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## SECTION 820 OF THE REVENUE ACT OF 1938*

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### GENERAL DESCRIPTION OF THE PROBLEM AFFECTED BY THE SECTION

Section 820 of the Revenue Act of 1938 is the first fruits of the following recommendation by the Subcommittee on Internal Revenue Taxation of the House Committee on Ways and Means:

> "It is recommended that there be prepared suitable provisions under which the statute of limitations should be so adjusted as to insure the taxation of income, and the allowance of deductions, in the year to which properly allocable."[1]

The statutory section does not exactly carry out the subcommittee's recommendation. In some respects it falls short of full compliance with the mandate; in other respects it extends the principle of the recommendation beyond the precise wording. It is a serious effort to deal decisively with certain aspects of a very extensive and irritating income tax question which has so long remained unanswered that many well-qualified lawyers, administrators, and legislators have come to think it insoluble.[2] Any advance toward a sound solution of this problem should be warmly welcomed; any move in the wrong direction has dangerous

*The final portion of this article, describing the mechanics of § 820 and the classes of cases to which it applies, will appear in the March issue.

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1. REPORT OF A SUBCOMMITTEE OF THE COMMITTEE ON WAYS AND MEANS ON A PROPOSED REVISION OF THE REVENUE LAWS, H. R. 75th Cong., 3d Sess. (1938) 79, recommendation No. 48; *cf.* pp. 54-55.

2. A particularly vigorous attack was made on the problem in 1927. See Revenue Revision 1927-28, *Hearings Before the Committee on Ways and Means*, H. R., Interim, 69-70th Congresses, pp. 148-152, 161-162, 302-303, 307-308, 534-535, 544-545, 547-548, 576-577. The speakers were a representative of the Illinois Chamber of Commerce, a public accountant from Iowa, a representative (Hugh Satterlee) of the Committee on Federal Taxation of the American Bar Association, and the secretary of a California Congressman.

possibilities. The American Bar Association's Standing Committee on Federal Taxation, in its report to the Sixty-first Annual Meeting of the Association, expresses unqualified disapproval of Section 820, damning it by implication as not even embodying a "constructive suggestion", and strongly urges its repeal.[3] With all due respect to the distinguished authors of this report, the present writers have reached the conclusion that its treatment of Section 820 is not only inadequate but seriously inaccurate. The section deserves something better than hasty misjudgment, since it was "the result of research by Treasury experts and conferences with members of the bar extending over a period of many months."[4] The purpose of this paper is to offer frank and careful analysis and criticism of the strength and weakness of Section 820. While we are in favor of the section, and do not pretend to write a merely neutral article, we appreciate the sincerity and strength of some counter-arguments, and feel that there should be amendatory and supplementary legislation.

As an introductory matter, it is necessary to characterize the field in which the legislation is intended to operate and to summarize briefly prior efforts to cope with the difficulties there encountered. By and large, the situations for which the subcommittee sought relief have appeared in two general forms. In the first form, a taxpayer has mistakenly returned income or mistakenly failed to claim a deduction in a year later closed by some provision of law, typically the statute of limitations; then, for another year, the same taxpayer has either been required to return the same income over again, and pay further tax with respect to it, or has been denied the benefit of the deduction on the ground that it was allocable only to the closed year. In the second form, difficulty has arisen from uncertainty as to taxpayers rather than as to chronology. For example, one of two spouses has erroneously included as taxable income an item which should have been attributed to the other spouse; then the Bureau of Internal Revenue has discovered the mistake while time still remained to correct the appropriate return of the second spouse by inserting the item, but after the statute of limitations has run upon a claim for refund by the first spouse. It has of course been equally possible for the government to suffer in complementary situations taking either form, as where a single deduction has been used to benefit the same taxpayer in two different years or to benefit both of two taxpayers whose relationship caused fiscal confusion. Cases of hardship to taxpayers being thus matched by cases of hardship to the government, no relief measure can be truly adequate unless it works both ways.

3. "We recommend that this provision be repealed, and that this committee cooperate with the Treasury in working out constructive suggestions, looking to the best possible solution." ADVANCE PROGRAM OF AMERICAN BAR ASSOCIATION, 61st Annual Meeting (1938) 104.

4. Treasury Press Release No. 14-38, 383 C. C. H. 1938 Fed. Tax Serv. ¶6502.

FAILURE TO SOLVE THE PROBLEM BY JUDICIAL ACTION

Prior to 1938 legislative proposals had been unavailingly offered to meet the difficulties outlined in the preceding paragraph. Dilemmas in concept and draftsmanship prevented affirmative action.[5] Lacking Congressional assistance, the Bureau and taxpayers tried step-by-step methods of litigation. The principle invoked, to use the broad terms of Mr. Justice Cardozo, was "that no one should be permitted to found any claim upon his own inequity or to take advantage of his own wrong."[6] In the field of Federal tax procedure this concept, under one name or another, has done much to prevent technical slip-ups from being fatal to the government's interests.[7] Applied to alleviate the effect of errors respecting the timing or proprietorship of income or deductions, it has led to appreciable consequences. Where, for instance, a taxpayer has claimed the benefit of a deduction for some open year, and investigation shows that he has already taken the same deduction for another year which is now closed, the government commonly contends that he has estopped himself to take the deduction over again in the open year. After a period of hesitation, the Board of Tax Appeals began to decide such controversies in the Treasury's favor.[8]

Turning to cases of a different kind, we find one where a taxpayer failed to disclose as income constructively received in years prior to 1923 certain items of salary and dividends unqualifiedly credited and made available to him during those prior years. In 1923 he actually received the amount of these items, and for that year returned these receipts as gross income. Then, after the statute of limitations had closed the prior years, he sought a refund for 1923 on the ground that the items referred to belonged in the closed earlier years. The Court of Claims denied the refund; ". . . the plaintiff cannot now . . . be heard to say that such credits do not constitute taxable income in the year in which he chose to receive them in a physical sense."[9] This result is rested on the decision of a somewhat similar controversy before the Board and the Court of Appeals for the First Circuit which really pressed the same principle further, because the taxpayer in that controversy was resisting a deficiency instead of seeking a refund.[10] Deficiencies depend upon cut-and-dried

5. *E.g.*, the discussion and proposals referred to in note 2, *supra*.

6. Stearns Co. v. United States, 291 U. S. 54, 61 (1934).

7. Maguire and Zimet, *Hobson's Choice and Similar Practices in Federal Taxation* (1935) 48 HARV. L. REV. 1281, *passim;* 5 PAUL AND MERTENS, LAW OF FEDERAL INCOME TAXATION §§ 53.02 *et seq.* (1938 Cum. Supp.).

8. The cases are reviewed in Firemen's Insurance Co., 30 B. T. A. 1004, 1011-1013 (1934). See Stern Brothers v. United States, 80 Ct. Cls. 223, 8 F. Supp. 705 (1934); Giant Furniture Co. v. United States, 80 Ct. Cls. 540, 9 F. Supp. 585 (1935).

