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DEPARTMENT OF THE TREASURY
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

FROM: Assistant Chief Counsel (Administrative Provisions and Judicial Practice)
CC:PA:APJP

SUBJECT: Arguing equitable recoupment to counter inconsistent treatment with regard to the amount of gift tax payable

This Field Service Advice responds to your memorandum dated September 8, 2000. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be used or cited as precedent.

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LEGEND

Estate =
Decedent =

Year 1 =
Year 2 =
Year 3 =
Year 4 =

a =
b =
c =
d =
e =
f =
g =

ISSUE

Whether, under the doctrine of equitable recoupment, the estate is precluded from including Year 1 gifts in computing the total gift tax payable under I.R.C. § 2001(b)(2) when the Year 1 gifts were not included in calculating gift taxes paid for taxable years Year 2, Year 3, and Year 4, and the statute of limitations bars assessment of gift taxes for those years.

CONCLUSION

While the estate is unjustly enriched by inclusion of Year 1 gifts in determining gift tax payable under I.R.C. § 2001(b)(2), equitable recoupment cannot be asserted.

FACTS

Decedent filed gift tax returns in Year 2, Year 3, and Year 4. The gift made during the Year 2 tax year was of public housing bonds ("Haffner Bonds") issued in 1937 under the Federal Housing Act. That act stated that the bonds were exempt from estate and gift taxes. Due to the controversial nature of the bonds, the return was audited and held in examination until the taxable nature of those bonds was resolved by the United States Supreme Court in United States v. Wells Fargo, 485 U.S. 351 (1988). Once it was determined that the bonds were subject to estate and gift taxes, decedent agreed to the deficiency. The Service computed the deficiency

for the Year 2 tax year on the basis of the information shown on the return, which failed to disclose Year 1 gifts of $a. The Service computed the tax as if the Year 2 gift was the first gift made resulting in an underassessment of $b.

Decedent made gifts in Year 3 and timely filed a return for those gifts. The gift tax return for Year 3 disclosed the Year 1 gifts, but failed to include the Year 2 transfer. The Year 3 gift tax payable did not take into account the Year 2 gift. The Year 3 gift tax was recomputed by the Service as if the Year 2 gift was the first gift (i.e., without regard to the Year 1 gifts), resulting in an underassessment of $c. The adjustment to gift tax payable in light of the Year 2 gift tax return was also omitted from the Year 4 gift tax return, resulting in an underassessment of $d.

The 3-year period of limitations for assessment of gift taxes for Year 2, Year 3, and Year 4 expired, leaving $e underassessed.

Decedent died on August 14, 1997. In filing the estate tax return and computing the estate tax under I.R.C. § 2001, the estate computed "gift tax payable" for the gifts made after 1976 (i.e., the Year 2, Year 3, and Year 4 gifts) using the correct gift tax liability (i.e., by taking into account the decedent's Year 1 gifts). The estate is claiming a deduction for gift tax payable after 1976 of $f (line 9 of the estate tax return). Therefore, more "gift tax payable" is being credited against the tentative estate tax than the $g actually assessed and paid by the decedent for those gifts.

LAW AND ANALYSIS

Occasionally, one party to a tax conflict may be given an unfair advantage, i.e., double taxation or double benefits, by asserting an inconsistent position while claiming the protection of the statute of limitations for the affected prior tax years. The doctrine of equitable recoupment may apply to lift the statutory bar by allowing a party to use a tax claim, barred by the statute of limitations, as a defense to the opposing party's timely tax claim where the two claims arise from the same transaction and involve the same taxpayer or two or more taxpayers who share an identity of interest.

