatically expressed a distaste for

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390. *Id.* at 298-99.
393. *Id.* at 299.
394. See WATERMAN, supra note 297, § 424, at 471.
396. *Id.*
397. *Id.* at 301.
398. *Id.* at 302.
399. The Court in *Dalm* recanted the agnosticism embraced in *Gooch Milling & Elevator Co.* v. *Commissioner*, 320 U.S. 418, 421 (1943), about whether a tribunal with general equity powers might exercise the power therein denied the Board of Tax Appeals. United States v. Dalm, 494 U.S. 596 (1990). That is surely understandable. Whether or not Article III courts

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judicial creation of remedies for injustices occasioned by limitations: "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."\(^{400}\)

And then there ensued over four decades of silence from the Court about recoupment! For the most part, recoupment languished in the stage of arrested development that Electric Storage Battery mandated.\(^{401}\) In 1990, however, the Supreme Court decided United States v. Dalm\(^{402}\) and took another step to curtail equitable recoupment. Dalm provides an elaboration of the Court’s uneasiness with the notion of equitable jurisdiction in the context of federal tax cases. In so doing, the Court signaled that the relation of limitations to sovereign immunity, rather than to the state claims considerations applicable to all litigants, is at the heart of this uneasiness.

In Dalm the taxpayer had been a loyal secretary to one Harold Schrier. Schrier died, and in May, 1975 the taxpayer was appointed administratrix of his estate. Owing to her loyal service to Schrier, Schrier’s brother Clarence paid Dalm $180,000 from assets in Schrier’s estate in 1976 and $133,813 in 1977. Clarence filed a gift tax return with respect to the 1976 payment, and Dalm paid a gift tax of $18,675.\(^{403}\)

Upon an audit of Dalm’s 1976 and 1977 income tax returns, the Commissioner concluded that amounts paid to her by Clarence represented additional fees for services as administratrix of Harold’s estate and that she should have reported them as income. The IRS asserted deficiencies in her income tax of $91,471 for 1976 and $70,639 for 1977. Dalm petitioned for redetermination of these deficiencies in the Tax Court. She and the IRS settled the case after two days of trial. In the course of the Tax Court proceedings, Dalm did not seek credit or recoupment of the gift tax she had paid with respect to the transfers Clarence made to her.\(^{404}\)

After the settlement in Tax Court, Dalm filed an administrative claim for refund of the gift tax she paid. This claim was filed nearly five years after expiration of the time that the Code requires a refund claim to be filed.\(^{405}\) The taxpayer eventually filed suit in district court for refund of “overpaid gift tax.”\(^{406}\) The district court granted the government’s motion to dismiss the suit as untimely. It held that equitable recoupment did not authorize an independent

possess such equitable powers, liberal exercise of recoupment would result in the diverting of cases to the district courts.


401. Resort to recoupment was also limited by the mitigation provisions, which have been held to preclude recoupment in circumstances in which they apply. See Benenson v. United States, 257 F. Supp. 101, 113 (S.D.N.Y. 1966). But see Coohey v. United States, 172 F.3d 1060, 1064 (8th Cir. 1999).

402. 494 U.S. at 598.

403. Id. at 598-99.

404. Id. at 599.

405. Id. at 600; see I.R.C. § 6511(a) (1994).

406. Dalm, 494 U.S. at 600.
lawsuit.\footnote{407} The Sixth Circuit reversed. It rejected the government's contention that Dalm's claim was an independent lawsuit barred by the statute of limitations and determined that the government had made a timely claim for deficiency of her income tax based on an inconsistent legal theory. In so holding, the Sixth Circuit sided with the Ninth Circuit; the Seventh Circuit had taken the opposite view.\footnote{408} The Court granted certiorari to resolve the conflict.

In the Seventh Circuit case, \textit{O'Brien v. United States},\footnote{409} the taxpayer transferred a 1975 liquidation stock he had received from the estate of his father. He used the same valuation on the stock as the estate had used for estate tax purposes. In 1980 litigation to determine the estate tax, the Tax Court fixed the value of the stock high enough to nullify the taxpayer's gain on his earlier sale.\footnote{410} The taxpayer thus sought a refund of the tax he had paid pertaining to the sale of the stock in 1975. The IRS denied the claim on the basis of the statute of limitations.\footnote{411}

The district court allowed the taxpayer to recover, but the Seventh Circuit reversed.\footnote{412} It focused on recoupment after holding that mitigation was inapplicable.\footnote{413} The court held recoupment inapplicable to a situation in which a taxpayer is not asserting a claim against a validly asserted deficiency. It noted that "[a]ttempts 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."\footnote{414}

In \textit{Kolon v. United States},\footnote{415} however, the Ninth Circuit took a different view. In 1972 the taxpayer exercised stock options offered to him by his employer. He did not report the bargain element entailed in exercise of the options as an item of tax preference subject to the minimum tax\footnote{416} because the stock was subject to certain restrictions. The taxpayer reported the bargain element as an amount of tax preference in 1973 and paid a minimum tax of $8,097. The IRS decided that the proper year for paying the minimum tax was 1972.\footnote{417} This position was upheld by the Tax Court in 1978.\footnote{418} The Ninth

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407. \textit{Id.}


409. 766 F.2d 1038 (7th Cir. 1985).


412. \textit{Id.} at 1042, 1051.

413. \textit{See id.} at 1042, 1048-51. The court held in part that the circumstance involving errors in basis, I.R.C. § 1312(7), was not met because the error occurred in respect of the liquidation rather than the transfer of the shares at death. \textit{Id.} at 1043.

414. \textit{Id.} at 1049.

415. 791 F.2d 762 (9th Cir. 1986).


417. \textit{Kolon}, 791 F.2d at 763-64.

Circuit affirmed the Tax Court. 419

The taxpayer filed a claim for refund of the minimum tax paid in 1973. In 1984 he sued for refund in district court. The district court held in favor of the taxpayer on the basis of mitigation. 420

In affirming the district court, the Ninth Circuit rejected the applicability of mitigation. 421 The court in Kolom completely misperceived the issue that was critical in O'Brien: that the lack of a pending proceeding instituted by the government signified that the taxpayer relied on recoupment as an independent basis of jurisdiction. In such a context, recoupment is robbed of its defensive character. Although a recoupment claim is not untimely if the main claim is timely, 422 a recoupment claim is not timely if there is no "main" claim. The court in Kolom insisted that the facts of the case were similar to those in Bull. 423 The court, however, overlooked an important jurisdictional change that had occurred in the decades between Bull and Kolom. In contrast, the Dalm court did not overlook this change.

In Bull the taxpayer maintained a suit in the Court of Claims to recover barred overpaid estate taxes after the Board of Tax Appeals upheld imposition of income taxes legally inconsistent with the barred estate taxes. 424 Recoupment of the overpaid, barred taxes appeared to be the sole jurisdictional basis of the suit in the Court of Claims, rather than a defense to an action by the government asserting tax liability. As the Court in Dalm noted, however, there was no direct judicial review of decisions of the Board of Tax Appeals in the tax years at issue in Bull. 425 If the Court of Claims action by the taxpayer in Bull is viewed as a surrogate for direct review of Tax Court decisions now provided in the courts of appeal, then Bull need not necessarily be read today as supporting the notion that recoupment will independently support an action for refund in a district court or the Court of Federal Claims.

Whether Bull is to be read restrictively or broadly concerning the scope of recoupment is as much a matter of policy as of logic. In Dalm, as in Electric Storage Battery, the policy basis of the Court's decision was clear. Unlike Electric Storage Battery, however, which relied primarily on the avoidance of

420. Kolom, 791 F.2d at 764-65.
421. Id. at 766. The court did not regard an item of tax preference as an item of gross income since I.R.C. § 421(a)(1) excludes it from gross income. Thus the mitigation circumstances entailing double inclusion of an item of gross income, I.R.C. § 1312(1), were inapplicable. Id. at 765-66.
423. Kolom, 791 F.2d at 768.
425. See United States v. Dalm, 494 U.S. 596, 603 n.4 (1990). Before the creation of review of Board decisions by courts of appeal in the Revenue Act of 1926, ch. 27, § 1001(a), 44 Stat. 109 (current version at I.R.C. § 7482(a)(1) (1994)), taxpayers unsuccessful before the Board were required to pay the deficiency and then seek a refund in a district court or the Court of Claims. See CrtMm, supra note 252, § 2.2.
stale claims, the Court in \textit{Dalm} emphasized sovereign immunity. It viewed the statute of limitations as a condition of Congress's waiver of sovereign immunity entailed in a refund suit. Since the taxpayer had not sought a refund of the gift tax within the time permitted by statute, her suit required a consent the Court deemed itself powerless to give: "If any principle is central to our understanding of sovereign immunity, it is that the power to consent to such suits is reserved to Congress." The Court reinforced its unwillingness to fashion a remedy to avoid limitations by noting that Congress had already fashioned such a remedy in enacting the mitigation provisions. The Court stated that application of recoupment under the circumstances "would be doing little more than overriding Congress' judgment as to when equity requires that there be an exception to the limitations bar."