9. Raleigh v. United States, 78 Ct. Cls. 653, 663, 5 F. Supp. 622, 627 (1934).

10. Estate of Thomas J. Moran, 26 B. T. A. 1154 (1932), *aff'd*, Moran v. Commissioner, 67 F. (2d) 601 (C. C. A. 1st, 1933); see Walter L. Ross, 30 B. T. A. 496, 501 (1934); Bothwell v. Commissioner, 77 F. (2d) 35, 37 (C. C. A. 10th, 1935).

technical tax law; refunds rest upon equitable principles. Equity is more touchy about unconscionable behavior.[11] In a related case the taxpayer was a lessor; his lessee erected improvements on the demised premises; the taxpayer never returned any gross income on account of this accession in value. Seven years after completion of the improvements he sold his interest in the premises and, when reporting the sale for income tax, claimed as part of his basis the depreciated value of the improvements. The Commissioner rejected this increase of basis, imposed a deficiency, and won the case.[12]

Most famous of all the government's victories in this connection is *Stone v. White*,[13] where the issue was "whether . . . testamentary trustees, who have paid a tax on the income of the trust estate, which should have been paid by the beneficiary, are entitled to recover the tax, although the government's claim against the beneficiary has been barred by the statute of limitations." Recovery was refused, the successful defense being described as a denial of the trustees' "equitable right to undo a payment which, though effected by an erroneous procedure, has resulted in no unjust enrichment to the government, and in no injury to [the trustees] or their beneficiary", the beneficiary being the only person who would have been in pocket by the refund.

Winning these cases was a real achievement by government counsel, but their decisions cover only a thin scattering of the situations constantly encountered. This fact so abundantly appears from our later discussion that no elaborate detail is offered here. It is enough to indicate the limits upon, and various qualifications of, the decisions just set forth. If, in *Stone v. White*, neither beneficiary nor trustees had ever paid the tax voluntarily, the trustees having duly taken a deduction for their payment of income to the beneficiary, it seems highly doubtful whether an attempt to deny this deduction by asserting a deficiency against the trustees, after the statute had run in favor of the beneficiary, would have succeeded. In a later case where other trustees apparently should have paid, but unquestionably did not pay, tax with respect to certain receipts, and no part of those receipts was ever passed on to the beneficiary, the latter, having erroneously paid tax with respect to the receipts, recovered his payment after the statute had run in favor of the trustees.[14] Where an income beneficiary should have paid tax, but did not, and fiduciaries

11. Schmidlapp v. Commissioner, 96 F. (2d) 680, 683 (C. C. A. 2d, 1938). But see Crawford v. Heiner, 23 F. Supp. 240, 241 (W. D. Pa., 1938).

12. William Merriam Crane, 27 B. T. A. 360 (1932), *aff'd*, Crane v. Commissioner, 68 F. (2d) 640 (C. C. A. 1st, 1934). Here, of course, there is a fundamental problem as to whether and when lessees' improvements constitute taxable income to lessors. This problem is aside from the immediate discussion. See Blatt Co. v. United States, 59 Sup. Ct. 186 (U. S. 1938).

13. 301 U. S. 532, 533, 539 (1937).

14. Lyman v. United States, 22 F. Supp. 14 (D. Mass., 1938).

should have claimed a corresponding deduction, but failed to do so, it was held that the running of the statute in favor of the beneficiary did not prevent recovery of the fiduciaries' overpayment by the remainderman to whom the trust corpus had ultimately been distributed.[15]

With respect to the lessee improvement situation in which the lessor was not allowed to augment his basis by the value of the improvement, because he had paid no income tax on account of its acquisition, we find the effect of the case in some degree weakened by the tone of a later United States Supreme Court opinion[16] and by the actual decisions of later cases in the lower Federal courts.[17] There is a tendency to offer specialized explanations for the lessee improvement result and also for the two constructive receipt cases described above in the same connection.[18] The government's most common formula in these matters has been that taxpayers are "estopped". In fact, it would not be seriously misleading to term this part of our exposition a discussion of the practical consequences of the estoppel theory. With increasing frequency the courts point out that no estoppel can be found where all facts have been honestly

15. Sewell v. United States, 85 Ct. Cls. 512, 524, 19 F. Supp. 657, 663 (1937); *cf.* Schlemmer v. United States, 94 F. (2d) 77, 78 (C. C. A. 2d, 1938), where the court could not tell who would have borne increased tax burden if an improper deduction had not been taken; and said, moreover, "we do not believe that the eventual incidence of the tax which has been lost, may be traced back, however indirectly, to the taxpayer in court so that his recovery shall be diminished pro tanto." Contrast Smith v. United States, 22 F. Supp. 1011, 1015 (E. D. Pa., 1938), where the remaindermen inherited from the life tenant as well as from the creator of the trust.

16. Helvering v. Salvage, 297 U. S. 106, 109 (1936), where the taxpayer disclosed in his return for 1922 no gain from certain profitable acquisition and exchange transactions during that year, but in connection with a partial closing out of his investment in 1929 resisted a deficiency by asserting a basis enhanced on account of the 1922 transactions. The lower court, says the opinion, held "that the failure to disclose 1922 taxable gain apparently resulted from innocent mistake of law; there was no false representation of fact; nothing gave support to the claim of estoppel." And the defense of estoppel not having been properly raised, "the court should have passed the point. *Furthermore, the facts disclosed give it no support.*" (Italics added).

17. United States v. Dickinson, 95 F. (2d) 65 (C. C. A. 1st, 1938); Schmidlapp v. Commissioner, 96 F. (2d) 680 (C. C. A. 2d, 1938); Helvering v. Williams, 97 F. (2d) 810 (C. C. A. 8th, 1938); R. E. Baker, 37 B. T. A. 1135, 1152, (1938); see Commissioner v. Farren, 82 F. (2d) 141, 143 (C. C. A. 10th, 1936), *cert. granted*, 298 U. S. 653 (1936), but dismissed on stipulation 299 U. S. 617 (1936), where the confusion of cases made the court doubtful; E. R. Hawke, 35 B. T. A. 784, 792 (1937). Contrast Alamo National Bank of San Antonio, 36 B. T. A., 402, 405-407 (1937), *aff'd*, 95 F. (2d) 622 (C. C. A. 5th, 1938), *cert. denied*, 304 U. S. 577 (1938).

18. See cases cited *supra* note 17; Steele Estate, 34 B. T. A. 173, 176 (1936), explaining the *Moran* and *Raleigh* cases as illustrations of election, and the *Crane* case as involving "a failure to disclose facts which amounts to a misrepresentation of facts"; *cf.* Sugar Creek Coal & Mining Co., 31 B. T. A. 344, 348, n. 2 (1934); Grauman's Greater Hollywood Theatre, Inc., 37 B. T. A. 449 (1938); Commissioner v. Union Pacific Railroad Co., 86 F. (2d) 637, 639 (C. C. A. 2d, 1936). Contrast Sugar Creek Coal & Mining Co., 30 B. T. A. 420, 423 (1934).

disclosed to the Bureau of Internal Revenue, or—this being probably an alternative wording of the same idea—where the taxpayer's erroneous conduct finds its sole basis in a mistake of law (or of "mixed law and fact") contemporaneously shared by the Bureau. The concept of "estoppel" is quite intricate. With a few standardized exceptions, such as estoppel by deed, cases in which this concept is claimed to apply present individual problems. Nothing could show this more vividly than the variations of facts, arguments, and results in the many Federal estoppel controversies, and the consequent extreme difficulty in classification.[19] The whole estoppel situation makes for dubiousness very unfitting to tax law. Citizen and Bureau alike should be able to find their legal positions more clearly and broadly forecast.

