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Recoupment and the Statute of Limitations in Tax Cases

Chester S. Jones

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Cases dealing with the scope of the power of a municipal corporation to regulate religious solicitation by ordinance, *(as an agent of the State),* for the protection of the citizens living within the municipality, have held that neither arbitrary nor absolute suppression of views is valid.[6] On the other hand, where an ordinance of a municipal corporation merely requires one to have a permit to solicit, sell or distribute literature, such ordinance is valid if the permit is issued as a matter of course upon application without any discretion on the part of a city official.[7]

The majority opinion in the principle case recognizes the fact that, had Chickasaw been a municipal corporation, the conviction by the Alabama Court must surely be reversed;[8] but Chickasaw *is* a company-owned town and in that sense is private property. But what about the citizens living there? They are just like citizens living elsewhere and entitled to hear whatever they wish without having arbitrary rules made for them by their immediate government. The majority opinion recognizes these points and follows the decisions restricting the States and their agencies of local government from infringing on freedom of religion, of the press, and of speech.[9]

It would seem that management of a company-owned town is a governmental function, therefore it is unnecessary to balance property rights against the rights of free speech. And since the protection of civil liberties is of great concern and the desirable result for this case, it would have been better to have said that a company-owned town is a quasi-municipal corporation and as such must be limited in its powers of regulation, instead of saying that the rights of a property owner are subordinate to the individual's right of free speech and religion. Ostensibly, this is the only justification for the holding of the majority opinion. Thus the Supreme Court would have protected the civil liberty involved and at the same time avoided the seemingly dangerous principle of subordinating property rights to individual civil liberty.

RICHARD BOSTWICK

RECOUPMENT AND THE STATUTE OF LIMITATIONS IN TAX CASES

From 1919 to 1926 plaintiff erroneously paid an excise tax on the sale of batteries. In 1935 plaintiff sued and recovered from the Collector refund of those taxes not barred by the Statute of Limitations, i.e. back to 1922. During the years that the excise tax was collected, plaintiff deducted it from income

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6. Lovell v. City of Griffen, (1938) 303 U.S. 444, 58 Sup. Ct. 666, 82 L. Ed. 949; Hague v. C.I.O., (1939) 307 U.S. 496, 59 Sup. Ct. 954, 83 L. Ed. 1423; Schneider v. State of New Jersey, (1939) 308 U.S. 147, 60 Sup. Ct. 146, 84 L. Ed. 155.
7. City of Manchester v. Leiby, (C.C.A. 1st. Cir. 1941) 117 F. (2d) 661, Cert. denied (1941) 313 U.S. 562, 61 Sup. Ct. 838, 85 L. Ed. 1522.
8. See Marsh v. State of Alabama, (1946) 326 U.S. 501, 504, 66 Sup. Ct. 276, 277, 90 L. Ed. 227.
9. Near v. Minnesota, (1931) 283 U.S. 697, 51 Sup. Ct. 625, 75 L. Ed. 1357; Martin v. City of Struthers, (1943) 319 U. S. 141, 63 Sup. Ct. 862, 87 L. Ed. 1313; Murdock v. Pennsylvania, (1943) 319 U.S. 105, 63 Sup. Ct. 870, 87 L. Ed. 1292, 146 A.L.R. 81; dissent of Stone, C.J., in Jones v. Opelika, (1942) 316 U.S. 584, 62 Sup. Ct. 1231, 86 L. Ed. 1691, 141 A.L.R. 514, adopted as the opinion of the Court (1943) 319 U.S. 103, 63 Sup. Ct. 890, 87 L. Ed. 1290.

before calculation of income tax, thereby deriving tax benefits. The Collector, therefore, treated the refund as income for 1935, the year in which it was received, and assessed an additional income and excess profits tax. Plaintiff paid the deficiency, filed claim for refund, and after it was rejected sued the Collector. Plaintiff contended that if the excise tax refund be considered income, it should be permitted to recoup the amount of the barred excise taxes which it had erroneously paid between 1919 and 1922, against the additional income tax imposed because of the refund. The district court found in favor of plaintiff, holding that the income tax liability of 1935 should be extinguished by recoupment of the 1919 to 1922 excise taxes, and circuit court of appeals for the third circuit affirmed the judgment. On certiorari the United States Supreme Court *held,* three justices dissenting, that the judgment be reversed. The policy of the Statute of Limitations in tax matters does not permit plaintiff to be entitled to a recoupment. *Rothensies v. Electric Storage Battery Co.,* (1946) 327 U.S. 774, 67 Sup. Ct. 271, 90 L. Ed. 731.

