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Mitigation of the Statute of Limitations in Federal Tax Cases

FOR MANY YEARS it has been the accepted policy, as reflected in the various revenue acts, to create statutory periods of limitation of federal tax liabilities, both with respect to the assessment of deficiencies in tax and the prosecution of claims for refund. While there have been numerous changes in detail as to the length of the period, the date when the period begins to run, the allowance of interest, and the like, the basic legislative policy is settled and there nowhere appears any tendency to reopen the general issue. Certain necessary exceptions to the general policy have been made by Congress, principally two: (1) The benefits of the statute do not accrue unless a return is filed; (2) Even if a return is filed, fraud in the return destroys the bar of the statute. Also, in a few special situations, Congress has provided a period within which a deficiency in income tax may be asserted by the Commissioner from one to several years longer than the usual three-year period.

The soundness of this established legislative policy is not open to serious question. The reasons justifying statutes of repose in other fields are fully applicable to federal tax liabilities. Indeed, the very large number of persons affected by the various federal revenue acts, the vital importance of such liabilities in the budgets of business enterprises, and the consequences to taxpayers which may result from failure to compute correctly under a highly complex law and discharge in full their federal tax obligations, combine to make a statute of repose in favor of honest taxpayers a matter of well-nigh imperative necessity. From the point of view of the government, the fiscal desirability and advantage of a reasonable period of limitation on claims and suits for refund of taxes illegally or erroneously collected is too obvious to require comment.

For these reasons no one would be likely seriously to propose the repeal of the statutes of limitations on federal tax liabilities. Nevertheless it cannot be said that the statutes have been an unmixed blessing. Their advantages have had to be purchased at a price.

They are of necessity more or less technical and arbitrary in their operation, a trap for the ill-advised or the unwary, and undoubtedly productive both of gross hardship to taxpayers and of inequitable, even if non-fraudulent, escape from tax liabilities by taxpayers in many individual cases. To the extent, however, that such hardship or tax escape is due to failure to make a timely assertion of rights, the hardships or inequities of statutes of limitations in the tax field do not differ significantly from those found in other fields of their operation. These are the sort of consequences inherent in any statutory limitation upon the period of time within which rights must be asserted in order to obtain the assistance of legal process for their enforcement. Such evils are clearly outweighed by the great advantages of a statute of repose, and represent the price which must be paid if those advantages are to be enjoyed.

Unfortunately, however, the inequities and hardships arising from the operation of the statute of limitations in the field of federal taxation are not limited to those which are inherent in any statute of repose. This is peculiarly true in the case of the federal income tax, chiefly because of the fact that the statutory net income which is the basis of the tax must be computed with respect to annual periods. Two or three simple cases will suffice for present purposes, to illustrate the general character of the problem. On the one hand, let us suppose that *A* has a cause of action against *B* for damages for breach of contract, or a cause of action in tort for damages for a violation of his right by *B*, or a cause of action to recover property of which *B* has unlawfully dispossessed him. In each case the statutes provide a specified period from the date the cause of action accrues within which *A* must prosecute his cause by filing suit. If *A* fails to bring his suit within such period, his right to the relief to which he would be otherwise entitled is barred by the statute. While such result may often be a great hardship on *A*, nevertheless he has failed to make a timely assertion of his right and that is the end of the matter. The ends of the public policy against prosecution of stale claims have been subserved. The statute in all these cases operates as a real statute of repose. The only advantage which has accrued to *B* is relief from the possibility of enforcement of a right against him arising out of a particular transaction or specific conduct in an earlier year.

On the other hand, let us compare with such cases, which involve only the normal consequences of a statute of limitations, a few cases which have arisen under the income tax laws. In the case of *Bigelow*

*v. Bowers*¹ the taxpayer in the year 1916 had received a stock dividend. In strict pursuance of the governing statute and regulations promulgated thereunder, he included the par value of this stock in gross income in his return for that year and paid a tax thereon. In 1918 the taxpayer sold both his original shares and the dividend shares for an amount less than the sum of the cost of the original shares plus the par value of the dividend stock. The amount of this difference he claimed as a deductible loss in his 1918 return. This action also appeared to be justified by the applicable statute and regulations. In 1920, however, came the decision of the United States Supreme Court in *Eisner v. Macomber*,² enunciating the constitutional doctrine that the mere receipt of a stock dividend did not result in taxable income. In 1923 the Commissioner of Internal Revenue, upon the audit of the taxpayer's 1918 return, changed the cost basis of his stock to accord with the decision of the Supreme Court, disallowed the loss, and assessed a deficiency on the basis of the recomputation, although the statutory period within which the taxpayer could file a claim for refund of the tax paid in 1916 had in the meantime expired.

The outraged taxpayer's attempt to procure relief in the courts proved in vain.³ Since income tax liability must be determined under our statutory scheme on the basis of annual periods, the liability for the year 1918 was effectively insulated from that for the year 1916. The Commissioner's determination of the 1918 liability was legally correct, in the light of the *Macomber* decision, and the courts felt powerless to afford relief. By virtue of the fact that income tax liability must be determined on the basis of annual periods, the statute of limitations here led to the peculiar and highly inequitable result that a taxpayer, who had acted in the greatest good faith throughout, was taxed twice upon the same increment of gain.

¹ (S. D. N. Y. 1933) 5 F. Supp. 346, (C. C. A. 2d, 1934) 68 F. (2d) 839, *cert. den.*, (1934) 292 U. S. 656.

² (1920) 252 U. S. 189.

³ One judge (Manton) dissented in the Circuit Court of Appeals, asserting, "The result is unfair and very wrong . . ." 68 F. (2d) at 844. While this characterization of the result seems entirely justified from the point of view of fairness and equity, the result is believed to be sound as a matter of strict law, in the absence of facts sufficient to create an estoppel. The courts have been extremely loath for various reasons to invoke an estoppel against the government to protect taxpayers from the consequences of changing official interpretation of provisions of the revenue acts, even when, unlike the instant case, such change is not directly constrained by judicial decision. For a full discussion of the doctrine of estoppel in tax cases, see Maguire and Zimet, *Hobson's Choice and Similar Practices in Federal Taxation* (1935) 48 HARV. L. REV. 1281, 1293 *et seq.*

It is scant comfort to a taxpayer who is the victim of such a concatenation of circumstances to know that this peculiar quality of the statute of limitations has worked in other income tax cases in favor of taxpayers rather than of the revenue. The case of *Helvering v. Salvage*⁴ is an example. In that case Salvage, the taxpayer, in 1922 received stock having a substantial value for which the consideration in part was a covenant by the taxpayer not to compete. The stock carried with it an option to exchange it for stock in another corporation on the basis of four shares of preferred and one share of common stock for each share he owned. The taxpayer exercised this option in 1922. He did not disclose these transactions in his 1922 return or report any gain therefrom, but his failure to do so was apparently due to innocent mistake of law rather than to any fraudulent intent, and there were no false representations of fact. In 1929 the preferred stock was retired. Whether the taxpayer derived a taxable gain on such retirement depended on the basis which he was entitled to claim with respect to this stock. The Circuit Court of Appeals, reversing the Board of Tax Appeals, held that the taxpayer was entitled to claim as his basis the fair market value in 1922 of the shares originally acquired in that year,⁵ although no gain had been reported at that time. The Supreme Court affirmed.⁶ Since the statutory period for assertion of a deficiency for 1922 had long since expired, the taxpayer escaped payment of any tax whatever upon a large increment of taxable gain. The statute of limitations enabled him, with profit to himself, to claim a basis for his stock in 1929 inconsistent with his treatment of the 1922 transactions.