Some criticisms of estoppel and related remedies in this connection are themselves subjects of controversy. It is said, for instance, that estoppel is objectionable because it freezes or perpetuates an error instead of setting matters aright according to the substantive requirements of the tax laws. Where a taxpayer ten years ago wrongly took a deduction which he should be taking now, it is truer to Congressional desires to open up and correct the decade-old return, than to fix the mistake immutably by an estoppel respecting the current year. But other critics vigorously take Section 820 to task because it embodies this very view. Orderly development of our topics demands postponement of such contested points. One fundamental objection to estoppel and the like as an exclusive cure, however, is open to no contest. Estoppel is hopelessly lop-sided. For reasons well enough understood, whether they be good or bad, it is practically impossible, or at least very difficult, for the taxpayer to make an estoppel operate against the government.[20] So in the main he who erroneously paid tax on supposed income for a year subsequently closed has had no hope of relief when, prior to the effective date of Section 820, he has been called upon to pay over again for the technically correct year. Neither has he had a better hope if, in connection with a capital transaction, he has tried to build into his basis a sum erroneously taxed as income.[21] The nearest approach to a taxpayer's success in any such case occurred under most unusual circumstances when, by virtue of the doctrine of recoupment, a deficiency collected on an open income-tax item was reduced and ordered partly refunded because of an erroneous and inconsistent estate tax payment made in connection with another aspect of the same

19. Grand Central Public Market, Inc. v. United States, 22 F. Supp. 119, 126 *et seq.* (S. D. Cal., 1938), contains an instructive review of the cases and allows recovery of an overpayment traceable to the return of income in the wrong year, despite the closing of the right years.

20. See Maguire and Zimet, *supra* note 7, at 1299 *et seq.;* PAUL AND MERTENS, *op. cit. supra* note 7, §§ 53.07, 53.11, 53.12 (1938 Cum. Supp.).

21. Bigelow v. Bowers, 68 F. (2d) 839 (C. C. A. 2d, 1934), *cert. denied,* 292 U. S. 656 (1934).

asset in a year which had been closed.[22] This peculiar case does not aid the broad situation and leaves the purely judicial remedy condemned as inadequate under the test stated at the close of the preceding section. Working often *against*, and never, or substantially never, *for*, the taxpayer, prosecution of this remedy was sure to cause growing resentment unless justly supplemented or replaced. Enactment of some legislative relief has become more emphatically imperative with each passing year.

## Reasons for Specialized Treatment of the Problem

Before proceeding to discuss the nature of possible legislative remedies and of the particular remedy actually afforded by Section 820, it is necessary to deal with a fundamental question hitherto put aside with tacit assumption of a favorable answer. What warrants specialized treatment of cases such as those which have been indicated? Mention of hardship and financial loss is unconvincing. The world at large, and the income-tax world in particular, are full of hardship and loss despite which it is deemed sound policy to enforce general rules inflexibly. Our Federal income-tax is already most intricate and every additional complexity demands clear affirmative justification. Indeed, the present modification occurs at a particularly sensitive spot in the administrative plan. Probably no informed person would deny the general desirability of a statute of limitations in connection with the Federal income-tax. The classical justifications for such laws apply well enough in this particular area. Speaking of possessory actions respecting real property, Blackstone says "there is a time of limitation settled, beyond which no man shall avail himself of the possession of himself or his ancestors, or take advantage of the wrongful possession of his adversary. For, if he be negligent for a long and unreasonable time, the law refuses afterwards to lend him any assistance, to recover the possession merely, both to punish his neglect . . . and also because it is presumed that the supposed wrongdoer has in such a length of time procured a legal title, otherwise he would sooner have been sued."[23] The great commentator does not here explain the reasons for the presumption, but suggests them at a later point, where he is talking about personal actions: "The use of these statutes of limitation is to preserve the peace of the kingdom, and to prevent those innumerable perjuries which might ensue, if a man were allowed to bring an action for any injury committed at any distance of time."[24] Speaking more exactly of the Federal income-tax, we deem it self-manifest on the government side that without the aid of periods of limitation the Bureau of Internal Revenue might become so hopelessly involved in old contro-

22. Bull v. United States, 295 U. S. 247 (1935).
23. 3 Bl. Comm., c. X.
24. *Id.*, c. XX.

versies as to make its dealings with instant problems nowhere near current. On the taxpayers' side, statutes of limitation give at least rough assurance that demands for tax will usually not lag too far behind receipt of income from which payment may be made.

Now it is true that taxpayers, Bureau, and courts have with remarkable unanimity sought some modification of the rigidity of periods of limitation in the present connection. But even to a complaisant legislature mere general demand can furnish only an inadequate standard of action. Technical administrative provisions of tax laws should be soundly explicable; besides, legislation cannot be effective or even safe until the causes of demands for it have been explored to determine how far relief should be carried. Hence we examine critically the explanations officially offered for the action of Congress in passing Section 820. The House Subcommittee, already quoted, backed its recommendation by saying that existing rulings and decisions "often permit taxpayers or the Commissioner to obtain a two-fold advantage by assuming in one year a position different from that taken in another year with respect to which the period of limitations has expired, so that adjustment of the tax liability for the earlier year is impossible. The sole purpose of the statute of limitations is to prevent the litigation of stale claims. Its use to obtain a two-fold advantage, whether by double deduction or double taxation, is not in keeping with its fundamental purpose."[25]

This employment of the terms "two-fold" and "double" naturally suggests the necessity of special relief because unusually serious financial consequences are involved. The suggestion is fallacious. Assuming the same taxable gross income, it costs the government not one cent more to have a taxpayer (a) take a deduction twice, once erroneously and once correctly, than it does to have the same taxpayer (b) take a completely unauthorized deduction once and once only. Likewise, the taxpayer is no more deeply out of pocket for having (a) to include the same item in gross income, once erroneously and once correctly, in two taxable years, than for having (b) to include in one year alone an item not properly taxable at all. But no seasoned tax man would seriously propose special tinkering of the statute of limitations to relieve the victims of the (b) cases above.

The term "double" has another possible connotation, namely that of duplicity. This is suggested in the first part of the foregoing quotation from the Subcommittee report, and appears again in the Statement of the House Managers following the conference: "Under the income-tax laws it is possible for a taxpayer or the Commissioner, after operation of the statute of limitations or some other provision of the internal-revenue laws prevents correction of an error, to obtain a double advantage

25. *Op. cit. supra* note 1, at 54-55.

by taking a position contradictory to that which caused the error."[26] But the idea of misrepresentation, followed by something in the nature of an estoppel or reparation, will not explain nearly all the cases in which relief against the rigidity of the statute of limitations has been felt desirable. Sometimes, but only sometimes, it is determinative. We feel certain that some situations in which all the actors had behaved with entire frankness would give rise to loud demands for special amelioration. Imagine, for instance, that under a view of law honestly shared by taxpayer and Commissioner tax has been paid with respect to an item supposed to be income for an earlier year, the statute of limitations has closed that year against refund, the Supreme Court has unexpectedly announced a different rule controlling the situation, and under that rule a second tax has had to be exacted for a later year with respect to the same item.[27] If we wish a truly comprehensive justification for specialized provisions in this connection, we must look beyond notions of deception. Also, talk of duplicity inevitably involves some implication of bad moral tone. Surely it is no worse morally to take a deduction ahead of time in 1938 and again at the proper time in 1940, than to claim as a deduction in either year some expense or loss not covered by the deduction sections of the statute.