The "equity" referred to by Justice Kennedy has no relationship to chancery jurisdiction exercised by state and federal courts. \textit{Dalm} indicates that if equity, in a colloquial rather than a jurisdictional sense, compels that the rigors of the statute of limitations be relaxed, it is entirely up to Congress to determine the nature and scope of such relaxation. So limited, recoupment closely resembles its common law ancestor. It poses no threat to sovereign immunity because it is in accord with the long-accepted notion that a barred claim may be asserted by a litigant to reduce a claim by the government. The only accommodation made to tax law is that a taxpayer, as plaintiff in a refund suit, may use recoupment. This goal is perhaps all the Court in \textit{Bull} wanted to accomplish. Although the Court in \textit{Dalm} expressed no opinion as to whether recoupment was available only in the district courts or the Court of Federal

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\bibitem{427} \textit{Dalm}, 494 U.S. at 608-10.
\bibitem{428} \textit{Id.} at 608.
\bibitem{429} \textit{See} I.R.C. § 6511 (1994).
\bibitem{430} \textit{Dalm}, 494 U.S. at 610.
\bibitem{431} \textit{Id.} To some extent this flies in the face of some legislative history that indicates that mitigation was not intended to stifle the development of recoupment but to supplement it. \textit{See} S. REP. NO. 75-1567, at 49 (1938). As mitigation would clearly not apply to \textit{Dalm}'s situation, which involved two taxes, a strong case could be made that Congress intended no such preclusion of recoupment. \textit{See} Willis, \textit{supra} note 206, at 626.
\bibitem{432} \textit{Dalm}, 494 U.S. at 610.
\bibitem{433} As Justice Story stated: "[O]ne of the most striking and distinctive features of Courts of Equity is that they can adapt their decrees to all the varieties of circumstances which may arise, and adjust them to all the peculiar rights of all the parties in interest . . . ." \textit{J}oseph Story, \textit{Commentaries on Equity Jurisprudence} 21 (Melville M. Bigelow ed., 13th ed. 1886).
\bibitem{434} The Court stated that recoupment would still be permitted with respect to a barred tax overpayment in administrative proceedings before the IRS, \textit{Dalm}, 494 U.S. at 610 (citing Rev. Rul. 71-56, 1971-1 C.B. 404), and in a court action in which another tax on the same transaction is challenged in a timely fashion. \textit{Id.}
\bibitem{435} \textit{See}, \textit{e.g.}, United States v. Ringgold, 33 U.S. (8 Pet.) 150 (1834) (allowing defendant to assert claim in action by the United States where no direct action was permitted).
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Claims, a point that was important to the dissent, the Tax Court has, since Dalm, held that it may allow equitable recoupment. If this holding is undisturbed, it would vitiate the charge that recoupment is more accessible to taxpayers who can more easily pay the tax before litigating, and thus litigate in a district court or the Court of Federal Claims.

Justice Stevens’s fulminations in dissent reach a level of stridency not seen in tax cases since the retirement of Justice Douglas. Insisting that “[t]he case casts a shadow on the Executive—and on this Court . . .,” he denigrates the importance of sovereign immunity. Deriding the “haunting charm” that the “majestic voices of ‘jurisdiction’ and ‘sovereign immunity’” have “for this Court’s current majority,” Justice Stevens held up Bull as reasoned “under the reliable guidance of a bright star in our jurisprudence: the presumption that for every right there should be a remedy.” Referring to sovereign immunity as “the vainest of all legal fictions,” Justice Stevens states:

Its persistence cannot be denied but ought not to be celebrated. Nor should its fictive origin ever be forgotten. There is no cause to expand the doctrine, and we do better to interpret § 1346(a)(1) by the light of equity and with due regard for the practicalities of revenue collection discussed in Bull.

Although Justice Stevens’s concern about “unjust retention of a previously paid tax” is understandable, his implication that the statute of limitations may

436. Dalm, 494 U.S. at 615 (Stevens, J., dissenting). Justice Stevens accepted the representation of Dalm’s counsel at oral argument that Dalm did not have the means to pay the income tax deficiency and sue for refund, simultaneously attempting to recoup the gift tax she paid. Id. at 615-16. Collection of the tax is prerequisite to a refund suit. See I.R.C. § 7422(a) (1994). Justice Stevens stated: “[A]n affluent taxpayer, but not a less fortunate one, can pay a deficiency assessment and file suit for a refund.” Dalm, 494 U.S. at 615.


439. Dalm, 494 U.S. at 612.

440. Id. at 616 (citing Marbury v. Madison, 5 U.S. (1 Cranch) 137, 162-163 (1803)). In a sense, Justice Stevens’s invocation of Marbury is odd. While Chief Justice Marshall did indeed state the above equitable principle, see Marbury, 5 U.S. (1 Cranch.) at 162, the Court, somewhat fecklessly (though understandably), declined on jurisdictional grounds to order Secretary Madison to deliver Mr. Marbury’s commission. See id. at 173-80.

441. Dalm, 494 U.S. at 622.

442. Id.

443. Id. at 613; see also Stephen J. Legatzke, Note, The Equitable Recoupment Doctrine in United States v. Dalm: Where’s the Equity?, 10 VA. TAX REV. 861, 862 (1991) (arguing that Dalm represents unfairness in the tax system).
be tempered "by the light of equity" runs afoul of notions of federal jurisdiction so entrenched that they may not be evaded by judicial decision.444

The Court again underscored its unwillingness to allow equity jurisdiction to provide relief from harsh consequences of the statute of limitations in United States v. Brockamp,445 a case in which the facts cried out for such relief even louder than those of Dalm.

Brockamp involved consolidated cases in which two taxpayers who had overpaid their taxes failed to make timely claims for refunds. Each claimed that the delay was caused by a disability.446 In both cases, the Ninth Circuit held that the statute of limitations under IRC § 6511 could be tolled for an equitable reason, thereby implying an equitable tolling exception.447 Because other circuits had rejected such an exception to the statute of limitations, the Supreme Court granted certiorari.

The taxpayers relied upon a nontax decision, Irwin v. Department of Veterans Affairs,448 in which the Court held that there is a rebuttable presumption that equitable tolling applies in suits against the government on the same basis as it applies in suits against private defendants.449 The taxpayers, in a manner similar to the Court in Stone v. White,450 analogized a tax refund action to one for "Money Had and Received," in which equitable tolling principles would be applicable against a private defendant.451

The Court accepted the analogy of a refund action to one for money had and received only for purposes of argument,452 but insisted that there was good reason to believe that Congress did not want equitable tolling to serve as an exception to I.R.C. § 6511. "[T]he iteration of the limitations in both procedural and substantive forms, and the explicit listing of exceptions" of I.R.C. § 6511 indicated to the Court "that Congress did not intend [the] courts to read . . . open-ended, 'equitable' exceptions into the statute that it wrote."453

The Court more broadly explained the rationale for not exercising equitable jurisdiction to mitigate the statute of limitations:

To read an "equitable tolling" exception into § 6511 could create serious administrative problems by forcing the IRS to

444. Dalm, 494 U.S. at 622.
446. One taxpayer claimed the delay was caused by senility; the other claimed it was caused by alcoholism. Id. at 348.
447. See Brockamp v. United States, 67 F.3d 260, 263 (9th Cir. 1995).
449. Id. at 95-96.
450. 301 U.S. 532, 534 (1937); see supra note 338 and accompanying text.
452. Id. at 350. The Court actually expressed its scepticism of this analogy by citing Flora v. United States, 362 U.S. 145, 153-54 (1960), in which the Court refused to equate the suit against the collector with the "common-law action of assumpsit for money had and received."
453. Brockamp, 519 U.S. at 352.
respond to, and perhaps litigate, large numbers of late claims, accompanied by requests for "equitable tolling" which, upon close inspection, might turn out to lack sufficient equitable justification. . . . The nature and potential magnitude of the administrative problem suggest that Congress decided to pay the price of occasional unfairness in individual cases (penalizing a taxpayer whose claim is unavoidably delayed) in order to maintain a more workable tax enforcement system.\textsuperscript{454}

Since the court decided \textit{Brockamp}, Congress has taken steps to mitigate the harshness of the result in that case.\textsuperscript{455} Nonetheless, \textit{Dalm} has cast a long shadow over use of recoupment, as discussed immediately below. It must be underscored, however, that the principal objection of the courts to recoupment is that Congress has not sanctioned its use. Recoupment has been restricted because it treads upon a congressional enactment—the statute of limitations.

\textbf{B. Application of Equitable Recoupment by the Lower Federal Courts}

As previously discussed, either taxpayers or the government may seek relief through equitable recoupment from equitably inconsistent tax consequences of a single transaction.\textsuperscript{456} A taxpayer who has an identity of interest with another taxpayer with respect to a single transaction may also seek relief pertaining to the tax consequences of such transaction for the other taxpayer. The government may also seek recoupment on account of inequitable inconsistencies involving taxpayers who have an identity of interest respecting a single transaction.\textsuperscript{457} The single transaction and identity of interest requirements have guided the lower federal courts in administering recoupment. As with the mitigation provisions, however, a principled reconciliation of the case law construing these requirements demands considerable struggle.

\textit{1. The Same Transaction Requirement}

Courts allow recoupment only for different tax aspects of a single

\textsuperscript{454} \textit{Id.} at 352-53. Although \textit{Brockamp} did not involve equitable recoupment, the Court therein cited \textit{Dalm}. See \textit{id.} at 352.