Recoupment is a common-law right to reduce plaintiff's claim which continues so long as plaintiff's cause of action exists, and the right must grow out of or be connected with the transaction on which plaintiff sues.[1] Recoupment differs from set-off in that it is confined to matters arising out of the same transaction, it has no regard to whether the claim be liquidated or unliquidated, and if the defendant's claim exceeds the plaintiff's, he cannot in that action recover the balance due him.[2] Counterclaim is a term normally used to include both set-off and recoupment, but recoupment differs from counterclaim in one important particular as shown in *State v. Arkansas Brick & Mfg. Co.,*[3] where it is stated, "A right left to the defendant to be worked out through the doctrine of recoupment, which could not be had through a counterclaim, is to use defensively a cause of action which, as a counterclaim, would be barred by lapse of time. A counterclaim must be an existing cause of action, but recoupment is a right to reduce the plaintiff's claim, and this right exists as long as the plaintiff's cause of action exists." The reason for such a rule in regard to a recoupment is found in the nature of limitations statutes. In general when the Statute of Limitations has run against a claim, the legal right to recover has been extinguished, but the claim itself it not extinguished.[4] Thus a barred claim may be presented by a defendant by the device of recoupment, as a recoupment is in its very nature defensive.

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1. State v. Arkansas Brick & Mfg. Co., (1911) 98 Ark. 125, 135 S.W. 843, 33 L.R.A. (N.S.) 376; Williams v. Neeley, (C.C.A. 8th Cir. 1904) 134 Fed. 1, 69 L.R.A. 232; C. Aultman & Co. v. Torrey, (1893) 55 Minn. 492, 57 N.W. 211.
2. Baltimore & Ohio Ry. Co. v. Jameson, (1876) 12 W. Va. 833, 31 Am. Rep. 775; St. Louis Nat. Bank v. Gay, (1894) 101 Cal. 286, 35 Pac. 876; McConnell, The Doctrine of Recoupment in Federal Taxation, (1942) 28 Va. L. Rev. 577.
3. (1911) 98 Ark. 125, 135 S.W. 843, 33 L.R.A. (N.S.) 376.
4. Maxwell v. Cottle, (1893) 72 Hun. 529, 25 N.Y.S. 635; Baker v. Kelley, (1865) 11 Minn. 480, 493, (Gil. 358, 371); It is stated in Hulbert v. Clark, (1891) 128 N.Y. 295, 28 N.E. 638, "The Statute of Limitations does not, after the prescribed period, destroy, discharge, or pay the debt, but it simply bars a remedy thereon. The debt and the obligation to pay the same remain, and the arbitrary bar of the statute alone stands in the way of the creditor seeking to compel payment."

The leading case in which a recoupment has been allowed in tax matters is *Bull v. United States.*[5] It was there held that an erroneous estate tax payment, refund of which was then barred by the Statuate of Limitations, could be used as a recoupment against a claim now made by the Commissioner for income tax due on the same taxable event, i.e. the receipt of an estate by the executor. The Court stated that ". . . recoupment is in the nature of a defense arising out of some feature of the transaction upon which the plaintiff's action is grounded. Such a defense is never barred by the Statute of Limitations so long as the main action itself is timely." The doctrine of recoupment has been held applicable in favor of the government as well as the taxpayer. In *Crossett Lumber Co. v. United States*[6] the Commissioner erred in determining the value of plaintiff's 1926 inventory which had the result of decreasing plaintiff's tax for 1926 and increasing it for 1927. The plaintiff filed for a refund for the overpayment in 1927 as soon as the 1926 taxes were barred by the Statute of Limitations. The Court denied recovery and held that the government could recoup the barred deficiency against the claim asserted by plaintiff. The facts here satisfied the test set up in *Bull v. United States* since one act, the erroneous valuation of inventory, set in motion the underpayment relied on by the government and the overpayment which plaintiff seeks to recover.