The first case to apply recoupment as a remedy was Bull v. United States, 295 U.S. 247 (1935). In that case, decedent died holding a participating partnership interest. Partnership profits which had accrued as of the date of decedent's death were included on the estate tax return as part of the gross estate. The Service asserted that the amount of profits included an additional amount of profits which had accrued from the date of decedent's death to the end of the partnership period one year later. The estate paid the additional estate tax assessment, but the amount of partnership profits that had been included in the gross estate were not included in

the decedent's final income tax return. After the expiration of the period of limitations for an estate tax refund, the Service asserted an income tax deficiency against the estate for the income as earned by the estate after decedent's death. The tax was paid and a timely suit for refund was instituted.

The government argued that if a mistake had been made, the expiration of the period of limitations prevented its correction. The Supreme Court determined that if the action were one for collection of tax brought by the Government, the estate could have interjected defense of recoupment in the nature of a setoff of the overpayment of estate tax even though an action for its recovery was barred. The court added that the ultimate issue in a deficiency action is the "recovery of a just debt owed the sovereign", and where the sovereign oversteps its bounds, the collection amounts to a "fraud on the taxpayer's rights". Bull, 295 U.S. at 260-261. The court found for the taxpayers, concluding: "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." Bull, 295 U.S. at 262.

In Stone v. White, 301 U.S. 532 (1937), the surviving wife and sole beneficiary of the testamentary trust elected to take her interest under the will in lieu of a statutory interest. At that time, the trust income paid in period installments to the wife was considered an annuity purchased by the surrender of her statutory interest, and was not taxable to her until she had recovered the value of that interest. After the statute of limitations had run against assessment of any income tax deficiency against the wife, the Service assessed a deficiency against the trust attributable to the periodic income payments. The trust paid the assessment. Shortly thereafter, the Supreme Court decided a case which held that such trust income was taxable to the beneficiary. The trust then filed a refund suit for the income tax wrongfully collected. The Service argued that the income tax which should have been paid by the beneficiary, now barred by the statute of limitations, was greater than that collected from the trust. Any refund to the trust would inure to the benefit of the wife, so the wife would be unjustly enriched by the refund. The Supreme Court held for the government, determining that, despite the fact that the trust and the beneficiary are separate entities under the tax code, a court of equity may view the situation as a whole and acknowledge the realities of the relationship between the trust and beneficiary.

In McEachern v. Rose, 302 U.S. 56 (1937), the Supreme Court upheld the statute of limitations. In McEachern, an estate filed income tax returns and paid an income tax for tax years 1928 through 1931 on amounts received under an installment obligation of the decedent's, erroneously treating each installment as a sale. Instead, the estate should have included in income the difference between the fair

market value of the obligation on the date of decedent's death and the basis of the obligation. Tax on the difference was only due during 1928. The estate filed a claim for refund of the income tax paid for 1929, 1930, and 1931. At that time, assessment on the 1928 tax year was barred by the expiration of the period of limitations. The Service denied the refund claim on the ground that the barred deficiency exceeded the amount of the overpayment. The Supreme Court stated that the statute of limitations was directly applicable and would not be overriden. The McEachern court distinguished Stone by characterizing the McEachern income tax overpayments as statutory overpayments, which were barred from being credited against the unpaid tax after the period of limitations for assessment had expired. The McEachern opinion, however, never considered or even mentioned recoupment as a remedy.

In Rothensies v. Electric Storage Battery Co., 329 U.S. 296, 302 (1946), the Supreme Court stated that the statute of limitations was designed to prevent consideration of stale claims, and, although it may occasionally result in unfairness, the statute existed as a fairness doctrine based on compelling public policy which should not be undermined. The Rothensies court also determined that the court must weigh not only the equities, but also tax policy in deciding whether to apply an equitable remedy.

As a result of the four Supreme Court cases, the four elements of equitable recoupment are: (1) that the refund or deficiency for which recoupment is sought by way of offset is barred by time; (2) that the time-barred offset arises out of the same transaction, item, or taxable event as the overpayment or deficiency; (3) that the transaction, item, or taxable event has been inconsistently subjected to two taxes; and (4) that if the subject transaction, item, or taxable event involves two or more taxpayers, there is sufficient identity of interest between the taxpayers subject to the two taxes so that the taxpayers should be treated as one.