\textsuperscript{455} Under the Internal Revenue Service Restructuring and Reform Act of July 22, 1998, Pub. L. No. 105-206, 1998 U.S.C.C.A.N. (112 Stat.) 740-41, \S \textdegree \text{6511(b)} was amended to allow tolling of limitations during a period in which an individual taxpayer is financially disabled "if such individual is unable to manage his financial affairs by reason of a medically determinable physical or mental impairment . . . which can be expected to result in death or which has lasted or can be expected to last for a continuous period of not less than 12 months."


\textsuperscript{457} Stone v. White, 301 U.S. 532, 537-38 (1937).
transaction. Lower federal courts have construed the term “transaction” in light of the bipolar concerns that underlie recoupment itself. On one hand, they have recognized that “it offends the sense of fairness to permit the sovereign to collect two taxes arising from a single transaction . . . .”458 On the other hand, they have recognized that failure to apply a same transaction limitation would mean that “every assessment of deficiency and each claim for refund would invite a search of the taxpayer’s entire tax history for items to recoup.”459

The case law under the single transaction requirement has involved an unceasing attempt to sort out precisely what sort of injustices recoupment is intended to redress. Three sorts of “injustices” or anomalies appear to have been encountered in the case law: (1) inconsistencies as to similar, but different, transactions; (2) multiple inconsistent taxation of a particular amount of income or property; and (3) circumstances in which the purported single transaction involves the relationship between the estate and income taxes with respect to a decedent or related decedents.

In the first group of cases, the party seeking recoupment invariably does so in vain. These attempts to obtain recoupment demonstrate that compelling inequities may escape correction because of recoupment’s limitations. Often the circumstances of these claims entail some strong factual connection between the open and barred claim other than the strict transactional relationship that Rothensies460 and later cases have required.

A good example of such a case is Missouri Public Service Co. v. United States.461 In that case a taxpayer, in tax years 1954 through 1957, had begun to depreciate assets in the years in which it acquired them rather than in the years in which they were put into service. The court determined this treatment to be incorrect.462 For all years but 1956, the taxpayer elected straight-line depreciation. By amended returns it sought to use a declining balance method.463 The court gave effect to the premature elections by the taxpayer for property placed in service in the years following such elections. Depreciation deductions based on such elections yielded a deficiency for 1956, which was barred, and an overpayment for 1957, for which the taxpayer had timely sought a refund.464

The government sought to recoup 1956 against 1957, which the court

458. Harrah v. United States, 77 F.3d 1122, 1125 (9th Cir. 1995) (denying use of recoupment because tax aspects did not relate to a common transaction).
460. 329 U.S. at 296.
461. 245 F. Supp. 954 (W.D. Mo. 1965), aff’d, 370 F.2d 971 (8th Cir. 1967).
462. Id. at 958-59. See also Treas. Reg. § 1.167(a)-10 (1999) (stating that the period for depreciation begins when the asset is placed in service).
463. The IRS contended that a change of method required its consent, which was not forthcoming. Missouri Pub. Serv. Co., 245 F. Supp. at 958. The taxpayer contended that the premature nature of its original elections meant that it had exercised no elections and, hence, was free to do so in amended returns without IRS consent. Id.
464. Id. at 960.
refused. It found that the same transaction requirement had not been met. The claims for the two different years involved different identifiable assets.465

The government's claim for recoupment had some plausibility. Claims respecting both years were at issue in different counts of the taxpayer's complaint in the refund action, and the effect accorded to premature elections was an issue common to both actions. It is reasonable that the government would not have known precisely what sort of assessment was necessary to protect its claim as to 1956 because liability for that year depended on the outcome of the refund action as to 1957.466 Nonetheless, the claims related to 1956 and 1957 may be seen as transactions sharing a common legal question rather than a single transaction.467

How does one determine that circumstances for seeking recoupment entail more than one transaction? The court in Bowen v. United States (In re Bowen)468 employed a useful approach to this problem.

In Bowen the court rejected an attempt by a bankrupt taxpayer to recoup (or offset) a claim for individual income taxes for tax years 1989 and 1990 against barred claims for refund involving transactions by the taxpayer's closely held corporation in 1985 and 1986.469

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465. Id. at 962.

466. In its analysis the court noted four possible resolutions of the election validity issue. Id. at 958-59. It is not clear that the government should have known which outcome to expect.

467. Milburn v. United States, 947 F. Supp. 1015 (W.D. Tex. 1996) and Twitchco, Inc. v. United States, 348 F. Supp. 330 (M.D. Ala. 1972) provide two additional examples of courts viewing related transactions as separate. In Milburn the taxpayers, who sold property at a loss in 1989, later filed a refund claim for that year. 947 F. Supp. at 1016. They claimed that interest paid in 1987 which related to acquisition of the property should have been capitalized. Id. Capitalization would have increased the taxpayers' loss. The IRS denied the claim because the interest should have been deducted as a business expense in 1987. Id. The taxpayers filed a refund suit based on equitable recoupment and mitigation. Id. at 1017. Respecting recoupment, the court held that although transactions in 1989 and 1987 were related because each concerned how to treat the 1987 interest expense, they remained separate "taxable events" for purposes of equitable recoupment. Id. at 1018. The Court also rejected the taxpayers' claim based on mitigation. Id. at 1020. In Twitchco the taxpayer "leased" three buildings from a municipality beginning in 1957 and sold its assets in 1967. 340 F. Supp. at 332. The government treated the lease as a financing arrangement by the municipality and treated the taxpayer as owner of the buildings. Id. at 333. This treatment increased the taxpayer's basis and decreased its capital gain in 1967. Id. The government sought to use equitable recoupment to obtain tax on the difference between depreciation deductions—that would have been allowable had the taxpayer treated itself as owner during the "lease" period—and the higher rental deductions the taxpayer took in those years. Id. The court denied recoupment for years closed by the statute of limitations. Id. at 335. It found that the single transaction requirement was not met because, while the taxpayer's claim for refund related to the 1967 sale, the government's claim for recoupment related to the purchase of the buildings; the court simply explained, "[a] purchase is not the same transaction as a sale." Id. at 337.


469. Id. at 857. The court did not address whether there was sufficient identity of interest between the individual taxpayer and his closely held corporation to warrant recoupment as to their respective tax attributes. Cf. Hufbauer v. United States, 297 F. Supp. 247 (S.D. Cal.
Accepting the taxpayer’s claim would have required the court to treat the taxpayer’s tax liability at issue in the bankruptcy proceeding as the transaction. With such an understanding of a transaction the court might then search, without regard to the statute of limitations, for any items that might affect the amount of the liability at issue. The court embraced a much narrower notion of a transaction (i.e., “that the evidence necessary to establish the recoupment claim is the same as the evidence necessary to establish the plaintiff’s claim”). Such an “operative facts” approach sensibly prevents offsetting tax attributes that are logically related only because they pertain to the same taxpayer.

In the second group of “same transaction” cases—involving multiple inconsistent taxation of the same income or property—recoupment claims are most likely to be successful. That fact is not surprising because those instances are closest to the model in Bull v. United States.

A relatively complicated example of such a case is Pond’s Extract Co. v. United States. Pond’s Extract involved the relationship between normal tax income and excess-profits taxes. The taxpayer in Pond’s Extract, for income and excess-profits tax purposes, allocated excise taxes paid in 1940 to tax years 1936 through 1939. The taxpayer learned from the Supreme Court in 1944 that

1968) (finding identity requirement satisfied when a corporation with a sole shareholder relationship exists).


471. Id.

472. The test employed in Bowen was once used in the RESTATEMENT (FIRST) OF JUDGMENTS § 61 (1942). This test was replaced by the transactional test of the RESTATEMENT (SECOND) OF JUDGMENTS § 24(2) (1982), which looks to the relationship of the facts in terms of “time, space, origin, or motivation, whether they form a convenient trial unit, and whether their treatment as a unit conforms to the parties’ expectations or business understanding or usage.”

473. 295 U.S. 247 (1935). Professor Andrews states, “[t]he effect of the conceded presence of the single transaction element in the Bull model of cases is, of course, that there is likely little or no significant problem of staleness.” Andrews, supra note 296, at 627. Professor Watson states that, “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.” Watson, supra note 298, at 754 (footnote omitted). Professor Watson also notes that this test has not always been applied so simply. Id. at 755.

474. 134 F. Supp. 476 (Ct. Cl. 1955). See also National Biscuit Co. v. United States, 156 F. Supp. 916, 925-26 (Ct. Cl. 1957) (finding that the taxpayer may receive a refund due to the government’s inconsistent treatment of a component of income when computing the excess profits credit of a previous year); E.I. du Pont De Nemours & Co. v. United States, 147 F. Supp. 486, 493-94 (Ct. Cl. 1957) (holding that taxpayer may recover interest paid relating to excess profits tax deficiencies as well as for interest resulting from an overassessment to excess profits taxes).