If limitations of space permitted, illustrations could be multiplied indefinitely of inequitable double benefits or double burdens resulting from the impact of a rigid statute of limitations upon a revenue system which requires the accurate assignment of items of gross income on the one hand and deductions or (less frequently) credits on the other, to their appropriate annual periods. Two or three more will suffice for present purposes. The correct timing of amounts in-

⁴ (1936) 297 U. S. 106.

⁵ *Salvage v. Commissioner of Internal Revenue* (C. C. A. 2d, 1935) 76 F. (2d) 112.

⁶ The Commissioner sought to invoke an estoppel against the taxpayer in support of the Board's determination sustaining the deficiency. The Supreme Court, through Mr. Justice McReynolds, made short shrift of the claim of estoppel, saying: "The defense of estoppel was not before the Board. Under what we regard as the correct practice, *General Utilities & Operating Co. v. Helvering*, 296 U. S. 200, the court should have passed the point. Furthermore, the facts disclosed give it no support." 297 U. S. at 109. (Italics added.)

cludable in gross income is far from being an exact science, particularly where income is reported on the basis of some accounting method other than cash receipts and disbursements. Questions of the proper year of accrual have been and will continue to be a fertile source of litigation.⁷ Factual situations are infinitely varied, and neither statute, regulations, nor decisions can supply rules sufficiently definite to provide a reasonably certain guide in all cases. Even accountants are not always in agreement as to the year to which particular increments of profit or gain should be assigned.

Here the statutes of limitations create a veritable trap for the unwary. Suppose that a taxpayer on the accrual basis includes in his return filed on March 15, 1934, as gross income a particular amount payable to him under a contract, reasonably believing it properly accrued in the calendar year 1933, and pays tax accordingly.⁸ In the latter part of 1938 the taxpayer receives notice that the Commissioner has determined a deficiency in tax for the calendar year 1934 on the ground that the amount in question was properly accrued in that year rather than 1933. Let us assume that the Board of Tax Appeals subsequently finds the Commissioner's determination to be correct, that the Board's decision is sustained on appeal, and that the Supreme Court denies certiorari. Unless the taxpayer has in some way been forewarned and has protected his rights with respect to the tax paid for the year 1933 by filing a timely claim for refund, the determination of a deficiency for 1934 will compel him, as in the *Bigelow* case,⁹ in effect to pay a second tax upon the same amount of income. Such taxpayers naturally feel themselves the victims of intolerable injustice; yet the harsh result may flow inevitably from a statute of limitations too rigid to admit of equitable modifications or exceptions.

Cases of this sort are painfully familiar to tax administrators and more numerous than might generally be supposed. They involve the element of double burden. Their converse is a class of cases in which the rigidity of the statute sometimes makes it possible for taxpayers to secure a tax benefit from a particular loss or other deductible item

⁷ For a good illustration see the case of *Helvering v. St. Louis Southwestern Ry.* (C. C. A. 8th, 1933) 66 F. (2d) 633, *aff'd* (1931) 24 B. T. A. 917, *cert. den.*, (1934) 292 U. S. 626.

⁸ A similar situation may occur when a taxpayer who is on the cash basis, by inadvertence or misunderstanding, includes in gross income in one year an item which is not actually received until a subsequent year.

⁹ *Supra* note 1.

in more than a single year.¹⁰ Some cases will involve the question in what year an item of expense is properly accrued; others in what year certain stocks became worthless, or bonds or other forms of indebtedness were ascertained by the taxpayer to have become worthless and were charged off; others in what year an embezzlement of the taxpayer's funds by a trusted employee occurred; still others in what year dividends were paid by a corporation to its shareholders so as to entitle the corporation to a dividends paid credit for purposes of a corporate tax upon or measured by undistributed corporate income. Here additional analysis becomes necessary to show the different typical situations (at least three) which may arise, depending upon the form of action pursued by the taxpayer.

First, let us assume that the item of loss or expense or payment which forms the basis of a deduction or credit to which the taxpayer is entitled in some year should properly be claimed as a deduction or credit in his return for the calendar year 1933. Due to some misunderstanding of fact or law, he claims the deduction or credit in his return for the year 1934. He does not discover his error until the deduction or credit claimed in his 1934 return is disallowed and a deficiency in tax for that year is determined against him by the Commissioner. If, prior to such time, the statutory period for filing a claim for refund with respect to 1933 has expired, he loses forever any tax benefit to which he was otherwise entitled, so far as the item in question is concerned. This result is undoubtedly a personal hardship on the taxpayer, but it will be noted that, in cases of this type, the statute of limitations has its normal and usual operation. The taxpayer has lost this benefit because he has failed to make a timely assertion of his rights, and that is all. There is no element of double burden upon the taxpayer or double benefit to the revenue involved. Individual hardships of this type could scarcely be prevented, even under tax

¹⁰ In cases falling into this class the courts have sometimes invoked the principle of estoppel in favor of the government and against the taxpayer. The better considered decisions, however, have refused to estop the taxpayer in the later year unless he has been guilty of fraud, or there is absence of good faith, or there has been some misrepresentation of fact or failure to disclose material facts in his return for the earlier year. Moreover, Mr. Justice McReynolds' dictum in the *Salvage* case, *supra* notes 4 and 6, indicates that the Supreme Court is not prepared to invoke the principle even where the taxpayer has failed to disclose material facts in his return for the earlier year, if his failure to do so is attributable to an innocent mistake of law. See Maguire and Zimet, *op. cit. supra* note 3, at 1299 *et seq.*, for a fuller discussion of the cases. See also 5 PAUL AND MERTENS, *LAW OF FEDERAL INCOME TAXATION* (Supp. 1937) § 53, for a complete collection of the authorities on estoppel.

laws much simpler than at present, by any means short of a repeal of the statute of limitations itself.

Second, let us assume the same facts except that the taxpayer, from excess of caution or some other reason, claims a deduction or credit with respect to the same item of loss or expenditure in both his 1933 and 1934 returns. In the absence of facts sufficient to create an estoppel against the taxpayer,¹¹ he is not precluded from obtaining the benefit of the deduction or credit for 1934, if, as is assumed, that is the proper year, merely because he has already obtained a similar benefit for 1933. If the Commissioner by error allows the deduction or credit in the earlier year, and fails to discover his mistake and take appropriate corrective action by assertion of a deficiency in tax before the statutory period has expired, the result will be that the taxpayer has obtained a tax benefit by way of deduction or credit from the identical item in two taxable years.¹² It should be further observed that the taxpayer has achieved this result by taking a position in the later year inconsistent with that adopted in the earlier year. Unlike the first example, this is not the normal result inherent in any statute of limitations.

Third, let us assume that the taxpayer claimed the deduction or credit in his return for 1934, herein assumed to be the proper year. Upon audit of the return, the deduction or credit is erroneously disallowed as premature by the Commissioner, and a deficiency in tax for that year is determined. The taxpayer does not contest the Commissioner's determination, and pays the deficiency. He then proceeds to claim a deduction or credit with respect to the given item in his return for the taxable year 1935, or perhaps a still later year. Upon audit the deduction or credit is again disallowed, and a deficiency in tax is determined by the Commissioner for such year. This determination, being legally correct, is sustained by the Board and the courts, which refuse to hold the government estopped by the Com-

¹¹ For the reasons indicated in note 10, *supra*, the judicial application of estoppel is too uncertain and too narrow in its scope to reach many of the cases of this type.