In order for the recoupment doctrine to apply it must be confined to matters arising out of the same transaction. However, where the plaintiff's claim and the defense are based on two different items, *within the same year,* the case of *Lewis v. Reynolds*[7] is authority for the proposition that a claim for refund from a year in which additional assessments would be barred, will open up that entire year to a complete redetermination of tax liability so that an adjustment could be made in accordance therewith. In that case, the assessment of any additional tax for the year in question was barred by the Statute of Limitations, but a claim for refund for that year was not barred. The Court held that the power to reaudit the return is implied in order to redetermine the ultimate question of whether there was actually an overpayment for that year. This doctrine seems to be firmly established in our tax law and has been extensively followed.[8] The doctrine of the *Lewis* case allows an adjustment of unrelated items within a single tax year and is simply a narrow exception to the Statute of Limitations, and is not a true recoupment.

However recoupment was not allowed in circumstances quite similar to those of the *Bull* case and the *Crossett Lumber* case, in *McEachern v. Rose.*[9]

5. (1935) 295 U.S. 247, 55 Sup. Ct. 695, 79 L. Ed. 1421.
6. (C.C.A. 8th Cir. 1937) 87 F. (2d) 930.
7. (1932) 284 U.S. 281, 52 Sup. Ct. 145, 76 L. Ed. 293. This case arose in the Federal District Court for the District of Wyoming.
8. Van Antwerp v. United States, (C.C.A. 9th Cir. 1937) 92 F. (2d) 871; Naumkeag Steam Cotton Co. v. United States, (1933) 2 F. Supp. 126, 137; In re Tax Liability of Pacific Mills, (D. Mass. 1938) 21 F. Supp. 925.
9. (1937) 302 U.S. 56, 58 Sup. Ct. 84, 82 L. Ed. 46. In this case plaintiff's decedent sold shares of stock to be paid for in yearly installments, and elected to return the profit for income taxation on the installment basis. After his death in 1928, the plaintiff, as administrator, filed income tax returns for years of 1928, 1929, 1930 and 1931 in behalf of the estate showing just the installment profit for those years. This was contrary to provisions of section 44 (d) of the 1928 act (26 U.S.C.A. 44), and re-

In that case recoupment was not specifically brought to the attention of the Court in its opinion.[10] It was stated that equitable principles would preclude recovery by plaintiff in absence of any statutory provisions requiring a different result. But it was held that the defendant collector could not take advantage of taxes which he had failed to assess in previous years, now barred by the Statute of Limitations, because of the provisions of the Internal Revenue Act.[11] These provisions preclude the government from taking any benefit from the taxpayer's overpayment by crediting it against an unpaid tax the collection of which has been barred by the Statute of Limitations.

The two cases of *Bull v. United States* and *McEachern v. Rose* have caused considerable confusion in the lower federal courts. In the *American Light & Traction Co. v. Harrison*,[12] Judge Evans stated, in his dissent, that he had not been able to fully and satisfactorily reconcile the opinion in the *McEachern* case with the opinion in the *Bull* case, and that the inferior courts had been quite generally confused by the two holdings. He further stated, "This opinion is written to emphasize the necessity of further enlightment by the Supreme Court —the only court that can clear the atmosphere with finality."

The instant case is of some help with the difficulties of which Judge Evans spoke, although not in specific terms. The majority of the Court declined to expand the doctrine of recoupment in tax law as set out in *Bull v. United States,* although the minority thought that the claims for refund of the illegal assessments did arise out of the same subject matter as was involved in the government's demand for additional taxes for 1935. The reasons given by the majority for refusing to expand the doctrine to this case were: 1. It would be intolerable to have an income tax system under which there would never be a day of final settlement; 2. If we approve recoupment here, we undermine the Statute of Limitations in tax matters. Every assessment of deficiency and each claim for refund would invite a search of taxpayer's entire tax history for items to recoup. It is for Congress, not the court, to create exceptions to the Statute of Limitations. It is stated in the instant case that the misunderstanding of the limitations on the doctrine of recoupment as applied to tax law leads the Court to state more fully reasons for declining to expand the doctrine *beyond the facts of the cited cases.* The 'cited' cases referred to were *Bull v. United States* and *Stone v. White*.[13] From

sulted in an underpayment of taxes for 1928, and an overpayment of the taxes for 1929, 1930 and 1931. When the collection of the 1928 payment was barred by the Statute of Limitations, plaintiff seeks recovery for overpayment in 1929, 1930 and 1931. Plaintiff was allowed to recover and the government was not allowed to recoup the amount of the barred 1928 taxes against the 1929, 1930 and 1931 overpayments.