475. Under the wartime excess-profits tax regime, tax was imposed under I.R.C. § 710(a)(1) (1939) (repealed Nov. 8, 1945) on excess-profits net income. Under I.R.C. § 711(a) (1939) the calculation of excess-profits net income started with normal tax income under I.R.C. § 13 (1939) (current version at I.R.C. § 11 (1994)). Under I.R.C. § 713(a) (1939) an excess-profits tax credit was allowed, which was 95% of the average excess-profits net income for the tax years between 1936 and 1940. In short, excess-profits taxes imposed during wartime years were affected by income and deductions of prewar years.
this was erroneous, that such excise taxes were deductible for income tax purposes only when paid in 1940.\textsuperscript{476} For its 1944 excess-profits taxes, the taxpayer treated the excise taxes properly by increasing its base period income in 1936 through 1939. This inconsistent treatment of these taxes entitled the government to make an addition to excess-profits taxes for 1944 in the amount of the income taxes saved in 1936 through 1939 by the taxpayer's earlier inconsistent position.\textsuperscript{477} The taxpayer sought to recoup against this adjustment the amount of income taxes it would have saved had it properly deducted the excise taxes in their entirety in 1940.

The court permitted the taxpayer to recoup its barred 1940 refund claim against the later deficiency in excess profits taxes. The court found the single transaction requirement met and held that the single transaction was the erroneous allocation of the excise tax.\textsuperscript{478} Without recoupment, the amount erroneously not deducted in 1940 would have been taxed twice on two inconsistent theories.

\textit{Hufbauer v. United States}\textsuperscript{479} provides another example. In \textit{Hufbauer} an individual taxpayer, who had practiced as a sole proprietor architect for a calendar year, incorporated his practice effective April 21, 1959. The corporation erroneously reported the taxpayer's income for the period from January 1 to April 21, 1959. After the time for the plaintiff corporation to claim a refund for 1959 had expired, the IRS issued a deficiency against the taxpayer for that amount.\textsuperscript{480} The court allowed the corporation to recoup its barred claim for refund for 1959 against the government's timely deficiency concerning the same income. Clearly, both the taxpayer and the corporation could not be compelled to report the same income.\textsuperscript{481}

Finally, in \textit{Kolom v. United States}\textsuperscript{482} the taxpayer paid tax in 1973 on the exercise of stock options received in 1972. The government later asserted a deficiency for the 1972 exercise. The court permitted the taxpayer to recoup for 1973 the barred refund claim against the government's 1972 successful claim for taxes on the same transaction.\textsuperscript{483}

\textsuperscript{476} See Dixie Pine Prods. Co. v. Commissioner, 320 U.S. 516, 519 (1944).
\textsuperscript{477} Pond's Extract Co., 134 F. Supp. at 477. See I.R.C. § 734 (1939) (repealed Nov. 8, 1945), which was, essentially, a mitigation provision.
\textsuperscript{478} 134 F. Supp. at 479.
\textsuperscript{479} 297 F. Supp. 247 (S.D. Cal. 1968).
\textsuperscript{480} Id. at 248.
\textsuperscript{481} Id. at 252. Because the corporation could not have pursued its own claim and action for refund, the sole basis upon which it could maintain its claim was recoupment. In the wake of Dalm, the corporation probably could not recover today under these circumstances.
\textsuperscript{482} 791 F.2d 762 (9th Cir. 1986).
\textsuperscript{483} Id. at 769. In United States v. Dalm, 494 U.S. 596, 600-01 (1990) the Court implicitly rejected the approach of Kolom as a means of allowing recoupment of barred gift taxes against income taxes that had already been adjudicated in the Tax Court. In that situation recoupment would have been the sole basis of jurisdiction. Litigation was not pending for an open year. The taxpayer in Kolom, under Dalm, would seemingly not be permitted to maintain a refund action as to the barred year 1973. Taxpayer's "refund" action was in reality an attempt,
Although, years purposes repayments and a recover to the case fits within the strictures of Electric Storage Battery.

The third class of cases involves the relationship between estate and income taxes, and occasionally, taxes on different estates that are difficult to reconcile.

Two older cases, United States v. Herring and United States v. Bowcut, allowed recoupment of barred claims for overpaid estate taxes against income tax liability that arose during decedents' lives. In both cases the courts' understanding of what constituted a transaction for recoupment purposes was broader than what the Court accepted in Bull v. United States.

In both Herring and Bowcut, the Commissioner examined predeath tax years of the decedents after the personal representatives had paid the estate tax. In both cases the personal representatives sought refunds of those income taxes because the taxes reduced the size of the taxable estates and because they were thus entitled to recoup overpaid estate tax.

Although unanticipated income tax liability for years preceding the decedents' deaths would reduce their estates, recoupment of barred claims in response to that liability is permitted only if claims for estate and income taxes

albeit successful, to obtain reimbursement for his payment of the Tax Court judgment in favor of the government with respect to 1972. Kolom v. Commissioner, 71 T.C. 235 (1978), aff'd, 644 F.2d 1282 (9th Cir. 1981).

484. See National Biscuit Co. v. United States, 156 F. Supp. 916, 928 (Ct. Cl. 1957).
485. 329 U.S. 296 (1946). It must be borne in mind that, in the wake of Dalm, recoupment is allowable only in the course of litigation of an open year. In a couple of instances—clearly motivated by public policy—courts have denied recoupment of claims that arguably pertain to the same funds. In United States v. Tomar Hills, Inc., 783 F.2d 753 (8th Cir. 1986), the IRS sued to recover a refund that had been barred by limitations. The taxpayer asserted a claim for recoupment with respect to the barred year. Although the funds at issue were the same, the court refused to allow recoupment because it did not want to encourage taxpayers to obtain refunds as to barred years and then resort to recoupment when the government sued to recover such refunds. Id. at 755. In O'Hagan v. Commissioner, 70 T.C.M. (CCH) 498 (1995), a lawyer who had embezzled client funds in 1986, 1987, and 1988 belatedly reported such funds and paid taxes for those years. He sought to deduct repayments of such amounts for purposes of the alternative minimum tax for 1989. Id. at 499. The IRS successfully contended that repayments in 1989 were nondeductible miscellaneous itemized deductions, not deductible for purposes of the alternative minimum tax. Id. at 500. The court refused recoupment for the earlier years of inclusion because the repayment in 1989 constituted a separate transaction. Id. at 502. Although, again, there is inconsistent treatment regarding the same funds, the court's action is consistent with other courts in refusing to allow an embezzler to shift the consequences of repayment to an earlier year. See, e.g., McKinney v. United States, 574 F.2d 1240, 1243 (5th Cir. 1978) (explaining that a taxpayer has no right to embezzle funds).

486. 240 F.2d 225, 228 (4th Cir. 1957).
487. 287 F.2d 654, 655 (9th Cir. 1961).
489. In both cases, the government was unhindered by limitations because it alleged taxpayer fraud. See I.R.C. § 6501(c)(1) (1994).
arise out of the same transaction. Claims for predeath income taxes arguably have only an indirect relationship to the estate tax, or at least a weaker relationship than the claims for income and estate taxes in Bull, which essentially involved the question as to how one fund should be taxed. The court in Herring acknowledged that Bull involved claims to the same money, but asserted that recoupment had the same practical effect therein as it had in Bull:

The Government has asserted two claims against the monies of the estate that came into the hands of the administratrix—one on account of past due income taxes and the other on account of the estate tax due on the net estate, and it is impossible to determine the amount of the latter without making due allowance for the deduction caused by the former.

The approach of Herring and Bowcut posits a transactional relationship between estate and income taxes because claims for the latter reduce the tax base of the estate and, hence, the amount of estate taxes. However, this approach overlooks the fact that income taxes themselves arise from circumstances unrelated to estate tax. This is not to say that cases like Herring and Bowcut do not alleviate an injustice, but simply that the injustice may be beyond the reach of recoupment to correct.

Later cases have taken a different approach from Herring and Bowcut. Wilmington Trust Co. v. United States provides an example. In Wilmington Trust different taxpayers in consolidated cases deducted from ordinary income, prior to their deaths, land and wood management expenses in connection with timber operations. The IRS denied the deductions because it contended that those expenses should have been offset against capital gains from the sale of timber. The IRS assessed income tax deficiencies against both taxpayers after their deaths on account of their allegedly erroneous treatment of these items. Those taxes were deducted against their estates, thus reducing their estate taxes. Although the government allowed the statute of limitations to run on any additional assessment of estate taxes, it sought to recoup claims for taxes

490. In Bull the inconsistent claims to income and estate taxes were against funds that were paid to the personal representative after the decedent's death and as to which there could be no pre-death income tax liability. See supra notes 304-36 and accompanying text.
491. Herring, 240 F.2d at 228. In Bowcut the district court held that estate and income taxes arose from the same transaction, and the government did not pursue the issue on appeal. 287 F.2d at 656, n.1.
492. See, e.g., Estate of Mann v. United States, 731 F.2d 267, 279 (5th Cir. 1984) (agreeing with the court below that a deduction for income tax purposes and the failure to later include the refund claims as an estate asset is not "a single transaction").
493. 610 F.2d 703 (Ct. Cl. 1979).
494. Id. at 706-07; see I.R.C. § 631(b) (1994).
against the estates’ successful income tax refund claims. The court sustained the taxpayers’ deductions against ordinary income.