¹² Such an inconsistency is, to be sure, less likely to be overlooked by the Commissioner when the taxable years involved are in immediate succession, than where one or more years have intervened. Even so, the practical impossibility of making a complete audit and field examination of more than a fraction of the total number of returns filed each year increases the possibility of failure by the Bureau promptly to detect such inconsistencies. On the side of the taxpayers, it must be admitted, however, that this sort of practice is due in considerable measure to a desire to avoid the possibility of double disallowance of deductions, another trap for the unwary which is more fully discussed hereinafter.

missioner's erroneous determination in the prior year.¹³ Unless the taxpayer has been sufficiently foresighted to protect his rights with respect to the overpayment for 1934 by filing a timely claim for refund, he loses forever the tax benefit of a deduction or credit to which he was otherwise lawfully entitled. The taxpayer is likely to feel, and with much justification, that he is the victim of injustice.

Cases of this general type are unfortunately all too common, particularly with less wealthy taxpayers who are reluctant to litigate the disallowance in the earlier year because the expense and worry of litigation may seem out of proportion to the amounts of tax involved. They undoubtedly present a serious problem, aggravated under the conditions of recent years when unbalanced budgets and the pressing need for revenue create or strengthen the tendency of revenue agents and administrators to deny claims of taxpayers to deductions and credits, where any element of doubt exists as to the taxable year to which such deductions or credits properly appertain. The example given above oversimplifies the problem, of course, by its assumption that 1934 was clearly the proper year.

Further analysis of this third situation which, for purposes of convenience, may be characterized as the "double disallowance of deductions or credits," will reveal that it possesses certain features in common with the first type of case and other features in common with the second. It is like the second type in that the taxpayer's unhappy plight is due, in part at least, to the Commissioner's erroneous determination in the earlier year. It is similar to the first type in that, strictly speaking, there is no element of double burden or double loss to the taxpayer by virtue of the operation of the statute of limitations.¹⁴ Moreover, while the Commissioner's error in the earlier year

¹³ One of the serious shortcomings of the principle of estoppel, as applied in tax cases, is that it is essentially one-sided in its operation. For various reasons, some of doubtful validity, the courts have hesitated to hold the government estopped by the erroneous determinations of Bureau officials. See Maguire and Zimet, *op. cit. supra* note 3.

It will be understood that the term "Commissioner" is not used herein in an individual or personal sense but includes subordinate officials, such as revenue agents in charge, and that few of the erroneous determinations referred to are personally made by the Commissioner, with or without the advice of the Chief Counsel for the Bureau.

¹⁴ This statement is made with full appreciation of the fact that the ordinary taxpayer feels in such cases that he has been the victim of a double injury. Yet from the standpoint of strict analysis the statement is unquestionably true. The key to the emotion of the outraged taxpayer is that the injury to himself presumably would not have occurred *but for* the error of some official in the Bureau itself. That such error may itself have been the product of bona fide judgment or honest doubt on the part of such official is no salve to the taxpayer's wounds.

started the chain of events which has resulted so unfortunately for the taxpayer, the latter's failure to contest the erroneous determination in the prior year by appeal to the Board of Tax Appeals or by prosecuting a claim for refund after payment of the asserted deficiency is also an essential condition to the ultimate result. If, therefore, sound equitable administration of the revenue laws demands that a remedy be found for cases of this type, the demand must be justified not so much by the theory of prevention of double burdens as by the important practical consideration of minimizing litigation. In the present state of the law, taxpayers can adequately protect themselves in this situation only by claiming the deduction or credit in several successive years and keeping all of such years open by litigating the Commissioner's adverse determinations until the proper year has been finally adjudicated or fixed by a statutory closing agreement.¹⁵ It must be admitted that such a situation is highly undesirable and not conducive to the spirit of co-operation between taxpayers and their government which is so essential to the proper administration of an income tax law.

The existence and seriousness of the problems involved in the foregoing examples and in many other similar situations have long been recognized. In 1933, the Acting Secretary of the Treasury in a statement regarding the prevention of tax avoidance, said:¹⁶

"The Treasury strongly endorses the proposal to amend the statute of limitations to insure that, in cases of disputes as to the proper year in which income or deductions should be reported, such items shall be taken into account once and only once."

¹⁵ The result of general adoption of such a practice is to multiply litigation and increase delay in the closing of back years, since two or more years may be held open pending the final disposition of the single item in controversy. The principal source of difficulty, however, is inherent in the subject matter of the deductions for losses due to securities and debts becoming worthless. The statutory scheme requires that such losses be correctly assigned to the appropriate taxable years. This requires an exact location of events in the stream of time, which is at best artificial and oftentimes extremely difficult for anyone to make. The optimistic taxpayer is particularly likely to be penalized. Honest doubts and reasonable differences of opinion as to the taxable year to which the loss is properly referable are inevitable, and the tendency of revenue officials to resolve doubts against the taxpayer has been aggravated by the ever-present possibility, prior to the enactment of section 820, that if the allowance of the deduction in the earlier year should prove to be erroneous, the taxpayer is not precluded from claiming it again in the subsequent proper year. See the remarks of Mr. Aubrey R. Marrs, Head of the Technical Staff, Bureau of Internal Revenue, in *Proceedings of the Seventh Tax Clinic of the American Bar Association* (1938) 16 TAX MAG. 663, 665, *et seq.*

¹⁶ Statement of the Acting Secretary of the Treasury Relative to Methods of Preventing the Avoidance and Evasion of the Internal Revenue Laws Together with Suggestions for the Simplification and Improvement Thereof, as reprinted in *HEARINGS BEFORE COMMITTEE ON WAYS AND MEANS, HOUSE OF REPRESENTATIVES, ON REVENUE REVISION, 1934, 73d Cong. 2d Sess. (1934) 132.*

The general problem was considered by the legislative draftsmen and the government's experts in connection with the drafting of the Revenue Act of 1934 and on other occasions, but nothing concrete in the form of legislation was forthcoming on those occasions, due to inability to solve the many formidable technical difficulties which even a partial legislative solution of the problem involves. Through the years the legislative staff of the Treasury Department and officials of the Bureau of Internal Revenue have continued to study the problem and to seek for some statutory formula which would afford a remedy for the most serious inequities without substantial impairment of the basic policy underlying the statute of limitations itself. The courts, confronted by these inequities in concrete cases, have sought to ameliorate them by extending the scope of application of the principle of estoppel. The judicial process has not been able to evolve any comprehensive solution and indeed in some instances has reached results difficult to justify.¹⁷ It is a field in which hard cases are peculiarly prone to make bad law. Some of the decisions have even tended to create serious confusion in administration because of uncertainty as to the scope of their application as precedents.¹⁸ A considerable literature has developed pointing to the crying need for a solution operating equitably as between taxpayers and their government.¹⁹