But "double" or "duplicate" does supply a significant clue to one explanation of the demand which gave rise to Section 820. In each of these "two-fold" cases concerning insertion of an item first in a closed year and second in an open year, the correspondence of issues and evidence as to both present and past eliminates the reasons behind provisions for periods of limitation. Stale claims are bad because the passage of time obscures the facts about them. Witnesses die, witnesses forget, other evidence is lost, the check on perjury disappears. They are bad because they force men who would defend against them to delve in the past and thus fall behind a progressing world. They are bad because, if sustained, they impose upon these men crippling liabilities. But as to categories of old claims not subject to these condemnations, the legislature may wisely make exceptions to the rules of limitation.[28]

26. H. R. Rep. No. 2330, 75th Cong., 3d Sess. (1938) 56.

27. Bigelow v. Bowers, cited *supra* note 21, is not far from this situation, and the dissenter in the Circuit Court of Appeals plainly expressed his indignation. Consider also the long drawn out episode as to the placement of tax when a widow is beneficiary of a trust under her dead husband's will, which episode culminated in *Stone v. White*, discussed *supra*, p. 512.

28. The importance of the considerations here suggested by our text deserves double emphasis. Much criticism of § 820 has been based on the sanctity of statutes of limitations. Thus Percy W. Phillips, an eminent practitioner: "But the fundamental error of this statute, as I see it, which requires that it should be repealed and a new start made rather than an attempt made to amend the section is the provision which requires that the statute of limitations be removed on years which are closed. That idea seems fundamentally wrong. Statutes of repose are necessary; business cannot be run without statutes of repose. They should not be removed nor enlarged after they have expired." (1938) 16 Tax Mag. at 694. Has Mr. Phillips paused adequately to consider the funda-

It is possible to assert reasonably that we deal here with such a category, as examples easily demonstrate. If the Commissioner has for 1933 taxed an officer of a corporation on the ground that stock received by the officer from the corporation in that year was an item of compensation, and then in 1938, when the officer sells the stock, reverses himself by insisting that the stock was a gift to the officer, and refuses to allow the 1933 value as a basis, he has or ought to have the full facts in hand. Indeed, his very action seems an admission that he has reviewed the first tax and found it erroneous. On principle, he is in no position to meet the taxpayer's demand for some sort of adjustment or allowance as to that first payment with the reply that this means digging up long-buried dry bones or unduly interfering with the currency of tax administration. The antiquarian job, he necessarily asserts, has already been done, the adequate evidence collected and appraised. As to having funds to make the adjustment, the Commissioner proposes to put himself in pocket by the impending deficiency assessment. And so, of course, if some taxpayer deducts for a bad debt in his 1934 return and repeats the deduction in his 1938 return on the ground that he timed it wrongly to begin with, he has little excuse for whimpering about being made to pay up too late if the Commissioner seeks a deficiency for 1934. In neither of these situations can the litigant who has precipitated trouble by seizing an advantage in the open year appeal to any of the reasons underlying rules of limitations. He who seeks repose should practice it by letting sleeping dogs lie.

The specialized arguments just made for inapplicability of the ordinary rules of limitations apply, it will be observed, only where the party who takes the offensive is the one against whom, if he had remained passive, enforcement of the stale demand would have been prevented. Turn either case the other way about, and the consequences are entirely different. If the corporate officer finds that he will save money by getting back his tax for 1933 and taking a lower or zero basis for 1938, the Commissioner can conscientiously stand his ground on the statute of limitations and say: "I am not called upon to search old files, resurrect dead witnesses or try the hazy memory of forgetful ones, or spend the Bureau's time and money over buried issues." The taxpayer in the second case, assuming he has treated the deduction as over and done with when used in 1934, may properly respond likewise if the Bureau tries to force the deduction on him for 1938 and collect a deficiency by taking it away for 1934. These are neither more nor less than the "(b) cases" referred to on a previous page.[29] Section 820 carefully respects this distinction by

mental reasons for statutes of limitations, and the possibility that they may be inapplicable here? Our own respect for wise periods of limitations is, we hope, as great as his. But blind worship of a legal institution is very dangerous both to the community and to the institution itself. Injustice results when even the wisest doctrine is pressed beyond its proper application, and obstinate persistence in such excess may cause a damaging rebellion against the doctrine as a whole.

29. P. 516, *supra*.

refusing to open a closed year except for reversal of position by the party whom the closing would otherwise safeguard.

While we consider the fundamental reason for special legislation in the immediate connection to be the one just explained, some subsidiary considerations point toward the same conclusion. The courts rather often assert that a taxpayer who claims a deduction in a certain year, or even a taxpayer who fails to return a possible income item in a certain year, is making a representation as to the propriety of his getting the deduction or the impropriety of charging him with tax respecting the income for the particular fiscal period. Present judicial tendencies seem, as noted above, to be toward arguing thus only where a representation of "fact" can be found.[30] But the idea can surely be enlarged to cover a representation as to the practical effect of a whole situation. If the Bureau accepts the return, it manifests reliance upon the representation as meaning in the first case that the claim of deduction will not be repeated or in the second that the income is to be returned for some other year. Whenever such a taxpayer repudiates or retracts his representation and, because limitations have closed the original year, succeeds in avoiding any sort of counterclaim or offset against the saving thus realized, he has put the statute of limitations to an unintended and improper use. It serves not merely as a shield to protect his passivity when threatened with a tardily asserted liability, but as part of his offensive apparatus in an active attempt to profit at the Treasury's expense.[31] Whether this contention applies fully to a case in which the government has received and retained erroneously paid tax for an earlier year, and later seeks to enforce a technically correct tax respecting the same item in a later year, is by no means certain. Bearing in mind the great mass of cases which the Bureau must handle in any taxable year, it is at least excusable and perhaps essential that many really doubtful points should be passed over untested. That is, merely accepting a return and a check in payment of the indicated tax can scarcely be considered in every instance as a representation that all items have been scrutinized and finally approved. Here, however, it is necessary to remember that the taxpaying constituency will demand what seems to it symmetrical justice, and that advocacy of adjustment where a deduction has been twice claimed will cause indignant reaction unless it includes a corresponding possibility where income has been twice taxed.

The suggestion just offered about the impracticability of a complete annual official check-up of returns has, however, definite significance in

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30. Pp. 513-4, *supra*.

31. The leading case of Dickerson v. Colgrove, 100 U. S. 578, 579, 580-581 (1880), involved defenses based upon both the statute of limitations and estoppel. Mr. Justice Swayne said that the court's "remarks will be confined to the point of estoppel . . . . It [estoppel] is available only for protection, and cannot be used as a weapon of assault . . . It is akin to the principle involved in the limitation of actions, and does its work of justice and repose where the statute cannot be invoked."

another aspect. It is clear enough that successful administration of income-tax laws depends largely upon the government's ability to minimize the detective work required to discover concealed items. Further, successful administration is much more likely if the quantity of litigation can be held down. An unyielding statute of limitations, with risks of uncompensated second taxes on debatably-timed income, discourages frank, early disclosure of such income. Thus it tends to compel more governmental detective work, and of course it compels prompt litigation by taxpayers against whose claims administrative rulings are made. Administration should be easier with the backing of statutory assurance that, if first impressions are reversed in the light of later examination and experience, corrective adjustments extending to the entire transaction will become possible. Furthermore, this same assurance, operating with respect to debatably-timed deductions, would reduce the necessity of obstinate contests by the Commissioner in connection with the initial making of deduction claims.