The court rejected the government’s recoupment claims because the income and estate taxes the government sought to offset for recoupment purposes did not arise out of common transactions. 495 In so holding the court seized upon an obvious distinction between the two claims in both cases: one related to tax treatment of timber maintenance expenses while the other related to the deduction from the estate. 496 That the allowability vel non of the taxpayers’ deductions affected both the claims of the taxpayer and the government did “not convert the two transactions into a single one.” 497

This holding is logically defensible, but it is not consistent with Herring or Bowcut. While not citing any particular decisions concerning the scope of a transaction for purposes of recoupment, the court acknowledged that there had been differences of opinion:

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. There is a large group of cases, however, somewhere in between. Where a case is within this middle range, so that the answer is more difficult to determine—and the present cases are of that type—it is important to consider the policy considerations the equitable recoupment doctrine is designed to implement. 498

The “policy considerations” highlighted by the court were those of Electric Storage Battery. For example, the court stated that “[t]he statute of limitations itself rests upon concepts of fairness, and an expansive application of equitable recoupment ‘would seriously undermine the statute of limitations in tax matters.’” 499 Thus, the taxpayers were able to enjoy double, inconsistent tax benefits related to tax treatment of their timber maintenance expenses.

Consistent with Wilmington Trust is Parker v. United States, 500 which involved estate taxes on the estates of two decedents. In Parker the taxpayers, after the death of their mother, resolved an estate dispute with their stepfather by creating a trust in which they were beneficiaries. The trust property was not included in the mother’s estate. At the stepfather’s death, the trust was included

495. Wilmington Trust Co., 610 F.2d at 713.
496. Id. at 714.
497. Id.
498. Id.
499. Id. (quoting Rothensies v. Electric Storage Battery Co., 329 U.S. 296, 302 (1946)).
in his estate, which paid estate tax on its value. The taxpayers filed as beneficiaries for a refund on the basis that the trust property was not includible in the stepfather’s estate. The taxpayers ultimately prevailed on this claim.\textsuperscript{501}

The government made a claim for recoupment on the basis that the trust property should have been included in the mother’s estate. The court agreed, but held that the erroneous payment of estate tax by the stepfather’s estate and the failure of the mother’s estate to pay tax represented two separate transactions.\textsuperscript{502} The facts that taxing the trust property to both estates was legally inconsistent under the circumstances and the claim for taxes against both estates was against the same property did not mean that those claims related to the same transaction. Like \textit{Wilmington Trust, Parker} is difficult to distinguish from \textit{Herring} and \textit{Bowcut}.\textsuperscript{503}

Another recent decision taking a restrictive view of a transaction, and one also influenced by \textit{Dalm}, is \textit{Harrah v. United States}.\textsuperscript{504} In that case, when decedent died in 1978, his estate included nearly six million shares of Harrah’s, Inc. In 1980 Harrah’s merged with Holiday Inns, Inc. In the merger the estate received cash, a promissory note, and convertible debentures. The value of the debentures was a factor in the value of the Harrah’s stock for purposes of the estate’s 1979 estate tax return, the estate’s income tax return for 1980 (the year of the merger), and other dispositions of stock obtained on conversion of the debentures by the estate and a trust in 1983 and 1984.

The value of the Harrah’s stock in the estate was not established until 1986. The estate had made a timely claim for a refund as to 1980, but not as to 1983 and 1984.\textsuperscript{505} Owing to the higher basis entailed in the estate tax valuation of the stock, the estate sought recoupment with respect to its 1983 and 1984 income taxes, and the trust sought recoupment with respect to its 1984 income taxes. In response to the obvious problem created by \textit{Dalm}, the taxpayer sought recoupment with respect to 1980, which it had kept open.\textsuperscript{506}

The court rejected these attempts to use recoupment. It acknowledged the factual relationship among all the refund claims and the issue of the stock’s basis, but regarded stock dispositions in 1983 and 1984 as transactions separate

501. \textit{Parker}, 110 F.3d at 685.

502. \textit{Id.} at 684.

503. In \textit{Estate of Vitt v. United States}, 706 F.2d 871 (8th Cir. 1983), the same real estate was included in the estate of both decedents, husband and wife. The wife’s estate sought recoupment for barred estate taxes paid by husband’s estate. The government argued that recoupment was inapplicable because the deaths of the two spouses were two separate taxable events. \textit{Id.} at 875. The court rejected the government’s contention, holding instead that only a single transaction by one of the spouses, an inter vivos transfer while retaining a life estate, resulted in the imposition of both taxes. \textit{Id.}

504. 77 F.3d 1122 (9th Cir. 1995).

505. \textit{Id.} at 1124. Additionally, the trust had not made a timely refund claim for 1984. \textit{Id.}

506. \textit{Id.} This was an unusual attempt to use recoupment because the taxpayer, rather than seeking to offset the opponent’s claim, was attempting to augment its own claim for refund with respect to an open year.
from those of 1980. This construction of a transaction is not illogical, but as this discussion demonstrates, it is not consistent with all decisions in this area.

It is not surprising, in light of Electric Storage Battery and Dalm, that courts have generally come to construe the transaction requirement restrictively. It is also not surprising, in light of the lack of statutory guidance for recoupment, that the course of decisions has been somewhat erratic.

2. The Identity of Interest Requirement

Whenever those with claims involving different taxpayers have sought recoupment, the courts have insisted on complete overlap of interest of such taxpayers. Stone v. White did not explicitly set out this requirement, but the lower courts have viewed it as necessary to keep equitable recoupment strictly within the bounds set out in Supreme Court decisions. If recoupment will adversely affect one other than the taxpayer against whom the barred claim might have been timely asserted, or one who shares a common interest with such taxpayer, the courts refuse recoupment.

Smith v. United States provides an example. In Smith the taxpayer was a trust that collected sums on notes and, in turn, paid such sums to a trust beneficiary. The beneficiary reported the payments as capital gain. In auditing the beneficiary’s income tax returns for 1953 and 1954, the IRS determined an overassessment. It applied this to a deficiency assessed against the trustee which was based on its determination that payments on the notes represented ordinary income. On the trustee’s suit for refund, the district court agreed that the payments represented ordinary income, but held that they were not taxable to the trust but, rather, to the beneficiary. However, the trial court allowed the barred claim against the beneficiary to be offset against the trustee’s refund.

The Fourth Circuit did not agree with the trial court. It noted that the remaindersmen of the trust were not known and that denial of the trust’s refund would injure them. It also noted that the beneficiary was neither a party nor was represented in the suit. It concluded that “[e]quitable relief will not be granted to the possible detriment of innocent third parties.” The court’s holding

507. Id. at 1127.
508. 301 U.S. 532 (1937).
509. As noted earlier, see supra notes 337-51 and accompanying text, Stone involved use of recoupment by the government against a refund claim by an estate which had erroneously been required by the government to report its income payments from a trust to a decedent’s widow. A claim against the widow, who should have reported such payments, was barred. The widow, however, was decedent’s sole beneficiary. Stone, 301 U.S. at 533. The Court allowed the government to recoup the barred claim against the widow with the claim by the estate stating “whether the tax is paid by one or the other, its source is the fund which should pay the tax, and only the equitable owner of the fund is ultimately burdened.” Id. at 537-38.
510. 373 F.2d 419 (4th Cir. 1966).
511. Id. at 421.
512. Id. at 420-21.
513. Id. at 423-24.
sanctioned at least a partial unjust enrichment to the beneficiary\textsuperscript{514} simply because recoupment would have adversely affected another.

*Kramer v. United States*\textsuperscript{515} provides another example. The plaintiffs in *Kramer* were executors of a decedent's estate. As part of its employment agreement with the decedent, the decedent's employer agreed to pay his widow $150.00 per week for life. Following the death of the decedent, the government sought to include the value of this agreement in the decedent's estate as an annuity.\textsuperscript{516} When the IRS took this action, the decedent's widow sought a refund under I.R.C. § 691(c).\textsuperscript{517} The IRS allowed such refund.\textsuperscript{518}

When the Court of Claims held that I.R.C. § 2039 did not require inclusion of the value of payments to the widow in the estate, the government sought recoupment of a barred claim against the widow for the erroneous refund. Although the widow, suing on behalf of the estate, was the plaintiff in the suit, the court refused to allow the government to use recoupment.\textsuperscript{519}

The court found recoupment inapplicable because under Ohio law the widow had but a life tenancy in the property of the estate. Remaindermen had a vested interest in the estate that would benefit by a refund to the estate.\textsuperscript{520} Lack of complete overlap between the parties to the open claim and the claim sought to be offset against it again resulted in denial of recoupment.\textsuperscript{521} Even the

\textsuperscript{514} The unjust enrichment was in the amount of the difference between treating the payments as capital gain and ordinary income assuming that the trust remitted the refund to the beneficiary.

\textsuperscript{515} 406 F.2d 1363 (Ct. Cl. 1969).

\textsuperscript{516} See I.R.C. § 2039 (1994).

\textsuperscript{517} I.R.C. § 691(c) (1994). This subsection allows a taxpayer that must report income in respect of a decedent to deduct a proportionate share of estate taxes attributable to the value of such income for estate tax purposes.

\textsuperscript{518} *Kramer*, 406 F.2d at 1365.

\textsuperscript{519} Id. at 1371.

\textsuperscript{520} Id.