¹⁷ Maguire and Zimet, *op. cit. supra* note 3, at 1293 *et seq.*

¹⁸ A striking example is the well-known decision of the Supreme Court in *Bull v. United States* (1935) 295 U. S. 247, where the Court invoked the principle of recoupment to enable a taxpayer (the executor of an estate) to credit against an income tax deficiency a barred overpayment of estate tax, both deficiency and overpayment being related to the same item. While it is difficult to quarrel with the result reached in the light of the peculiar facts involved in the case, we are left in the dark by the opinion as to whether the rationale of the decision will be closely limited to such facts or whether the decision may be invoked as a precedent in income tax cases involving the same taxpayer but different taxable years. Many years may elapse before the exact scope of application of such a decision can be marked out by subsequent decisions, and in the meantime confusion and uncertainty are increased. This process has already begun in the important case of *McEachern v. Rose* (1937) 302 U. S. 56, where the Supreme Court reversed the Circuit Court of Appeals for the Fifth Circuit (C. C. A. 5th, 1936) 86 F. (2d) 231, which relied in part on the *Bull* decision to allow the government to credit a barred deficiency in income tax for a prior year against an overpayment for a later year, the situation on its facts involving inconsistent treatment of a particular transaction by the taxpayer. It was in this respect the converse of the *Bull* case. The Supreme Court held that such an application of equitable principles to the facts presented was precluded by sections 607 and 609 of the 1928 Act. 45 STAT. (1928) 791, 874, 875, 26 U. S. C. (1934) §§ 1670(2), 1675. It may be noted in passing that the situation in this case is one to which section 820(b)(3) of the 1938 Act would be applicable.

¹⁹ PAUL AND MERTENS, *loc. cit. supra* note 10; Jackson, *Changes in Treasury Tax Policy* (1934) 12 TAX MAG. 342; Magill, *Trends in Revenue Legislation* (1934) 12 *ibid.*

Those years of study and agitation finally culminated in the enactment by Congress, as a part of the Revenue Act of 1938, of the first major remedial legislation in the field.²⁰ The *Report* of the Sub-

464, 465; Maguire and Zimet, *op. cit. supra* note 3; Reiling, *The Function of a Taxpayer's Ethics in Income Tax Liability* (1934) 12 TAX MAG. 294; Reiling, *Shall We Simplify and Preserve the Federal Income Tax?* (1935) 13 *ibid.* 3. MAGILL, *TAXABLE INCOME* (1936) 163 *et seq.* points out certain serious dangers and inadequacies in the principle of estoppel as a solution and suggests as a better alternative an approach similar to that upon which section 820 is based (p. 186 *et seq.*).

²⁰ Section 820, Revenue Act of 1938 [Pub. L. No. 554, 75th Cong. 3d Sess. (May 16, 1938)]. The text of this section is as follows:

"SEC. 820. MITIGATION OF EFFECT OF LIMITATION AND OTHER PROVISIONS IN INCOME TAX CASES

(a) Definitions.—For the purpose of this section—

(1) Determination.—The term 'determination under the income tax laws' means—

(A) A closing agreement made under section 606 of the Revenue Act of 1928, as amended;

(B) A decision by the Board of Tax Appeals or a judgment, decree, or other order by any court of competent jurisdiction, which has become final; or

(C) A final disposition by the Commissioner of a claim for refund. For the purposes of this section a claim for refund shall be deemed finally disposed of by the Commissioner—

(i) as to items with respect to which the claim was allowed, upon the date of allowance of refund or credit or upon the date of unailing notice of disallowance (by reason of offsetting items) of the claim for refund, and

(ii) as to items with respect to which the claim was disallowed, in whole or in part, or as to items applied by the Commissioner in reduction of the refund or credit, upon expiration of the time for instituting suit with respect thereto (unless suit is instituted prior to the expiration of such time).

Such term shall not include any such agreement made, or decision, judgment, decree, or order which has become final, or claim for refund finally disposed of, prior to ninety days after the date of the enactment of this Act.

(2) Taxpayer.—Notwithstanding the provisions of section 901, the term 'taxpayer' means any person subject to a tax under the applicable Revenue Act.

(3) Related Taxpayer.—The term 'related taxpayer' means a taxpayer who, with the taxpayer with respect to whom a determination specified in subsection (b) (1), (2), (3), (4) is made, stood, in the taxable year with respect to which the erroneous inclusion, exclusion, omission, allowance, or disallowance therein referred to was made, in one of the following relationships: (A) husband and wife; (B) grantor and fiduciary; (C) grantor and beneficiary; (D) fiduciary and beneficiary, legatee, or heir; (E) decedent and decedent's estate; or (F) partner.

(b) Circumstances of Adjustment.—When a determination under the income tax laws—

(1) Requires the inclusion in gross income of an item which was erroneously included in the gross income of the taxpayer for another taxable year or in the gross income of a related taxpayer; or

(2) Allows a reduction or credit which was erroneously allowed to the taxpayer for another taxable year or to a related taxpayer; or

(3) Requires the exclusion from gross income of an item with respect to

committee of the Committee on Ways and Means, House of Representatives, Seventy-fifth Congress, on *A Proposed Revision of the Revenue Laws*, which was the basis of public hearings by that Committee preceding the introduction in the House of the Revenue Bill of 1938, contained the following recommendation (No. 48):

"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."

which tax was paid and which was erroneously excluded or omitted from the gross income of the taxpayer for another taxable year or from the gross income of a related taxpayer; or

(4) Allows or disallows any of the additional deductions allowable in computing the net income of estates or trusts, or requires or denies any of the inclusions in the computation of net income of beneficiaries, heirs, or legatees, specified in section 162(b) and (c) of this Act, and corresponding sections of prior revenue Acts, and the correlative inclusion or deduction, as the case may be, has been erroneously excluded, omitted, or included, or disallowed, omitted, or allowed, as the case may be, in respect of the related taxpayer; or

(5) Determines the basis of property for depletion, exhaustion, wear and tear, or obsolescence, or for gain or loss on a sale or exchange, and in respect of any transaction upon which such basis depends there was an erroneous inclusion in or omission from the gross income of, or an erroneous recognition or nonrecognition of gain or loss to, the taxpayer or any person who acquired title to such property in such transaction and from whom mediately or immediately the taxpayer derived title subsequent to such transaction—

and, on the date the determination becomes final, correction of the effect of the error is prevented by the operation (whether before, on, or after the date of enactment of this Act) of any provision of the internal-revenue laws other than this section and other than section 3229 of the Revised Statutes, as amended relating to compromises), then the effect of the error shall be corrected by an adjustment made under this section. Such adjustment shall be made only if there is adopted in the determination a position maintained by the Commissioner (in case the amount of the adjustment would be refunded or credited in the same manner as an overpayment under subsection (c) or by the taxpayer with respect to whom the determination is made (in case the amount of the adjustment would be assessed and collected in the same manner as a deficiency under subsection (c))), which position is inconsistent with the erroneous inclusion, omission, allowance, disallowance, recognition, or nonrecognition, as the case may be. In case the amount of the adjustment would be assessed and collected in the same manner as a deficiency, the adjustment shall not be made with respect to a related taxpayer unless he stands in such relationship to the taxpayer at the time the latter first maintains the inconsistent position in a return, claim for refund, or petition (or amended petition) to the Board of Tax Appeals for the taxable year with respect to which the determination is made, or if such position is not so maintained, then at the time of the determination.

(c) Method of Adjustment.—The adjustment authorized in subsection (b) shall be made by assessing and collecting, or refunding or crediting, the amount

Unfortunately the Revenue Bill as passed by the House did not include a provision to give effect to this recommendation, pressure of time and circumstances necessitating that the bill be introduced before the necessary work of drafting such provision had been completed. Subsequently the substance of section 820 was approved by the Committee on Finance of the Senate and reported as section 819 of the Senate Bill,²¹ which was passed by the Senate. The new sec-

thereof, to be ascertained as provided in subsection (d), in the same manner as if it were a deficiency determined by the Commissioner with respect to the taxpayer as to whom the error was made or an overpayment claimed by such taxpayer, as the case may be, for the taxable year with respect to which the error was made, and as if on the date of the determination specified in subsection (b) one year remained before the expiration of the periods of limitation upon assessment or filing claim for refund for such taxable year.