Down to this point no explicit attempt has been made to justify on principle a special modification of the statute of limitations in cases where the proprietorship, instead of the proper timing, of income or deductions is in doubt. All the argument of the preceding paragraph clearly applies to such situations. As to the antecedent arguments, their application is also clear and easy whenever the government seeks two or several taxes from two or more taxpayers with respect to the same item of income, or successively denies to two or more taxpayers the benefit of a deduction which certainly belongs to one of the pair or group. The same sort of culpable retraction of a representation and of misuse of the statute of limitations can be found. But when the error is costly, instead of profitable, to the Commissioner and its rectification involves making taxpayer *A* render compensation for the success of taxpayer *B*, our problem has plainly become complicated by a new consideration. Why, to put the matter more specifically, should *A* be deprived of the normal benefit of the statute of limitations simply because he and a separate person *B* have both taken advantage of a deduction properly attributable to *B* alone? Where this description is complete, and no other relevant fact appears, we do not believe that a special modification of the principle of limitation of actions can be justified. Addition of other factors, though, may properly change the conclusion. For example, if *A* has put himself in a position of vicarious responsibility, as by concocting and executing with *B* a scheme to trick the government into a double allowance, it will not be hard to justify a device for stripping *A* of the statutory shelter and compelling him to set matters straight. So, too, where *A* is the beneficiary of *B*'s success, as in trustee—life tenant cases. Upon these fundamental situations for exceptional treatment Section 820 has elaborated with the idea

of "related taxpayers". Whether this idea covers too much or too little ground is left for later discussion.

The recommendation of the Subcommittee quoted at the opening of this paper suggests that only the statute of limitations gives rise to the kind of controversy under discussion. In fact, several other provisions of the internal-revenue laws, and some more general principles of legislation or of judicial decision, such as *res judicata,* accomplish or appear to accomplish similar results. Examples derived from the internal-revenue laws include (a) the collateral effects of petitions to the Board of Tax Appeals in preventing further deficiency letters, or credits or refunds; (b) statutory closing agreements; (c) tax compromises; and (d) provisions barring voluntary, as distinguished from compelled, refunds or credits after the periods of limitations have expired.[32] So far as the underlying reasons for existence of these restrictive provisions resemble the reasons underlying the ordinary action of the statute of limitations, the preceding discussion applies equally well to them. Where different reasons control or additional considerations color the picture, the conclusions as to modification of such statutory or common law provisions in the present connection may vary from those put forward above. Here again is a topic better postponed than treated fully at this point.

The conclusions from this particular part of our discussion are that there is justification for specialized legislative treatment of the types of controversies being considered, so far as each controversy involves but one taxpayer; that this justification extends within limits to such controversies involving two or more taxpayers; and that it also extends to a number of restrictive principles different from but allied with the statute of limitations. Our next and final preliminary task, before taking up in detail the content of Section 820, is to sketch in broad general terms the various possible lines or philosophies of legislative attack upon the problem which the section might have followed.

## Possible General Lines of Legislative Attack Upon the Problem

Suppose taxpayer *A* erroneously returns as income in 1933 a sum of $1,000 and pays for that year $150 more income-tax than if he had omitted the item. In 1938 the item actually becomes taxable, the Bureau discovers it, and *A* is called upon to pay a consequent deficiency of $300 for 1938. Meanwhile, the statute of limitations has run against a refund for 1933. Rectification might be accomplished in any one of several ways:

32. See Regulations prescribed with respect to § 820, especially Art. 820(b)—0. Regulations 101, Appendix, T. D. 4856.

First, by application in the taxpayer's favor of a statutory estoppel theory which freezes the mistake into permanent acceptability. The result will be that by paying $150 for 1933, *A* escapes a liability of $300 for 1938. Even allowing for five years' interest (or discount), this result is calculated to make *A* quite happy. It is calculated to sadden the Commissioner and the community, for *A* has avoided paying his full share of the price of civilization. But if the tax figures are reversed—$300 for 1933 and $150 for 1938—and the same freezing principle applied, *A* will be very unhappy. To be sure, he escapes a double payment, but the tax paid in error greatly exceeds the theoretically correct tax. Yet the government retains the whole payment.

Second, by application in the taxpayer's favor of a theory of recoupment. In the case first put, he will have $150 plus interest applied to reduce the $300 deficiency, and will have to pay the remainder with new money. This result seems beyond criticism. It accurately carries out the tax obligation which Congress imposed upon *A*. Reverse the figures once more, however, and we get a result unsatisfactory to *A* in precisely the same degree and for the same reasons as in the reversal under the estoppel theory.

Third, by application in the taxpayer's favor of a rule that this situation must be comprehensively adjusted so that *A* will pay no more and no less than the theoretically correct amount of tax (and interest) respecting the contested item. Here, no matter in which order the smaller and larger tax payments are put, *A* ends up by having paid exactly what is found to have been required by statute, and with respect to the right year. There has been no undeservedly lucky escape and no unlucky subjection to disproportionate burden.

An additional factor may be made to affect the result under either the second or the third method. Change the original hypothesis by imagining that, although *A*'s tax return for 1933 shows only an overpayment of $150 by inclusion of the doubtful item, he has failed to claim a loss of $1,500 properly deductible in the same return. Had this loss been claimed, his tax would have shrunk another $200. Should the taxable year 1933 be opened up completely, so that this second error is taken into account as well as the first? If the answer be affirmative, *A* would, under the recoupment theory, pay nothing at all on the deficiency asserted for 1938; and under the third or accurate correction theory he would actually receive a net refund representing $50 plus interest, probably for somewhat more than five years, on his 1933 overpayment of $350.

Section 820 has in fact adopted the accurate correction method, and rejected consideration of the additional factor just described. Much of the adverse criticism by the American Bar Association's Standing Committee on Federal Taxation is directed toward both of these fundamental points. The Committee's report says that the method "proceeds on the

unreliable assumption that the Bureau of Internal Revenue, whenever it takes a position inconsistent with something it has done in an earlier year, is conscious of such inconsistency, and likewise that taxpayers are conscious of their inconsistencies"; and since "the new liability for the reopened year may involve a much larger sum in tax than was involved for the open year" the method "requires reaudits for years with which the Government Departments have finished." Also: "By making it risky for a taxpayer to file claims for refund . . . it induces taxpayers to exercise the greatest care never to overpay—a state of mind which creates new and difficult problems for the taxation authorities." Then, striking at the refusal by Congress completely to open the taxable year in which the foundation of the inconsistency was laid, "it may involve a much larger sum in tax as to the reopened year than would be indicated for that reopened year on a complete and correct recalculation as to that year."[33] An appealing illustration for the last contention is: Taxpayer *A* for 1933 claims a deduction of $1,000 to which he will not legally be entitled until 1938; this reduces his taxable income to zero; therefore he does not take the trouble to claim another and immediately legitimate deduction of $500; for 1938 he again claims the $1,000 deduction; his inconsistency is discovered and he is subjected to a deficiency assessment for 1933 which discards his erroneously taken $1,000 deduction but gives him no benefit for the potentially valuable $500 deduction.

None of the foregoing criticisms seems to deny the theoretical soundness of the proposition that if erroneous treatment of an income item or a deduction is to be corrected, the correction should produce the same result as if the error had never been made. The contention seems to be that income-tax administration cannot be operated upon purely ideal hypotheses. Practical difficulties must have recognition. The suggestions of such difficulties made above amount to a collective assertion that inadequate protection is afforded by the rule, which Section 820 has adopted, of refusing to open a closed year unless the party who takes the offensive by claiming a deduction, seeking a refund, asserting a deficiency, or otherwise "is the one against whom, if he had remained passive, enforcement of the stale demand would have been prevented."[34] There is, says the Committee, too much risk that the inconsistent party will move in ignorance of his inconsistency and find himself trapped, at least unless he exercises inordinate pains to safeguard his steps.

Take first the counter-argument with respect to the government. Reaudits for closed years, which the Committee mentions as raising a problem, are necessary whenever the Bureau puts forward the familiar contention that a taxpayer is estopped by something he did in a year

33. *Op. cit. supra* note 3, at 106. The Committee makes its various points in an order somewhat different from that followed above.