\textsuperscript{521} In a more recent and unusual equitable recoupment case, *Lockheed Sanders, Inc. v. United States*, 862 F. Supp. 677 (D.N.H. 1994), the plaintiff in a refund action urged that:

\begin{quote}
[I]n all cases where the equitable recoupment doctrine has been invoked, there has been a complete identity of interest between the taxpayer in both the year barred from assessment by the statute of limitations and the later year where the government seeks to invoke the doctrine as a defense against a refund.
\end{quote}

*Id.* at 682 (emphasis added).

In *Lockheed Sanders* the taxpayer had acquired all the stock of Calcomp which, in turn, had acquired a large amount of the stock of a third corporation, CDS. Calcomp had filed consolidated returns with CDS. The IRS disputed whether Calcomp had acquired more than 80% of CDS stock—thereby gaining its eligibility to file a consolidated return with CDS—but the court held the claim barred. Lockheed Sanders sought a refund on the basis of its attempt to remove CDS from consolidated returns to free up credits and net operating loss carrybacks and carryforwards. *Id.* at 679.

The court rejected the attempt by the government to offset taxpayer's claims against the barred claims related to the consolidated returns. Although the court spoke in terms of
few cases in which the identity of interest requirement has been at issue and in which it was found to be met demonstrate that it is a significant barrier to recoupment.\footnote{522}

Although decisions of lower federal courts pertaining to equitable recoupment are not completely consistent with each other, particularly with respect to the same transaction requirement, for the most part one may view them as carrying out the mandate of Electric Storage Battery and Dalm to limit equitable recoupment.

V. PROPOSAL AND RATIONALE FOR REPLACING MITIGATION WITH A STATUTORY VERSION OF RECOUPMENT

"sufficient identity of interest between Lockheed [Sanders] and the owners of CDS at the time CDS joined in Calcomp's consolidated return," it accepted the plaintiff's contention that complete identity was necessary. \textit{Id.} at 682. The court rejected recoupment because there were minority shareholders (i.e., shareholders other than Calcomp) in CDS who had benefited from the earlier resort to a consolidated return by Calcomp and would now be unaffected by use of recoupment against the plaintiff. The court stated that to ignore the interests of such minority shareholders "would broaden the doctrine beyond the limited scope mandated by the Court in Rothensies \textit{v. Electric Storage Battery Co.})\textquoteleft; \textit{Id.}

522. In \textit{Estate of Vitt v. United States}, 706 F.2d 871 (8th Cir. 1983) the government, because of an intervening change in its view on estate taxation of property, see Rev. Rul. 69-577, 1969-2 C.B. 173 (revoking Rev. Rul. 57-448, 1957-2 C.B. 618), sought inconsistently to tax a portion of the value of real property to the estates of both spouses of a deceased married couple. The government, on the basis of the identity of interest requirement, resisted the attempt by the estate of the spouse who died second to recoup estate taxes against a barred claim for estate taxes of the estate of the spouse who died first. Under the circumstances, however, the court found that the identity of interest requirement had been met. \textit{Vitt}, 706 F.2d at 875. Both spouses had created interests in the property—life interests in their children, remainder to their grandchildren—that were unaffected by estate proceedings. The same persons detrimentally affected by the overpayment of taxes by the estate of one spouse would benefit from recoupment of such overpayment by the estate of the other spouse. \textit{Id.} at 875, n.3.

In \textit{McMullan v. United States}, 78-2 U.S. Tax Cas. (CCH) ¶ 9656 (Ct. Cl. 1978), the government enjoyed a short-lived triumph in the identity of interest requirement. In that case a decedent's estate successfully adjudicated an issue about decedent's predeath income taxes. The government contended that the estate's success in reducing decedent's income taxes necessarily reduced the deduction for income taxes previously allowed the estate. The government thus sought to recoup barred estate taxes against the estate's income tax refund. \textit{Id.} at 85, 178.

The refund action was pursued by decedent's widow and his estate represented by the widow as executrix. Although it was not clear that there were no beneficiaries to the estate other than the widow, the court focused only on the interests of the estate, sidestepping the interests of the widow as an individual with respect to the identity of interest requirement. The court determined that the estate alone had been entitled to a deduction for decedent's income taxes. \textit{Id.} at 85, 184 (citing to Treas. Reg. § 20.2053-6(f) (1958)). Thus the widow had no individual interest in the deduction of income taxes by the estate or recoupment of the benefit of the deduction against the estate's income tax refund. At any rate, the effect of the Trial Division's holding in McMullan was nullified in Wilmington Trust Co. \textit{v. United States}, 610 F.2d 703, 713 (Ct. Cl. 1979), which denied recoupment in McMullan and a companion case on the basis that the government's claims for recoupment failed the same transaction requirement.
The current mitigation provisions poorly redress multiyear inequities created by the tax law. The principle of recoupment, on the other hand, can correct such inequities while simultaneously preserving the advantages of annual accounting and the statute of limitations. The following is the text of a proposal which would embody recoupment.

A. Proposed Statutory Change

1. Section 1311 Demand for Consideration of Tax Consequences of Otherwise Barred Taxable Years

(a) If a determination (1) sought by a taxpayer with respect to a transaction would, because of treatment of such transaction in a different taxable year, result in (a) double allowance of a deduction or credit, (b) double exclusion of income or otherwise multiple inconsistent tax benefits from such transaction; or (2) sought by the Secretary with respect to a transaction would, on account of treatment of such transaction in a different taxable year, result in (a) double disallowance of a deduction or credit, (b) double inclusion of income or otherwise multiple inconsistent taxation of such transaction, then the Secretary or any court from which such determination is sought, shall, upon demand of the Secretary or the taxpayer, as provided in section 1312, and notwithstanding any statute pertaining to limitations or other rule of law, take into consideration in making such determination and make appropriate adjustment for the different reporting of such transaction by the taxpayer, or the different treatment of such transaction by the Secretary, in order that such determination shall be consistent with proper taxation as a whole of such transaction. No adjustment under this section shall, if sought by the taxpayer, exceed the amount of tax sought by the Secretary or, if sought by the Secretary, exceed the tax refund claimed by the taxpayer. In determining the amount of adjustment under this section, there shall be no calculation of interest.

(b) Definitions

(1) For purposes of this section and section 1312, "taxpayer" means the taxpayer who seeks the determination or a related taxpayer.

(2) For purposes of paragraph (1), "related taxpayer" means a taxpayer who, with respect to the taxpayer seeking the determination, stood in the different taxable year the tax consequences of which are considered in the determination, in one of the following relationships:

(A) husband and wife,

(B) grantor and fiduciary,

523. See I.R.C. § 1311 (1994) for a comparison of the original to the proposed statutory changes.

(C) grantor and beneficiary,
(D) fiduciary and beneficiary, legatee or heir,
(E) decedent and decedent's estate,
(F) partner,
(G) member of an affiliated group of corporations (as defined in section 1504), or
(H) transferor of property to taxpayer in a disposition with respect to which the determination establishes the recognition or nonrecognition of gain by the transferor was erroneous.

(3) For purposes of this section and section 1312, "determination" means:

(A) the disposition of a claim for refund by the Secretary, or
(B) a decision of the Tax Court, the Court of Federal Claims, or a United States District Court.

(4) For purposes of this section and section 1312, "transaction" means a circumstance or set of related circumstances that gives rise to a liability for federal tax or to any tax benefit or reduction in tax.

(5) For purposes of this section and section 1312, "inconsistent" means that which negates the factual premise on which tax treatment of a transaction in a barred year is based.

(6) For purposes of this section and section 1312, "tax" means all taxes that may be imposed on a transaction under the Internal Revenue Code of 1986.

2. **Section 1312 Manner of Making Demand**

(a) The demand for consideration of the tax consequences of a different taxable year shall be made:

(1) with respect to a determination as defined in subparagraph (b)(3)(A) of section 1311, by the Secretary in his or her disposition of the taxpayer's claim for refund;

(2) with respect to a determination as defined in subparagraph (b)(3)(B) of section 1311:

(A) by the taxpayer in his petition to the Tax Court or complaint in the Court of Federal Claims or a United States District Court, or such amended pleading as is permitted by rules of such courts, or

(B) by the Secretary in his or her responsive pleading in the Tax Court, the Court of Federal Claims, a United States District Court, or such amended pleading as is permitted by rules of such court.


526. In recognition of the administrative burdens on the government, particularly when such inconsistent treatment involves related taxpayers, the proposed statute perhaps should include a provision allowing the IRS to assert a deficiency within one year after a determination creates an inequitable inconsistency with a barred year if (a) it can prove by clear and convincing
B. Explanation of Provisions

The above proposal permits tax consequences of closed years to be considered to prevent inequitably inconsistent results as to open years. One seeking consideration of closed years may not obtain affirmative recovery. An explanation of how its provisions would work is provided below.

1. Change in the Timing of Demands for Adjustment

Under the mitigation provisions, a court may not make an adjustment based on tax treatment of a closed year until there has been a determination as defined in I.R.C. § 1313(a). Often such a determination is the product of completed litigation. For purposes of the statute proposed herein, a determination is either a disposition by the Secretary of a claim for refund or an adjudication by a court. An adjustment taking into account the tax treatment of a barred year may be made when a refund sought by taxpayer or an adjudication sought by taxpayer or the government would create inequitably inconsistent double taxation or tax benefit. The IRS or a court may adjust any refund or judgment sought to prevent an inequitable inconsistency with a barred year.