The threshold question is whether the Service may use recoupment for offensive purposes.

The largest hurdle for claiming equitable recoupment in this case is that, in the view of the National Office, the Tax Court lacks authority to apply the doctrine of equitable recoupment, as it is not a power delegated to the Article I court by Congress. See N(35)000-142 (December 17, 1996). In Estate of Mueller v. Commissioner, 107 T.C. 189 (1996), the court stated, "Use of equitable recoupment is limited to defending against a valid claim. It allows an otherwise time-barred tax claim arising out of the same transaction to be used as a defense or credit against any additional tax ultimately found to exist in the main action." In that case, the Service argued that equitable recoupment can only be used as a defensive

measure, and the Court cited Estate of Mueller v. Commissioner, 101 T.C. 551, 552 (Year 4) in support: "[T]he party asserting equitable recoupment may not affirmatively collect the time-barred underpayment or overpayment of tax."

The estate is properly allowed to use the correct gift tax payable for purposes of calculating the tentative estate tax. The result is that the estate will receive a windfall since it will be allowed to use the correct gift tax payable for the Year 2, Year 3, and Year 4 years for purposes of credits against tentative estate tax instead of the actual gift tax payable for those years. Except for the equitable recoupment argument, there would be no deficiency in this case, since the computation is the only item in dispute. Accordingly, equitable recoupment cannot be asserted in this case.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

Other equitable remedies which might be considered include estoppel and the duty of consistency. The doctrine of equitable estoppel has been applied to remedy situations where one party would obtain an unfair advantage if that party's earlier misleading conduct were allowed to stand. For estoppel to be applied in favor of the government, it must be shown that: (1) the taxpayer misrepresented or concealed a material fact; (2) the taxpayer had actual or imputed knowledge of the misrepresentation; (3) the government did not have knowledge of the misrepresentation; (4) the taxpayer's intention or expectation was that the misrepresentation would be acted upon by the government; (5) reliance by the government; and (6) detriment to the government. Sangers Home for Chronic Patients v. Commissioner, 72 T.C. 105, 115 (1979).

The duty of consistency doctrine is:

> based on the theory that a taxpayer owes the Commissioner the duty to be consistent with his tax treatment of the same or related items and will not be permitted to benefit in a later year from an error or omission made in a prior year which cannot be corrected because the statute of limitations has expired.

Erickson v. Commissioner, T.C. Memo. 1991-97, citing Southern Pacific Transportation Co. v. Commissioner, 75 T.C. 497, 838-839 (1980). The doctrine requires the presence of three elements: (1) a representation by the taxpayer; (2) reliance on the representation by respondent; and (3) an attempt by the taxpayer, after the statute has run, to change the representation.

With regard to these equitable remedies, the Service will also have a difficult time supporting their position. Where the Service knows or has reason to know of the errors on the return prior to the expiration of the period of limitations with respect to that return, the Service is prohibited from demonstrating reliance on the representation by the taxpayer. See Mayfair Minerals, Inc. v. Commissioner, 56 T.C. 82, 91 (1971), affd. per curiam 456 F.2d 622 (5th Cir. 1972); Spencer Med. Assocs. v. Commissioner, T.C. Memo. 1997-130; Erickson v. Commissioner, T.C. Memo. 1991-97. Again, there were two chances to catch and cure the errors prior to the expiration of the period of limitations: the original audit of the Year 2 gift tax return and the examination of the Year 3 return, in which the Year 1 gifts were disclosed. It will be difficult to argue that the Service relied on the estate's representation since it should have known about the Year 1 gifts prior to the expiration of the period of limitations. The Service should have known of the Year 1 gifts when the periods of limitations were still open and, therefore, will have difficulty arguing reliance, particularly in light of the reluctance of courts to utilize equtiable remedies.

Please call if you have any further questions.

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