34. See p. 518, *supra*.

now beyond reach of correction. The auditing problem has never, apparently, proved an insurmountable or even a serious barrier in such litigation. Requiring a reaudit of one or more earlier years to protect the government's interests when a decision is being made about assertion of a deficiency involving items which may affect such years as well as the immediate year should commend itself to taxpayers, if such requirement be practicable. The Bureau is often criticized for attacking situations without first surveying them comprehensively, thus subjecting citizens to extended series of annoyances and demands which might have been consolidated. As to practicability, the Bureau replied affirmatively, while Section 820 was before Congress, when asked if it would be able to do the necessary reauditing. It seems possible that the perils to the Treasury outlined in the quoted passages are meant to give outward symmetry to an argument at bottom solely for the taxpayers' interests.

Of course, if the argument is sound and just, it should be none the less acceptable because one-sided. But the Committee makes no specifications as to undue risk imposed upon taxpayers. Why is not *A* in a dilemma if he claims a deduction for 1938 and, faced with evidence that he erroneously took the same deduction for 1933, answers that the situation should continue unrectified because he has forgotten all about 1933 or never knew of his claim with respect to that year? Either his affairs are simple, in which case forgetfulness or ignorance is unreasonable, or his affairs are complicated, in which case it is scarcely unjust to say that he or his lawyers or accountants should check over what has been done in past returns before claiming a benefit from the government in the present return. The Committee's argument has not been cordially received by the courts or the Board of Tax Appeals in estoppel cases of this type.[35] It seems even less convincing where basis in capital transactions is involved, for here the ascertaining of basis implies a search of the past, and conscientious men, making such search, do not come back with only the profitable facts, neglecting the unprofitable ones. We venture the assertion that if substantial numbers of double deduction cases and analogous basis cases were fully analyzed, it would be found that the ultimate inconsistent positions had generally been taken not because of ignorance but because of acute advice from lawyers or accountants who knew perfectly well the whole genesis and development of the situations. It is highly pertinent to reassert the taxpayer's duty of reasonable care to the United States in making his income-tax returns, because that duty, adequately discharged, will nearly always warn him of self-inconsistency. Nor, it may be added, is correction of these inconsistency situations under the third method a matter of onerous and unjust penalty, even when there is exacted "a much larger sum in tax than was involved for the open year." That sum represents simply an amount by which 'the tax-

35. *Cf.* note 8, *supra.*

payer concerned failed initially to bear his share of the common burden.

The last assertion seems to be specially challenged by the Committee on the ground that Section 820 does not provide complete recomputation of tax for the reopened year. While the section was being shaped, precisely the reverse argument prevailed. In *Lewis v. Reynolds*,[36] it will be remembered, a taxpayer to whom a certain deduction had been improperly denied was refused a refund because, after the running of the statute of limitations, the Commissioner discovered and relied upon an improper deduction taken with respect to the same tax, which improper deduction more than counterbalanced the one that should have been permitted. This principle, if inserted in Section 820, and enforced by ingenious and determined reauditing, might be employed to block most refunds unless taxpayers were willing to carry their litigation out of the Bureau and into the courts. Whether any such use would actually be made of the principle is rather beside the point. Many taxpayers, lawyers, and accountants would have thought the risk substantial enough to detract seriously from the merits of the legislation. The American Bar Association's Committee would scarcely have failed to take that side of the argument.

So far as the omission or mistreatment of other items in the reopened year is unconnected with the item involved in the inconsistency, the reasons for specialized modification of the statute of limitations do not extend to them. Hence on principle there is good ground for refusing to reopen as to such items.[37] Of course this involves distinct departure from the concept that income-tax liability for each year is a unitary matter, not to be split into subordinate fractions. The Bar Association Committee, however, seems to us to speak soundly when it says: "Statutes of repose are based on such practical reasons that exceptions should be rare *and should be closely limited in their effect.*" (Italics supplied.)[38] Precisely this consideration justifies close limitation by the unusual procedure of splitting liability in the present unusual situation. So far as omission or mistreatment of items in the reopened year is connected with the item involved in the inconsistency, different considerations apply. One possible example has been given in the form of a deduction omitted because it seemed superfluous, as the original return for the reopened year disclosed no tax liability. Special provision might be made for such situations. It should be borne in mind, however, that they will ordinarily involve comparatively slight tax burdens because the operation of such deductions, if duly asserted, would as a rule be only to reduce or cancel liability for normal tax. Few individuals, surely, fail to report deductions

36. 284 U. S. 281 (1932).

37. *Report of the Senate Committee on Finance*, SEN. REP. NO. 1567, 75th Cong., 3d Sess. (1938) 51-52.

38. *Op. cit. supra* note 3, at 106.

as large as $4,000 and the requirements of corporation returns are such that this kind of omission will not occur. Then, too, reasonably careful individual taxpayers, working with Section 820 in mind, will not from now on make these omissions but will set out the whole story. Consequently the risk of any injustice from this cause will steadily decrease as old returns are finally disposed of, and is likely to be negligible with respect to situations relevant to tax returns made after the middle of 1938. Unless and until experience demonstrates otherwise, it would seem sound to avoid complicating this part of the Revenue Acts with a special protective clause. In weighing this conclusion, the reader should remember that the Commissioner will never be able to collect additional tax for a closed year under Section 820 except when inconsistent action on the taxpayer's side clears the way for reopening. He should also note that the foregoing remarks deal with other *items,* whether related or unrelated to the items directly involved in inconsistencies. They do not deal with *computations* based upon items, either singly or in the aggregate. Correction of the erroneous treatment of one item may have far-reaching consequences in diverse computations. That problem is discussed hereafter.

We regard as extremely important the effect of any tax provision upon the willingness of taxpayers to make payments without goading by the collecting authorities. It seems plain beyond argument that the Federal income-tax cannot continue to function successfully unless the bulk of the revenue receipts from it are paid in voluntarily. In a preceding section of this article the point is made that statutory assurance of correction in case of mistake will encourage voluntary tax payments. But the American Bar Association's Committee report asserts that the particular kind of assurance given by Section 820 will cause taxpayers to minimize their voluntary payments because of the risks involved in claims for refund that may conceivably disclose inconsistencies and open up remote years to damaging recomputations of tax.

Stated in these general terms the contention has a delusive suggestion of importance which rapidly fades out when concrete, practical terms are substituted. To begin with, most items involved in income-tax returns are clear both as to timing and proprietorship. By no reasonable flight of imagination can it be assumed that willingness to make due disclosure of, and pay tax with respect to, these items will decrease because corrective machinery exists exclusively applicable to items of an entirely different nature.

So far as doubtful items or plainly mishandled items are concerned, claims for refund create risk of the reopening of closed years in only two situations. First, a taxpayer who seeks a refund as to an open year by asserting a deduction not claimed in his original return for that year will run this risk if he has taken the deduction already for a year now

closed. But neither this situation, nor the analogous ones which may arise in basis cases or cases involving related taxpayers, can be thought of as having any bearing upon willingness to return income and pay tax correspondingly. Here, the corrective principle merely discourages the double use of subtractions from gross income which may not legitimately be used more than once. Second, a taxpayer who seeks a refund as to an open year by asserting that an income item included in his original return for that year really pertains to another year, now closed, will run the risk of reopening if he omitted the item from his return for the closed year. The analogous situation involving related taxpayers, in which a claim of refund by *A* may, if successful, have the effect of laying *B* open to a deficiency assessment, can raise a substantially identical problem if *A* is under a legal obligation, or considers himself under a moral obligation, to reimburse or exonerate *B*. When, as will usually be the case, *A*'s responsibility is less than this, his reluctance to disclose the income item will also be less marked. Hence we can do full justice to the contention of the Committee report by discussing it in terms of a single taxpayer.