When a determination that would create tax treatment of a transaction inconsistent with a barred year is sought, the proposed statute generally places the burden on the responding or defending party to identify the inconsistency and demand an adjustment. In recognition of the administrative burdens on the government, particularly when such inconsistent tax treatment involves related taxpayers, the IRS may determine a deficiency within one year after a determination creates an inequitable inconsistency with a barred year if it proves by clear and convincing evidence that it was unaware that the determination might result in a double or otherwise multiple inconsistent tax benefit to the taxpayer and that it could not have learned through reasonable diligence that such result might occur.

2. Change in the Circumstances in Which Adjustments May Be Demanded

The mitigation provisions allow adjustments in only seven circumstances. In contrast, the statute proposed herein allows an adjustment to reflect tax consequences of a transaction in a barred year as to any inconsistent treatment sought in a determination concerning an open year about

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evidence that it was unaware that the determination might result in a double or otherwise multiple inconsistent tax benefit to the taxpayer, and (b) that it could not have learned through reasonable diligence that such a result might occur.

527. I.R.C. § 1312.
the same transaction.

Under the proposed statute, "transaction" has a broader meaning than it has come to be construed in the case law of equitable recoupment. It is defined as the circumstance or set of related circumstances that gives rise to liability for federal tax or to any tax benefit or reduction in tax. This definition does not necessarily fix a transaction to one particular year. It acknowledges, notwithstanding the primacy of annual accounting, that taxes and tax benefits or reductions are often the product of circumstances that span more than one taxable year. Although both mitigation and recoupment also acknowledge that transactions may have multiyear components, recoupment employs a restrictive notion of transaction and mitigation functions only in a specified list of multiyear transactions. The contrast between the statute proposed herein and mitigation regarding the definition and function of transaction may be seen in a consideration of O'Brien v. United States. This case involves the basis portion of the mitigation provisions, the only provision that itself specifically employs the term "transaction."

In O'Brien the estate of a decedent in 1974 valued stock for estate tax purposes at $215.7796 per share. The IRS disputed this valuation. In 1975 the corporation in which the stock was held was liquidated. In computing gain on liquidation, the estate used the above valuation. In 1980 the stock's value for estate tax purposes was established in the Tax Court as $280.10 per share. Because this would reduce the estate's capital gain on the liquidation distribution, the estate sought an adjustment against additional estate taxes based on the higher valuation.

The court held that mitigation was inapplicable and that there would be no adjustment for the erroneously overpaid capital gain. The court separated the operative facts of estate and income taxation of the estate into two transactions: the transfer of the stock at decedent's death, on which basis depended, and the liquidating distribution the following year. Because the error was not in respect of the transaction that determined basis, mitigation was inapplicable.

Under the statute proposed herein, a taxpayer such as the estate in O'Brien would be able to demand an adjustment in estate taxes should the Tax Court impose higher estate taxes based on a higher valuation of stock in the estate. This adjustment would reflect the lower capital gain on the liquidating distribution that the higher valuation at decedent's death would represent. In keeping with the traditional notion of recoupment, such an adjustment to the tax consequences of an open year may only diminish recovery of the

528. 766 F.2d 1038 (7th Cir. 1985).
530. 766 F.2d at 1040.
531. Id.
532. Id. at 1043.
533. Id.

https://scholarcommons.sc.edu/sclr/vol51/iss1/4
government for taxes or of the taxpayer for a refund. If a taxpayer is litigating in Tax Court, the adjustment may be considered in any redetermination of the deficiency. In contrast to the mitigation provisions, the proposed statute would require the estate to bring to the attention of the tribunal the inequity that would result from the tax consequences sought by the government—higher estate valuation, and hence, higher estate taxes—if consequences dependent upon the matter at issue in a barred year are not considered. The proposed statute permits the court to avert the potential inequity if the matter is called to its attention.

But what sort of inequity may a tribunal or the IRS, in disposing of a refund claim, avert? At first blush, the proposed statute’s definition of transaction (i.e., circumstance or set of related circumstances giving rise to a liability for federal tax or to any tax benefit or reduction in tax) may seem unduly broad. The statute, however, requires multiple, inconsistent tax benefit or liability. Inconsistent is defined as “that which negates the factual premise on which tax treatment of a transaction in a barred year is based.”

This language is derived from the brief for the government in Hillsboro National Bank v. Commissioner. Hillsboro involved the tax benefit rule, which, like mitigation and equitable recoupment, seeks “to approximate the results produced by a tax system based on transactional rather than annual accounting.” In the companion case in Hillsboro, the government sought to require the taxpayers to report income to offset deductions they had enjoyed in earlier years. The Court held that the government may require a taxpayer to

535. See I.R.C. § 6214(a) (1994). The proposed statute would require an amendment to I.R.C. § 6214 to prevent the Tax Court from increasing a deficiency based on taxes from a barred year.

536. See supra Part V.A.1.

537. Brief for Commissioner at 7.


539. Id. at 381.

540. In Hillsboro an incorporated bank paid Illinois personal property taxes on its shares for its shareholders. It deducted these taxes under I.R.C. § 164(c) (1954). After a state court upheld the repeal of the tax, the County Treasurer refunded taxes, held in escrow, to the shareholders. The government contended, unsuccessfully, that the refund of the tax to the shareholders should be reported as income by the bank because it was inconsistent with the bank’s earlier deduction. Hillsboro, 460 U.S. at 372-73.

In United States v. Bliss Dairy, Inc., 460 U.S. 370 (1983), the companion case to Hillsboro, a closely held corporation operating a dairy deducted the cost of purchases of cattle feed. In the next taxable year, it adopted a plan of liquidation under then I.R.C. § 336 (1954) (repealed by Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2269). Hillsboro, 460 U.S. at 374. Pursuant to this plan, the corporation distributed the assets, including a substantial portion of the feed, to the shareholders. The shareholders, who operated the dairy in a noncorporate form, allocated part of their basis in its assets to the feed and deducted the amount as a business expense under I.R.C. § 162 (1954). Hillsboro, 460 U.S. at 376. The government contended, successfully, that the deduction by the shareholders of a portion of the same feed, the cost of which the corporation had deducted, amounted to a double deduction for the same cattle feed. Brief for the Commissioner at 11-12. This required the corporation to report as income the amount deducted later by the shareholders. Hillsboro, 460 U.S. at 389.
report income in a later year when an event inconsistent with a deduction occurs that, had it occurred in the year of the deduction, would have resulted in disallowance of such deduction.\textsuperscript{541}

The circumstances today addressed by mitigation and equitable recoupment involve a tax problem that is both different from and related to that in \textit{Hillsboro}. They are different because, in cases such as \textit{Hillsboro}, the taxpayer's actions in the year she enjoys the tax benefit are proper. An event that occurs later renders inequitable the benefit enjoyed earlier. Mitigation and recoupment both entail assumptions that the taxpayer's actions in a closed year were wrong. The problems addressed by mitigation and recoupment, on one hand, and the tax benefit rule, on the other, are related in that all address the inequities of annual accounting; all counteract incompatibly multiple benefits or burdens in spite of the statute of limitations.

Although the Court in \textit{Hillsboro} did not explicitly adopt the government's formulation of the prerequisite for the tax benefit rule (\textit{i.e.}, that "subsequent events establish the invalidity of the factual premise" on which an earlier deduction is based\textsuperscript{542}), it instead spoke of a later event being "fundamentally inconsistent" with the premise on which a deduction is based.\textsuperscript{543} The test proposed by the government in \textit{Hillsboro} appears more focused and precise and, hence, a more appropriate qualification for a mechanism that may sometimes sidestep the statute of limitations. That is why it is embraced herein. The degree of inconsistency between a determination sought for an open year and treatment of the same transaction in a closed year should be a stark "either, or." If the item must be reported in 1996, it cannot properly be subject to tax in 1995; if A and B are equal partners in 1997, and B is thus compelled to report 50% of the partnership income, A cannot be liable on 100% of such income for the same year.\textsuperscript{544}

The proposed statute allows an adjustment based on tax consequences of a transaction in a closed year only when such consequences entail an inequitable inconsistency—a negating of the factual premise of consequences of the same transaction sought in the open year. Allowing an adjustment under such circumstances entails substitution of an open-ended test for the exclusive list of circumstances in which mitigation is allowable. The inconsistency requirement of the proposed statute—mutual exclusivity of tax treatment in the two years as a condition of an adjustment—is intended to foster the same

\textsuperscript{541} \textit{Hillsboro}, 460 U.S. at 389.
\textsuperscript{542} Brief for Commissioner at 7.
\textsuperscript{543} \textit{Hillsboro}, 460 U.S. at 385.
\textsuperscript{544} \textit{Hillsboro} involves the inclusionary aspect of the tax benefit rule, which requires recapture of a benefit as income if its premise is undermined in another year. The rule has an exclusionary aspect also, which limits this recapture to the amount that an earlier deduction has reduced a taxpayer's taxes. See I.R.C. § 111(a) (1994). Although the rule urged by the government in \textit{Hillsboro} would have applied only to require a taxpayer to report income (or not), it may just as sensibly be employed under the proposed statute to preclude the government from benefitting from a multiyear inconsistency.
protection of the statute of limitations as the exclusive list of circumstances of adjustment in I.R.C. § 1312.