(d) *Ascertainment of Amount of Adjustment.*—In computing the amount of an adjustment under this section there shall first be ascertained the tax previously determined for the taxable year with respect to which the error was made. The amount of the tax previously determined shall be (1) the tax shown by the taxpayer, with respect to whom the error was made, upon his return for such taxable year, increased by the amounts previously assessed (or collected without assessment) as deficiencies, and decreased by the amounts previously abated, credited, refunded, or otherwise repaid in respect of such tax; or (2) if no amount was shown as the tax by such taxpayer upon his return, or if no return was made by such taxpayer, then the amounts previously assessed (or collected without assessment) as deficiencies, but such amounts previously assessed, or collected without assessment, shall be decreased by the amounts previously abated, credited, refunded, or otherwise repaid in respect of such tax. There shall then be ascertained the increase or decrease in the tax previously determined which results solely from the correct exclusion, inclusion, allowance, disallowance, recognition, or nonrecognition, of the item, inclusion, deduction, credit, gain, or loss, which was the subject of the error. The amount so ascertained (together with any amounts wrongfully collected, as additions to the tax or interest, as a result of such error) shall be the amount of the adjustment under this section.

(e) *Adjustment Unaffected by Other Items, Etc.*—The amount to be assessed and collected in the same manner as a deficiency, or to be refunded or credited in the same manner as an overpayment, under this section, shall not be diminished by any credit or set-off based upon any item, inclusion, deduction, credit, exemption, gain, or loss other than the one which was the subject of the error. Such amount, if paid, shall not be recovered by a claim or suit for refund or suit for erroneous refund based upon any item, inclusion, deduction, credit, exemption, gain, or loss other than the one which was the subject of the error.

(f) *No Adjustment for Years Prior to 1932.*—No adjustment shall be made under this section in respect of any taxable year beginning prior to January 1, 1932."

²¹ See Report of Committee on Finance, United States Senate, on the Revenue Bill of 1938, p. 48 *et seq.*, for explanation and discussion of the Senate provision. SEN. REP. No. 1567, 75th Cong. 3d Sess. (1938).

tion, with a change in number, was accepted by the House in conference, after a number of important, though not fundamental amendments had been agreed to, and became a part of the revenue laws.²² To its operations, merits, and defects the remainder of this discussion will be directed.

The primary objective of the section, as stated in the *Report* of the Committee on Finance,²³ is to "supplement the equitable principles applied by the courts and to check the growing volume of litigation by taking the profit out of inconsistency, whether exhibited by taxpayers or revenue officials and whether fortuitous or the result of design."²⁴ The purpose of the statute of limitations to prevent the litigation of stale claims is fully recognized and approved by the *Report*, but it is asserted that "it was never intended to sanction active exploitation, by the beneficiary of the statutory bar, of opportunities only open to him if he assumes a position diametrically opposed to that taken prior to the running of the statute."²⁵

The essential condition precedent to the operation of section 820 is inconsistency of position, whether on the part of the taxpayer or the government, which operates adversely to the interests of the other party. In general, neither party can, by his own conduct, bring the statute into operation for his own benefit. There must first be made a determination of tax liability adopting a position taken by a taxpayer or by the Commissioner with respect to one taxable year which is in conflict with the position taken by such party in an earlier year, and either the assessment of a deficiency or the granting of a claim for refund for such earlier year must be barred by the statute of limitations or by some other provision of the internal revenue laws. Such other provisions are chiefly those relating to closing agreements²⁶ and those relating to the collateral effect of a proceeding before the Board of Tax Appeals as a bar to determination of additional deficiencies or claims for refund with respect to taxable years

²² The changes in the section made in Conference are explained and commented upon on page 56 *et seq.* of the *Conference Report on the Revenue Bill of 1938*, in the "Statement of the Managers on the Part of the House." H. R. REP. No. 2330, 75th Cong. 3d Sess. (1938).

²³ SEN. REP., *op. cit.* *supra* note 21, at 49.

²⁴ *Ibid.*

²⁵ *Ibid.*

²⁶ Section 606, Revenue Act of 1928 [45 STAT. (1928) 791, 874, 26 U. S. C. (1934) § 1660] as amended by sections 801 and 802 of the Revenue Act of 1938.

which have been adjudicated by the Board.²⁷ Not included, perhaps unfortunately, is the bar of the judicial doctrine of *res judicata*. By specific provision the statute cannot operate to produce an adjustment in the earlier year, if such year is a taxable year beginning prior to January 1, 1932,²⁸ or if the tax liability for the earlier year has been compromised under the authority of section 3229 of the Revised Statutes.²⁹ The condition to the operation of the section stated in the first sentence of this paragraph is a limitation which is essential if the substance of the statute of limitations is to be preserved.³⁰

CASES IN WHICH ADJUSTMENT IS AUTHORIZED

There are five principal situations to which the adjustment provided by section 820 applies:

(1) Section 820(b)(1) covers cases wherein it is determined that an item of income is taxable in a particular year and such item has

²⁷ Sections 272(f) and 322(c) of the Revenue Act of 1938 and corresponding provisions of prior acts.

Other such important provisions overridden are sections 607, 608, and 609 of the Revenue Act of 1928, relating to payments, refunds or credits after the period of limitations has expired. See art. 820(b)-o of Treas. Dec. 4856, which contains the regulations under section 820.

²⁸ Section 820(f), Revenue Act of 1938.

²⁹ The reasons for this exclusion from the adjustment provided by the section are chiefly those of administrative convenience. Well-nigh insoluble technical difficulties of apportionment and allocation of the amount of tax actually paid in compromise would be presented if it were attempted to make an adjustment of tax liability for such a year in the manner provided by the section.

³⁰ Consideration of one or two simple examples will suffice to show the truth of this statement.

(a) A taxpayer first claims a deduction in his return for the taxable year 1938 on account of certain stock becoming worthless. The Commissioner disallows the deduction and determines a deficiency on the ground that the stock became worthless in 1937 or 1936. Assuming the Commissioner's determination to be correct, and that the statute has tolled on a claim for refund with respect to the earlier year, no adjustment is provided by the section, for there has been no inconsistent determination by the Commissioner. To permit an adjustment in such a case would in effect destroy the statute of limitations so far as taxpayers' deductions are concerned.