If a single taxpayer is not aware of the existence of Section 820, or has no suspicion that any income item with which he is dealing has been improperly omitted from his return for some closed year, he will of course have no greater incentive to suppress this item than would exist if Section 820 had never been enacted. If he becomes certain, either with or without legal advice, that the item pertains exclusively to a closed year, his conduct with or without Section 820 will be identical. Should he be an extremely sensitive man about income-tax liability, he will seek to correct the outlawed return; should he be a normal person, he will do nothing at all about disclosing the item. This statement must be understood as implying absence of fraud in connection with the old return. Otherwise that year will not be closed. If this hypothetical taxpayer, with or without legal advice, becomes reasonably doubtful as to whether the item pertains exclusively to a closed year, his natural action, entirely aside from Section 820, will be to withhold the item from his current return, thus paying no tax with respect to it unless the Bureau discovers the omission and a deficiency assessment results. Should he be too honorable or too timid to pursue this reticent course, it seems to us practically certain that he will act no less openly with Section 820 in the statute than without it. Let any lawyer test the general soundness of this analysis by considering what advice he would give a client who came to him with each of the varying shadings of the problem. If the analysis *is* sound, this particular criticism by the Committee has been quite completely evaporated.

Just as the willingness of taxpayers to make voluntary payments is a matter of the highest importance, so must it be essential to avoid profuse tax litigation, in the achievement of really satisfactory administration. One obvious shortcoming of the judicial "estoppel" remedy for the prob-

lem under discussion is that its application has required incessant litigation. Dozens of estoppel cases have been decided one way or the other during the past eight or ten years without attainment of anything like reasonable certitude. When possible statutory methods of relief are canvassed, one prime consideration must be that of reducing litigated controversy. The best way to cut down litigation is to abolish or lessen the incentive to do the things which lay bases for law suits. The adverse critics of Section 820 seem to assert that its fundamental theory tends to increase this incentive, and that other fundamental theories are therefore preferable.

Of course the action which causes law suits in the present connection is the taking of inconsistent positions on either the government's or the taxpayers' sides. Remedial theories which make inconsistency attractive or at least harmless would be likely in practice to continue the recent disputatious conditions. Remedial theories which make inconsistency impossible or costly would tend to change these conditions. Let us consider the theories one by one in the light of this thesis:

1. The theory of recoupment or set-off. Under this it will be remembered that when an item is twice taxed, the erroneous tax paid for the closed year is to be credited against the tax correctly exacted for the open year. Correspondingly, where a deduction has been twice used, the tax saving by its correct use for the open year is to be reduced by the saving resulting from its erroneous use for the closed year.[39] This process produces a theoretically correct result only where the two taxes or the two savings are exactly equal (taking into account an allowance for

39. This seems to enlist the support of Mr. Phillips, already quoted in note 28 *supra*, although his terminology is different: "For myself, I believe that there is (a legislative solution). There will not be time to permit an exposition of the full idea, but if my memory serves me correctly, a draft of such an idea was proposed by Congress some ten years ago. At that time it died because Congress did not have the time to complete the draft in satisfactory form. The principle underlying that draft was one of equitable estoppel, applying equally to the taxpayer and to the government, making an adjustment in the open year which would correspond with the tax liability which was escaped, and adjusting the open year with respect to the tax liability which might have been but was not imposed during the closed year; at the same time not increasing the tax liability beyond that which would be equitable under a proper adjustment of the liability as between both years. The idea is very difficult to work out." (1938) 16 TAX MAG. at 694. This reference seems to be to the proposal of Mr. Satterlee's committee in 1927, which reads: "Provided, That whenever the commissioner determines an additional tax for a taxable year, the effect of which determination is to decrease the tax for some other year or years, the refund or credit of which tax would be barred by limitation, such refund or credit, up to the amount of said additional tax, shall be allowed, notwithstanding such limitation: And provided further, That whenever the commissioner reduces the tax for a taxable year, the effect of which reduction is to increase the tax for some other year or years, the assessment or collection of which additional tax would be barred by limitation, such additional tax may be assessed and collected up to the amount of said reduction, notwithstanding such limitation." *Hearings, supra* note 2, at 544; *cf.* 535 and 548.

interest by reason of the time spread), or the tax or saving for the closed year is smaller than the tax or saving for the open year. When the tax or saving resulting from erroneous action for the closed year is larger than the correct tax or saving, the Commissioner in the first instance and the taxpayer in the second instance may retain the improper excess. In other words, under this theory inconsistency never results in any loss with respect to income-tax either to government or taxpayer. Since there is always a chance that inconsistency will pass undetected, or unredressed even to the limited extent permitted, the theory does not end the Commissioner's incentive to tax doubtfully-timed income twice or the taxpayer's incentive to claim doubtfully-timed deductions twice. And so, of course, in related taxpayer cases, where proprietorship instead of timing is the problem. Like any rule of "heads I win, tails we tie", the recoupment theory does not tend to decrease litigation.

2. The theory of recoupment or set-off modified by an application of the principle of *Lewis v. Reynolds* in favor of as well as against the taxpayer, and with respect to deficiencies as well as refunds. Perhaps a simpler way to state this theory is to say that the closed year shall be completely reopened, the tax for that year recomputed so as to correct *all* errors discoverable therein, and any relevant balance disclosed by this computation used for recoupment. The balance may fall the wrong way and, therefore, not be relevant. For example: For the year now closed the taxpayer erroneously took advantage of a deduction, which saved him $1,000; he also erroneously failed to claim another deduction, with the net result that he overpaid his tax; for the open year he correctly, but for a second time, claims the first deduction and saves $900 thereby; the inconsistency is detected and a correction sought; but, because a net overpayment (irrelevant for recoupment in the government's favor) appears when the closed year is completely reaudited, the taxpayer reaps the full benefit of his inconsistency. Suppose, to put things the other way around, the Commissioner had erroneously compelled the taxpayer to include for the closed year an income item which increased the tax $1,000; the Commissioner also erroneously failed to disallow a deduction for personal (not business) expense which saved the taxpayer $1,500; and for the open year the Commissioner correctly, but for the second time, insists upon including the income item and thus increases the tax by $750. The Commissioner, this time, will be able to reap the full benefit of his inconsistency, since the taxpayer cannot produce from the closed year a single cent for recoupment. Under this theory there is a most dangerous incentive to inconsistency and litigation because so far as the Bureau can dig out for use in connection with an open year an item of income subjected to untimely taxation for a closed year, it can with respect to that closed year at least partially resurrect tax liability as to erroneously omitted income items. In the converse situation, the taxpayer has a like golden

opportunity with respect to erroneously omitted deductions. Very likely these possibilities were among the considerations which moved Hugh Satterlee to say in 1927, when speaking to the Committee on Ways and Means about our general problem, that the Committee on Federal Taxation of the American Bar Association did not "think that simply because there is one change to be made in a return for a year, it should be given the effect of opening up the return for the previous year wide open."[40]

3. The theory of correct adjustment—that is, the theory of Section 820 — modified by a similar application of the principle of *Lewis v. Reynolds*. Under such a scheme the possibilities are just as alarming as under the scheme just described. Both these schemes obviously offer strong incentives to inconsistency and litigation whenever with respect to closed years ordinary erroneous omissions or inclusions can be revivified in collateral consequence of an attack on the timing or proprietorship of other items.