3. Transactions Involving Related Taxpayers

The proposed statute permits adjustments for an open year because of tax treatment of the same transaction in a barred year by related taxpayer. The proposal preserves the catalogue of relationships in which adjustments are permitted under the mitigation provisions. An innovative feature of the proposal is the inclusion in the definition of related taxpayers of certain transferors to taxpayer of property about which a determination of tax consequences is sought. An adjustment is permitted if a determination is sought by a taxpayer for an open year that would result in the sort of inconsistency of double tax benefit or double taxation that would allow an adjustment if tax treatment of the property in both years involved the same taxpayer. Defining a transferor as a related taxpayer in such circumstances provides a substitute in situations involving more than one taxpayer for the current provision that treats certain errors relating to basis as circumstances of adjustment for mitigation. As to errors related to basis that do not involve more than one taxpayer, the proposed statute does not require a specific provision. An adjustment is allowed for an open year if a taxpayer or the government seeks a determination that would result in treatment inconsistent with basis or an item affecting basis in a closed year. The same is true if the taxpayer or the government seeks a determination for an open year that would be similarly inconsistent with basis or an item affecting basis by another taxpayer who has transferred property to the taxpayer seeking the determination, and such determination establishes that recognition or nonrecognition of gain by the transferor was erroneous.

The proposed statute is broader than the mitigation provisions in that it does not contain a closed-ended set of circumstances in which errors related to basis may be corrected. On the other hand, the proposed statute is narrower than I.R.C. § 1312(7) in that it would not allow an adjustment by or against a party that has simply sold property in an arm’s-length transaction to one that later obtains a determination that his transferor has committed some sort of error with respect to basis. That possibility under the current mitigation provision, in light of its potential harshness, has perhaps warranted the miserly construction of I.R.C. § 1312(7) in the courts.

If an adjustment is sought by or against a related taxpayer and such a

545. See I.R.C. § 1313(c) (1994).
546. I.R.C. § 1312(7)(B)(ii) (1994) allows an adjustment for erroneous treatment of a second taxpayer who acquired title to the property in the transaction in which the error occurred and from whom the taxpayer that obtained the determination, mediately or immediately, derived title; I.R.C. § 1312(7)(B)(iii) permits an adjustment as to a second taxpayer that had title at the time of the transaction that gave rise to the error and from whom the taxpayer who obtained the determination derived title if the basis of such taxpayer is determined under I.R.C. § 1015(a).
taxpayer is not a the beneficiary of an estate or trust or a partner subject to notice under the proposed statute, such taxpayer has one year from the determination to seek an adjustment by a claim for refund. If the taxpayer is subject to notice, she must be given an opportunity to intervene in the proceeding in which a determination is sought. If the government can demonstrate by clear and convincing evidence, following a determination that brings about multiple, inconsistent tax benefits with respect to a transaction, that it was not aware of the possibility of the inconsistency and could not by reasonable diligence have become aware of it, then the government may within one year of the determination seek an adjustment by notice of deficiency to the taxpayer or related taxpayer.

C. Why the Proposed Statute Is Preferable to the Current Mitigation Provisions

The current mitigation provisions have generated much criticism, and rightly so. They are extremely complex, both facially and in their application. The primary difficulty in applying the mitigation provisions is determining which tax inequities fit within the limited circumstances to which mitigation applies. Limiting mitigation to a closed-ended list of circumstances creates both a linguistic conundrum about whether particular inequities fit any circumstance on the list and capriciously neglects inconsistencies that cry out for adjustment.

The discussion in Part III identified two areas in which mitigation's restricted circumstances have prevented redress of tax inequities that are not significantly different from those for which mitigation is available. These two areas involve the limitation generally of mitigation in I.R.C. § 1312 to circumstances of adjustment and, more particularly, in I.R.C. § 1312(7) with respect to a limited number of errors related to basis of property.

Most circumstances of adjustment require that the opponent of the party seeking adjustment has maintained a position with a determination that is inconsistent with earlier tax treatment of the item involved in such determination.\(^{547}\) Some courts have required that this inconsistency be active. This approach has led to difficulty in determining whether particular inequities involved were purposefully brought about through inconsistent advocacy. In instances in which that was not found to be the case, the approach has produced a failure to redress tax inequities.

In contrast to the mitigation provisions, the proposed statute adopts a no-fault approach towards inconsistencies. When the present provisions require an active inconsistency, they have sometimes required detailed analysis of the motives and actions of the parties to a transaction. The proposal herein focuses on the inconsistency alone as a sufficient basis for redress without respect to

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547. This requirement does not apply to the circumstances of adjustment in I.R.C. § 1312(3)(B) (relating to double exclusions from income) and I.R.C. § 1312(4) (relating to double disallowance of deductions or credits).
which party caused it or the motives of such party.

Finally, the proposal herein places a burden on the taxpayer and the government to be attentive to the possibility that a determination in a refund claim or litigation may create an inequitable inconsistency with tax treatment of a transaction in a closed year. The taxpayer or the government must generally act to prevent an inequitable adjudication from taking place by preemptively seeking adjustment for the earlier treatment of the transaction. This approach is more consistent with modern doctrines of former adjudication that prevent parties from holding back issues to litigate another day.

D. Allowance of a Recoupment Adjustment in All Instances in Which Inequitably Inconsistent Treatment of a Transaction Is Sought

Under the current mitigation provisions, far too much judicial energy has been expended on whether particular inequitable inconsistencies fit within the circumstances of adjustment. A catalogue of circumstances was deemed necessary to limit the effect of mitigation—but is that really necessary? No such catalogue has limited the scope of the tax benefit rule, which also may override the effect of the statute of limitations. The tax benefit rule is applied on a case-by-case basis.548 It redresses a generic inconsistency regardless of the type of transaction.549 No evidence demonstrates that failure to limit application of the tax benefit rule to particular specified circumstances has gravely compromised the policies underlying the statute of limitations. The statute proposed herein would allow an adjustment in circumstances in which tax treatment of a transaction sought by taxpayer or the government would create the sort of inconsistency that would invoke the tax benefit rule. The party seeking a determination is not permitted to enjoy the consequences sought without adjustment for earlier inconsistent treatment of the same transaction.

The difference in this respect between the operation of the statute proposed herein and mitigation may be seen by revisiting the egregious circumstances of B. C. Cook & Sons, Inc. v. Commissioner.550 As described earlier, the taxpayer in 1965 discovered that its bookkeeper had embezzled over $800,000 in tax years 1958 through 1965 through fictitious fruit purchases. Because these purchases had been treated as part of cost of goods sold, the IRS sought to deny

548. Hillsboro, 460 U.S. at 385.
549. The exclusionary aspect of the tax benefit rule, codified at I.R.C. § 111 (1994), which limits taxation of recoveries of previously deducted items to the amount of the benefit enjoyed, has also been deemed by the IRS to apply generally to all such recoveries. See Treas. Reg. § 1.111-1(a)(1) (1999).
550. 65 T.C. 422 (1975). This case was discussed in Part III, see supra notes 105-23 and accompanying text, and was described as Cook II. An earlier related case, B. C. Cook & Sons, Inc. v. Commissioner, 59 T.C. 516 (1972), was also discussed supra notes 105-23 and referred to as Cook I.
nearly half of the theft loss. In *Cook I* the Tax Court opined that the IRS would have to use mitigation to reckon with consequences inconsistent with allowance of the theft deduction. In *Cook II* the Tax Court then held that mitigation was inapplicable because an overstatement of cost of goods sold is not a deduction within the meaning of I.R.C. § 1312(2). Whether or not the semantics of the Tax Court were correct, if the tax law is to contain *any* sort of corrective mechanism for multiyear anomalies, such mechanism should have provided relief to the government in *Cook II*. Treatment of the embezzled monies in different years was logically incompatible and taxpayer should not have benefitted by refusal of the court to account for tax consequences of closed years.

VI. CONCLUSION

The catalogue of errors in I.R.C. § 1312 reflects a legislative determination that such errors represent logical incompatibility of tax consequences in open years with those in closed years. The mitigation provisions reflect a determination that it is better for the legislature to set out the errors in advance. Whatever uncertainty about the statute of limitations has been avoided by that determination, it has been at the expense of a great deal of uncertainty and litigation about the meaning of the mitigation provisions themselves. The courts do not need advance legislative restriction or delineation in order to recognize the sort of inequity involved in permitting a taxpayer to hide behind the statute of limitations. The courts’ time and effort would be more effectively employed addressing inequities within the scope of the statute proposed herein rather than untangling the complexities of a statute that after six decades still mystifies practitioners.

The most significant aspect of the proposed statute is that it relies upon the courts, without strict legislative definition, to recognize and correct inequities caused by a combination of the statute of limitations and the annual accounting principle. It relies on the courts to do so without unduly compromising either the statute of limitations or annual accounting.

The proposal entrusts the courts with recoupment. That they have employed this remedy so cautiously in the past is compelling evidence that they would employ it carefully in the future. Their hesitation has been based not on the repugnance of the remedy itself, but rather on the lack of explicit legislative

552. 59 T.C. at 521.
553. 65 T.C. at 428.
authorization for its use. That concern was appropriate, but it in no way calls into question the efficacy of the remedy or its preferability to mitigation. It is time for Congress to adopt a statutory version of recoupment and to discard the mitigation provisions.