(b) Suppose a taxpayer should have reported an item of income in his return for the taxable year 1935 but fails to do so, the omission not being attributable to fraud. Such omission is discovered by the Commissioner after the statute has tolled on the deficiency for that year. The Commissioner asserts this item should have been reported in gross income for 1938 and determines a deficiency for that year, but on appeal by the taxpayer to the Board, such determination is properly overruled. The section does not operate in such a case for there has been no inconsistency of position on the part of the taxpayer operating adversely to the government, and the Commissioner cannot by his own conduct cause the statute to operate against the taxpayer and in favor of the government. Were the section to provide an adjustment in such a case, it would in effect abrogate the statute of limitations so far as deficiencies in tax due to failure to report items of income are concerned.

been reported as gross income of the taxpayer or a related taxpayer for an earlier year and the statutes of limitations or other provision of the revenue laws bar a claim for refund for such earlier year. Section 820 permits an adjustment by way of refund for the barred year.³¹

(2) Section 820(b)(2) governs cases where it is determined that the taxpayer is entitled to a deduction or credit in a particular year which was erroneously allowed in an earlier year to the taxpayer or a related taxpayer, and the statute of limitations or other provision of the revenue laws precludes the assessment of a deficiency with respect to such earlier year. Section 820 permits an adjustment by way of a deficiency for such earlier year.³²

³¹ The following are examples of double inclusion of items of gross income, where adjustments would be authorized by section 820(b)(1):

(a) A taxpayer who makes his return on the accrual basis includes in his return for the taxable year 1935 an item of accrued compensation, such inclusion being erroneous because his right thereto is subject to some contingency. The Commissioner subsequently asserts a deficiency in tax against him for the taxable year 1936 on the ground that the above item was taxable in that year because the contingency was resolved in such year. Prior to notice of the Commissioner's determination the period of limitation on refunds for 1935 has expired. In 1941 the Board of Tax Appeals sustains the deficiency and the taxpayer does not appeal. An adjustment by way of refund or credit is authorized with respect to 1935. If the taxpayer had returned the compensation for both 1935 and 1936 and by a determination was denied a refund for 1936 on account of the compensation item, a similar adjustment would be authorized.

(b) A husband assigned to his wife salary to be earned by him in the year 1936. (Assume the spouses to be residing in a non-community property state.) The wife included such salary in her separate return for that year and the husband omitted it. The Commissioner asserted a deficiency against the wife for 1936 with respect to a different item and she contested that deficiency before the Board of Tax Appeals, and so would be barred by section 322(c) of the Revenue Act of 1936 [49 STAT. (1936) 1648, 1731, 26 U.S.C. (1934) § 322(c)] from filing a claim for refund for 1936. Thereafter, the Commissioner asserted a deficiency against the husband on account of the omission of such salary from his return for 1936 and the deficiency was sustained by the Board of Tax Appeals, whose decision became final. An adjustment by way of refund or credit is authorized with respect to the wife's tax for 1936. The same principle would apply if the spouses were in a community property state, but the amount of the adjustment would be different, because the wife properly included one-half the salary in her return for 1936.

See Treas. Dec. 4856, art. 820(b)-1.

For reasons of convenience many of the examples used in this and the following footnotes are taken from the *Regulations*. While some of the illustrations may seem somewhat far-fetched or not very likely to occur in fact, the author does not hesitate to venture the opinion that all of them have their duplicates or analogies in the experience of the Bureau of Internal Revenue.

³² The following are examples of double allowance of a deduction or credit, where adjustments would be authorized by section 820(b)(2):

(a) A corporate taxpayer in its return for the taxable year 1936 claimed and was allowed a credit for dividends paid. Subsequently it was discovered that due to the

(3) Section 820(b)(3) covers cases wherein the determination requires the exclusion from gross income of an item with respect to which tax was paid in a particular year and which was erroneously excluded or omitted from the gross income of the taxpayer or a related taxpayer for another taxable year, with respect to which the assessment of a deficiency is barred by the statute of limitations or other provision of the revenue laws. While the taxpayer can obtain his refund for the particular year, section 820 permits the assessment of a deficiency with respect to the item against the taxpayer or related taxpayer for the earlier year.³³ It will be noted that these are cases

carelessness of a clerk the dividend checks were not mailed in time to reach the shareholders before the end of 1936. After the expiration of the period of limitations for the assessment of a deficiency for 1936, the taxpayer filed a claim for refund of surtax paid for 1937, based upon an increase in the credit for dividends paid in that year, on account of this delayed payment. The Commissioner allows this claim for refund. An adjustment by way of a deficiency in surtax is authorized with respect to 1936.

(b) The beneficiary of a testamentary trust in his return for the taxable year 1934 claimed, and was allowed, a deduction for depreciation of the trust property. The Commissioner asserted a deficiency against the beneficiary for 1934 with respect to a different item and final decision of the Board of Tax Appeals was rendered in 1936, so that the Commissioner was thereafter barred by section 272(f) of the Revenue Act of 1934 [48 STAT. (1934) 680, 742, 26 U.S.C. (1934) § 272(f)] from asserting a further deficiency against the beneficiary for 1934. The trustee thereafter filed a timely refund claim contending that under the terms of the will the trust, and not the beneficiary, was entitled to the allowance for depreciation. A court decision sustaining the refund claim becomes final in 1940. An adjustment by way of a deficiency is authorized with respect to the beneficiary's tax for 1934.

See Treas. Dec. 4856, art. 820(b)-2.

³³ The following are examples of the erroneous exclusion of items of gross income with respect to which tax was paid, where adjustments would be authorized by section 820(b)(3):

(a) A taxpayer received in 1936 a large payment as interest upon an obligation owed to him and included this payment in his return for that year. Subsequently he entered into a closing agreement with the government covering his tax liability for the taxable year 1935, the above payment not being taken into account. Thereafter, the taxpayer filed a claim for refund for the year 1936, based upon the theory that the above payment was properly taxable in 1935, inasmuch as the interest accrued in that year and the taxpayer made his returns upon an accrual basis. The claim for refund is allowed in 1939. An adjustment by way of a deficiency is authorized with respect to the year 1935.

(b) Two brothers, A and B, conduct a partnership business, sharing equally in the net profits. A included the entire net income of the partnership in his return for 1934, and B included no portion of this income in his return for that year. Shortly before the expiration of the period of limitations with respect to deficiency assessments and refund claims for both brothers for 1934, A filed a claim for refund of that portion of his 1934 tax attributable to the half of the partnership income which should have been included in B's return, and this claim is sustained by a court decision which becomes final in 1940. An adjustment by way of a deficiency is authorized with respect to B's tax for 1934. Of course in the unlikely event that, other things being equal, B would have had

involving a double error; also that this subsection applies only where the taxpayer has paid a tax with respect to the item in the subsequent year.³⁴

(4) Section 820(b)(4) applies to cases of fiduciaries and beneficiaries in a trust or estate relationship, involving the allowable additional deductions in computing the net income of estates or trusts, and the required inclusions in the computation of net income of beneficiaries, heirs, or legatees, specified in section 162(b) and (c) of the 1938 Act, and the corresponding provisions of prior acts. If a trustee erroneously reports income which should have been reported by a beneficiary and the error is corrected and the beneficiary is required to pay the tax by a final determination, although the statute otherwise bars a claim for refund by the trustee, section 820 permits an adjustment by way of refund to him.³⁵ In the converse situation, it

no taxable net income for 1934 even though he had properly included in his return one-half the partnership net income, the adjustment authorized by section 820(b)(3) would not result in the collection of an additional tax from B.

See Treas. Dec. 4856, art. 820(b)-3.

³⁴ Thus, in example (a) in note 33, *supra*, if the taxpayer had not included the interest payment in any return and the Commissioner had asserted a deficiency for 1936 with respect to this payment, and the deficiency was not sustained in the final decision subsequently rendered, no adjustment would be authorized with respect to the year 1935. Although the determination requires the exclusion of the item from gross income, no tax had been paid with respect thereto. The result would be aliter, of course, if the taxpayer had paid the deficiency for 1936 and thereafter successfully contested it before the Board or obtained a final judgment for a refund in court. In either event an adjustment would be authorized.