4. The theory which freezes the mistake permanently and which might be termed the estoppel notion carried over into statute, made to work both ways, and operated under less intricate requirements than those of judicial estoppel *in pais*. In broad terms this means that a taxpayer who takes the advantage of a deduction for one year under one theory of timing may not, after that year has closed, shift position and take advantage of the same deduction for another year under another theory; correspondingly, that the Commissioner, having accepted payment of tax with respect to an income item, is similarly bound. Sweepingly and rigidly applied, this discourages litigation with a vengeance by prohibiting inconsistency. It would operate to the benefit of designing taxpayers who, avoiding fraud and failure to file returns,[41] chose the least expensive method of return despite possible incorrectness, with a hope that the year might be closed by limitations or otherwise before their method was questioned. Such an application of the estoppel notion really makes the limitation period for each year potentially a limitation period for some problems of other years. As the other years will usually be later ones, the result is highly anomalous. It demands vigilance and quickness of decision by the Bureau far beyond what has hitherto been necessary and probably beyond what is possible with the present personnel and scheme of administration. No such acute celerity has been required of the government in connection with judicial estoppels because these cannot be fastened upon the Treasury. The taxpayer, too, may have good reason to complain of specially abbreviated limitation periods. Suppose, for instance, that in compliance with existing judicial decision a deduction far exceeding gross income of 1935 is

40. *Op. cit. supra* note 2, at 535. Mr. Satterlee's remarks may, however, be read simply as an expression of preference for recoupment or set-off as contrasted with thoroughgoing correct adjustment.

41. See Revenue Act of 1938, § 276(a), 26 U. S. C. § 276(a) (Supp. 1938).

claimed as a business expense for that year. In 1940 the Supreme Court reverses the earlier cases, and lays down the rule that such deductions must be prorated over a series of years, these years running in our particular case through 1945. So prorated, the deduction would be more valuable to the taxpayer than as applied in a lump to 1935. Yet, under the estoppel or freezing rule, he will be told that as to past years still generally open and even as to future years he may not have the benefit of the Supreme Court's decision.[42]

5. The actual theory of Section 820, which is the theory of correct adjustment is uncomplicated by the principle of *Lewis v. Reynolds.* This rule, "by taking the profit out of inconsistency"[43] removes the incentive of undue advantage which has obviously caused most inconsistency and most litigation in the past, and has given rise to most discontent with the old conditions. It does not further restrict the Treasury's opportunity to detect and deal with income-tax returns in which items have been manipulated for the purpose of reducing tax rather than of complying with the law. At the same time, in cases such as the hypothetical situation described at the end of the last paragraph, this rule does not prevent matters from being completely straightened out. The American Bar Association's Committee complains because such readjustments are possible even though the taxpayer has "negligently allowed the statute to expire against him."[44] If distinctions between the diligent and non-diligent were easily and surely made, a differentiation might be worded and added to the section. But of course such distinctions are neither easy nor certain of application. Congress can hardly be blamed for establishing a broad rule based on the view that it is wisest to permit the correction of clear injustices, accepting the risk that some comparatively undeserving persons may take advantage of the opening.

One further consideration should be touched upon with particular reference to the foregoing paragraphs 4 and 5. The Supreme Court has told us that it is a violation of due process to charge a husband with tax liability for his wife's income, assuming that he has not in any fashion

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42. The American Bar Association's Committee of 1938 seems to favor estoppel. At least its report says that a statute of limitations "should be simple and understandable," and talks about "the simple estoppel solution which has been attempted by some courts." *Supra* note 3, at 106. Contrast Paul (1938) 16 TAX MAG. at 694 ("I do want to emphasize the seriousness of the subject, and I don't believe that the cure can be effected through the operation of the estoppel principle. I tried myself to deal with estoppel one time and I ran into sixty or seventy pages on the subject, and I don't believe we are going to be able to put that into a comprehensible statute.").

43. *Report, supra* note 37, at 49.

44. *Supra* note 3, at 105. Such insistence upon due care is strikingly at variance with the Committee's implied insistence in the very next page that taxpayers owe the Government no perceptible duty to be careful about taking identical deductions twice over. See pp. 524, 525 *supra.*

consented to being thus charged.[45] For this reason it seems highly questionable whether the statutory estoppel doctrine of paragraph 4 can be invoked with respect to related taxpayers, except so far as there is a special agency relationship between them, as in cases of collusion to defeat the revenues, or when one of them is proprietor of the whole beneficial interest involved, as in *Stone v. White*. It has been suggested that forced application of the correct adjustment principle to related taxpayers would also be unconstitutional.[46] While the issue is not beyond doubt, we believe this suggestion unsound. Statutes of limitation may be modified and amplified by particular exceptions, provided the modifications and exceptions are reasonable. The general notion of proper classification as not violating equal protection is relevant here, although the Fifth Amendment contains no explicit equal protection clause.[47] Nor is it a violation of due process to revive a remedy by legislation passed after the statute of limitations has run against enforcement.[48] So the application of the correct adjustment principle with respect to related taxpayers for years already past seems to present no peculiar difficulty. If these constitutional views are correct, and (as we contend hereafter) it is desirable to extend to related taxpayers whatever ameliorative doctrine Congress employs for the immediate purpose, the correct adjustment rule seems in this respect preferable to the statutory estoppel rule.

Our general conclusion on the problem of choosing one corrective principle rather than another as a basis of legislation is that the correct adjustment rule has perceptible theoretical and practical advantages over the other possible rules, and that the criticisms leveled against it are not convincing.

*(This article will be concluded in the March issue.)*

45. Hoeper v. Tax Commission, 284 U. S. 206 (1931).

46. Mr. Phillips raised the point. (1938) 16 TAX MAG. at 694.

47. Elaborate citation seems needless, but attention may be called to the Supreme Court's remarks about the classification involved in § 611 of the Revenue Act of 1928, 45 STAT. 875 (1928). Graham & Foster v. Goodcell, 282 U. S. 409, 431-432 (1931).

48. Campbell v. Holt, 115 U. S. 620 (1885). See Graham & Foster v. Goodcell, 282 U. S. 409, 426-430, and particularly several of the antecedent cases in lower Federal courts, such as Huntley v. Gile, 32 F. (2d) 857, 859 (C. C. A. 9th, 1929); Regla Coal Co. v. Bowers, 37 F. (2d) 373, 377 (S. D. N. Y., 1929), *aff'd sub nom.* Daniel Reeves, Inc. v. Anderson, 43 F. (2d) 679, 682-683 (C. C. A. 2d, 1930); Imhoff-Berg Silk Dyeing Co. v. United States, 43 F. (2d) 836, 843 (D. N. J. 1930). Mascot Oil Co., Inc. v. United States, 282 U. S. 434 (1931), and Helvering v. Newport Co., 291 U. S. 485 (1934), should also be consulted. But contrast with these two cases the discussion in Commissioner v. Northern Coal Co., 62 F. (2d) 742 (C. C. A. 1st, 1933), *aff'd by equally divided court, per curiam,* 290 U. S. 591 (1933), *rehearing denied,* 293 U. S. 191 (1934); see National Surety Co. v. Architectural Decorating Co., 226 U. S. 276, 282 *et seq.* (1912). *Cf.* William Danzer & Co., Inc. v. Gulf & Ship Island R. R., 268 U. S. 633, 636-637 (1925); Stewart v. Keyes, 295 U. S. 403, 416-417 (1935); Home Insurance Co. v. Dick, 281 U. S. 397, 409 (1930).