10. McConnell, The Doctrine of Recoupment in Federal Taxation, (1942) 28 Va. L. Rev. 577, 607. It was stated here that had recoupment been properly placed in issue in the case of McEachern v. Rose, a different result probably would have been reached.
11. 26 U.S.C.A., Sec. 3770 (a) (2), 6A F. C. A. tit. 26, sec. 3770 (a) (2); 26 U.S.C.A., sec. 3775, 6A F.C.A. tit. 26, sec. 3775.
12. (C.C.A. 7th Cir. 1944) 142 F. (2d) 639, 643.
13. (1937) 301 U.S. 532, 57 Sup. Ct. 851, 81 L. Ed. 1265. In this case trustees of the estate erroneously paid the tax on the income of the estate. The trustees then sued to recover after assessment of the tax to the beneficiary was barred. It was held that the government could recoup the amount owed by the beneficiary against the refund due the trustees. There was but one taxable event involved in both the claim and the recoupment, and a refund to the trustees would inure to the benefit of the beneficiary.

this statement it may be inferred that *Bull v. United States* is still good law but that the Supreme Court will not expand the doctrine beyond what the facts of that case warrant. The Court mentions the *McEachern* case only incidentally, by pointing out that it seemed to direct a result for the Collector. Consequently, so far as tax matters are concerned, in order for a barred claim to be allowed as a recoupment against an adverse claim which is not barred, the fact situation must conform to either the *Lewis v. Reynolds* case or to the *Bull v. United States* case. The test to be applied in the Lewis case would be whether the main claim arose in the *same tax year* as the recoupment claim. The test to be applied under *Bull v. United States* is whether the main claim arose out of the *same transaction* as the recoupment claim, and this requirement must be strictly construed according to the instant case. If the fact situation will not fit either test outlined above, recoupment will probably be denied.

CHESTER S. JONES

FLIGHT OF AIRCRAFT AS A TAKING OF PROPERTY

Plaintiff was the owner of a chicken farm in North Carolina situated near an airport which was leased by the United States in June, 1942, for the duration of the national emergency. Constant landing and taking off of military planes flying at low altitudes[1] over plaintiff's farm caused a decrease in production, and frequently chickens became frightened to the extent that they would fly against buildings and were killed. As a result plaintiff was forced to abandon the chicken business. He brought an action against the United States in the Court of Claims alleging an appropriation of his property, and recovered a judgment.[2] On certiorari the United States Supreme Court *held,* by a six to two decision, that a servitude had been imposed upon the land, and that there had been a taking of property within the meaning of the fifth amendment of the United States Constitution. *United States v. Causby,* (1946) 328 U.S. 256, 66 Sup. Ct. 1062, 90 L. Ed. 971.

This was the first case in which any court had held that the noise and glare of low flying aircraft would constitute a taking of property. Regarding the ancient common law maxium, *cujus est solum ejus est usque ad coelum,* meaning literally that surface ownership extends vertically to the heavens, the court stated that the doctrine had no place in our modern world,[3] although the landowner's property right in superadjacent airspace is well recognized when inter-

1. Following the 30-1 glide angle, which means one foot of elevation for every thirty feet of horizontal distance, the planes passed over the complainants property at an average altitude of 83 feet. This was only 67 feet above the house and 63 feet above the barn.
2. Causby v. United States (Ct. Cl. 1945) 60 F. Supp. 751 (The court awarded damages to the plaintiff in the sum of $2,000.00, or one half the total value of the plaintiff's property).
3. United States v. Causby, (1946) 328 U.S. 256, 66 Sup. Ct. 1062, 1065, 90 L. Ed. 971. (The decision of the Court of Claims was reversed because it was not clear whether the easement taken was temporary or permanent and consequently the Supreme Court did not determine whether or not the award of damages was proper).