The inclusion of subsection (b)(3) in section 820 is perhaps more questionable on grounds of policy than any other provision of the section. Superficially at least, it seems to discriminate against taxpayers who pay asserted deficiencies and then litigate their validity. Its inclusion also strengthens the criticism hereinafter considered that section 820 does nothing to assist taxpayers who are victims of double disallowance of deductions. Also, its application may require further litigation to determine the year in which the item of gross income was erroneously excluded or omitted from the gross income of the taxpayer. The principal argument in support of the provision is that in effect it merely makes a limited extension of the equitable principle of *Lewis v. Reynolds* (1932) 284 U.S. 281, to cases wherein the barred deficiency is in a different year than that with respect to which the claim for refund is successfully maintained, and prevents for the future the result the Supreme Court reached with rather obvious reluctance, under the compulsion of sections 607 and 609 of the Revenue Act of 1928 [45 STAT. (1928) 791, 874, 875, 26 U.S.C. (1934) §§ 1670(2), 1675], in the recent case of *McEachern v. Rose*, *supra* note 18.

³⁵ This situation may be illustrated by the following example:

For the year 1935, a trustee reported the full amount of the net income of the trust, without claiming a deduction for amounts distributed to the beneficiary in that year, erroneously believing such amounts to be chargeable against corpus and taxable to the trust under *Helvering v. Pardee* (1933) 290 U.S. 365. The beneficiary did not report such amounts in his return for 1935. In 1939 the Commissioner asserted a deficiency against

permits a deficiency to be assessed against him.³⁶ Or the adjustment permitted may be by way of the granting of a refund to or assessment of a deficiency against a beneficiary, depending upon the nature of the facts involved in the particular case.³⁷

(5) Section 820(b)(5) comprehends a group of cases quite distinct from those governed by the foregoing subdivisions of subsection (5). The statutory concept of the "related taxpayer," which is discussed hereinafter, has no application to the cases covered by subsection (b)(5). Under this subsection, where there is a determination of the basis of property for the purpose of depletion, exhaustion, wear and tear, or obsolescence, or for gain or loss on a sale or exchange, and in a barred earlier year *in any transaction upon which such basis depends*, a position was taken which was erroneous and

the beneficiary with respect to such amounts on the ground that, upon a proper interpretation of the trust instrument, such amounts were not chargeable to corpus and constituted income to the beneficiary. The deficiency is sustained by a final decision of the Board of Tax Appeals in 1941, after the period of limitations on a claim for refund by the trust has expired. An adjustment is authorized with respect to the tax of the trust for 1935.

³⁶ This situation may be illustrated by the following example:

A trustee claimed a deduction for the taxable year 1935 on account of income distributed to a beneficiary. The income was included by the beneficiary in his return for that year. In 1939 the beneficiary filed a claim for refund on the ground that the amount so distributed to him represented a charge against corpus and hence, under the decision of the Supreme Court in *Burnet v. Whitehouse* (1931) 283 U. S. 148, did not constitute income to him. The claim for refund is sustained by the court in 1941, after the expiration of the period for assessing a deficiency in tax against the trust for 1935. An adjustment is authorized with respect to the tax of the trust for the year 1935.

³⁷ These situations may be illustrated by the following examples:

(a) A trustee claimed a deduction for the taxable year 1935 on account of income distributed to a beneficiary. The income was included by the beneficiary in his return for that year. In 1939 the Commissioner asserted a deficiency in tax against the trust for 1935 on the ground that the amount distributed to the beneficiary represented a charge against corpus and hence, under the decision in *Burnet v. Whitehouse*, *supra* note 36, did not constitute a distribution of income to the beneficiary. The deficiency is sustained by a final decision of the Board of Tax Appeals in 1941, after the expiration of the period for filing a claim for refund by the beneficiary for 1935. An adjustment is authorized with respect to the beneficiary's tax for the year 1935.

(b) For the taxable year 1935, a trustee, pursuant to direction in the trust instrument to accumulate the trust income, made no distribution to the beneficiary and returned the entire net income as taxable to the trust. Accordingly, the beneficiary included no part of the trust income in his return for the year 1935. In 1937, a state court held invalid the clause directing the accumulation. In 1939, just prior to the expiration of the period of limitations, the trustee, relying upon this court decision, files a claim for refund of the tax paid on behalf of the trust for the year 1935. The claim is sustained by the court in 1941. In the meantime the period of limitations upon a deficiency assessment against the beneficiary for 1935 has expired. An adjustment is authorized with respect to the beneficiary's tax for the year 1935.

inconsistent with that adopted in such determination, section 820 permits the granting of a refund or the assessment of a deficiency to correct the tax consequences of the error in the earlier year. Such adjustment is authorized against the taxpayer if he himself made the mistake in the earlier year, or against any person who acquired title to the property in a transaction upon which such basis depends and from whom mediately or immediately the taxpayer derived title subsequent to such transaction.³³ To illustrate, if a taxpayer who is a donee of property should claim that his donor received such property in a taxable exchange, although the donor had treated the exchange as one in which no gain or loss was recognizable, and the determination adopted the taxpayer's contention, thereby allowing the donee a basis different from that to which he would be otherwise entitled, section 820 would permit the assessment of a deficiency against the donor or the granting of a refund to him, as might be appropriate on the particular facts of the case.

It will be seen therefore that the statute in general operates only where there has been a determination in a particular year adverse to the taxpayer or Commissioner, as the case may be, inconsistent with the position adopted in an earlier year by the party in whose favor the determination operates, or by a related taxpayer. In certain cases under section 820(b)(5), however, the position inconsistent with the determination may have been taken in an earlier year by a predecessor in title of the taxpayer, *i.e.*, cases in which, under the law,

³³ A number of varied illustrations of the operation of section 820(b)(5) may be found in Treas. Dec. 4856, art. 820(b)-5. Limitations of space preclude their inclusion here.

It should be pointed out, however, in order to correct a common misapprehension, that the section does not apply to a case in which there has been a non-taxable reorganization with respect to which no gain is recognized to a transferor corporation, except with respect to cash or "other property," *i.e.*, so-called "boot," received by it, where the transferee corporation subsequently asserts the right to step up the basis of the property received by it to the extent that it has assumed the obligations of the transferor at the time of the transfer, under the recent decision of the Supreme Court in *United States v. Hendler* (1938) 303 U.S. 564. Even though the transferee's right to a "stepped up" basis is subsequently sanctioned by a determination and even though there has been an erroneous non-recognition of gain to the transferor in a barred year with respect to the assumed liabilities, still no adjustment is authorized with respect to the tax liability of the transferor for such year. The reason for this result is that the transferor is not the taxpayer with respect to whom the determination is made, nor does the determination relate to property which the transferor acquired in the exchange incident to the reorganization in the earlier barred year. Rather it relates to the property which the transferor corporation transferred in such exchange.

the taxpayer is required to take the basis of the predecessor in title.³⁹ Moreover, in the situations covered by section 820(b) (4) and in certain other cases where related taxpayers are involved, the section will operate because of inconsistency with the determination of the positions adopted by related taxpayers in their treatment of a particular item in the same taxable year.⁴⁰ Hence, it becomes necessary to inquire what is meant by the terms "taxpayer," "related taxpayer," and "determination under the income tax laws," as they are used in the section.

DEFINITION OF TERMS

The definitions of these terms are found in section 820(a) of the Act. The term "taxpayer" is defined comprehensively in section 820(a) (2) to mean "any person subject to a tax under the applicable Revenue Act." The term "related taxpayer" (section 820(a) (3)) means a taxpayer who, with the taxpayer with respect to whom a determination specified in subsection (b)(1), (2), (3) or (4) is made, stood, in the taxable year with respect to which any of the errors therein referred to was made, in any one of six specified relationships. These relationships are: (1) husband and wife;⁴¹ (2) grantor and fiduciary;⁴² (3) grantor and beneficiary;⁴³ (4) fiduciary and bene-

³⁹ The cases in which the transferee of property is required to use a so-called "carry-over" basis, *i.e.*, a substituted basis ascertained by reference to the basis of the property in the hands of a predecessor in title, are specified in various provisions of section 113 of the Revenue Act of 1938 and corresponding provisions of prior acts. The most important for the purposes of section 820(b)(5) are section 113(a)(2) relating to gifts after December 31, 1920, and section 113(a)(3) relating to transfers in trust after that date. See also sections 113 (a)(7), (8), (13) and (16).

⁴⁰ See the illustrations given in notes 35, 36 and 37, *supra*, of situations governed by section 820(b)(4).

Another not uncommon type of case may be illustrated by the following example:

A and *B* are husband and wife, living in a community property state. Each files a separate return for the year 1935. By error not attributable to fraud, the whole of a substantial item of community income is reported in the husband's return and no part of it in the wife's. In 1939, just prior to the expiration of the period of limitation on claims for refund of tax for 1935, *A* files a claim for refund. This claim is allowed by the Commissioner and paid in 1940. In the meantime the period of limitation on the assessment of a deficiency against *B*, the wife, for 1935 has expired. An adjustment is authorized with respect to *B*'s tax for 1935.

⁴¹ See note 40, *supra*, for an example.

⁴² Inconsistency of position here is likely to occur, other than in cases of inadvertent errors, where there is uncertainty whether the income of a trust is taxable to the fiduciary (or beneficiary) in the manner provided by section 162 of the Revenue Act of 1938 or corresponding provisions of prior acts, or to the grantor either under section 166 or section 167 of the 1938 Act or prior acts, or under the decisions of the

ficiary, legatee, or heir;⁴⁴ (5) decedent and decedent's estate;⁴⁵ (6) partner.⁴⁶ If such relationship exists, it is not essential that the error be with respect to a transaction which is possible only by reason of the existence of the relationship.⁴⁷ However, the application of the section to related taxpayers is considerably circumscribed by an additional limitation that no adjustment by way of a deficiency assessment may be made against a related taxpayer unless the relationship existed *both* in the taxable year with respect to which the error was made and at the time the taxpayer, with respect to whom the determination is made, first maintained the inconsistent position

Supreme Court relating to trusts for maintenance, education, and support of dependents of the grantor, or for payment of alimony or other pecuniary obligations of the grantor. See *Douglas v. Willcuts* (1935) 296 U.S. 1; *Helvering v. Blumenthal* (1935) 296 U.S. 552; *Helvering v. Schweitzer* (1935) 296 U.S. 551; *Helvering v. Stokes* (1935) 296 U.S. 551. Cf. *Shanley v. Bowers* (C. C. A. 2d, 1936) 81 F. (2d) 13.

⁴³ Inconsistency of position here is likely to occur for the reasons stated in note 42, *supra*.

⁴⁴ The principal reason for inconsistency here, other than mere inadvertence, is the difficulty of determining in many cases whether amounts distributed by the fiduciary are in the nature of annuities and constitute income taxable to the recipients under *Irwin v. Gavit* (1925) 268 U.S. 161, and so are deductible, or represent charges against corpus, taxable not to the distributees but to the fiduciary. See *Burnet v. Whitehouse*, *supra* note 36, and *Helvering v. Pardee*, *supra* note 35.

⁴⁵ The principal reason for inconsistency here, other than inadvertence, is the difficulty of allocating many items correctly between the decedent and his estate. The situation would be worse were it not for section 45 of the Revenue Act of 1938 and corresponding provisions of prior acts.

⁴⁶ The chief source of inconsistency here arises from improper allocation of partnership income (and losses) between the individuals who are members of the partnership and are, of course, taxpayers under the revenue acts.

⁴⁷ See Treas. Dec. 4856, art. 820(a)-4, giving the following example:

"... if the error with respect to which an adjustment is sought under section 820 grew out of an assignment of rents between taxpayer A and taxpayer B, who are partners, and the determination is with respect to taxpayer A, an adjustment with respect to taxpayer B may be permissible despite the fact that the assignment had nothing to do with the business of the partnership."

This result flows from interpretation of the statute by the *Regulations*, rather than from any specific provision in the statute, but is probably correct. It may be questioned whether, as a matter of policy, adjustments should be authorized in such a case merely because the assignor and assignee happen to be partners. If they stood in the relation of husband and wife, it is believed the close community of interest and likelihood of collusion would justify application of the statute. It is a matter of judgment whether the same considerations are applicable to the partnership relation. For further discussion of this problem see p. 152, *infra*.

It should also be noted that it is sufficient that the specified relation exists at any time during the year with respect to which the error was made.

as to the item with respect to the taxable year to which the determination relates.⁴⁸

Section 820(a) (1) defines the important term "determination under the income tax laws" to mean any one of three things. The first of these is "a closing agreement made under section 606 of the Revenue Act of 1928, as amended."⁴⁹ The second is "a decision by the Board of Tax Appeals or a judgment, decree, or other order by any court of competent jurisdiction, which has become final."⁵⁰ The third is "a final disposition by the Commissioner of a claim for refund."⁵¹ With respect to all of the three categories it is specifically provided that the terms do not include such a determination made prior to ninety days after the date of enactment of the Act.⁵²

⁴⁸ This limitation was added in conference and appears in the last sentence of section 820(b). See Treas. Dec. 4856, art. 820(b)-8 for interpretation of this provision. In general it means that, where an inconsistent position is maintained in a return, claim for refund, or petition (or amended petition) to the Board of Tax Appeals, for the taxable year in respect of which the determination is made, the requisite relationship must exist on the date of filing such document; if the inconsistent position was not thus maintained, the relationship must exist on the date of the determination.

It will be noted that the limitation does not apply if the adjustment would be made as if it were an overpayment. It is sufficient in such cases that the requisite relationship exist during the year with respect to which the error was made.

The limitation affords protection to taxpayers against harsh results which might otherwise flow from making adjustments by way of deficiencies where a complete change of relationship has occurred subsequent to the year of the error, as for instance divorce or dissolution of partnership.

⁴⁹ Section 820(a)(1)(A) of the Revenue Act of 1938. See also Treas. Dec. 4856, art. 820 (a)-1, which provides that "if it becomes necessary or desirable to effect a determination in order to obtain or accelerate an adjustment authorized by section 820, a closing agreement may be used for such purpose whenever a taxpayer and the Government have concurred in the disposition of an item or items."

This is important as an official indication of Treasury policy to use closing agreements effectively to implement the administration of the section.

⁵⁰ Section 820(a)(1)(B) of the Revenue Act of 1938. Section 1005 of the Revenue Act of 1926 (44 STAT. (1926) 9, 110, 26 U.S.C. (1934) § 640), as amended, prescribes the date as of which a Board of Tax Appeals decision becomes final. The date on which a judgment of a court becomes final depends upon the facts of the particular case. A judgment of a United States District Court ordinarily becomes final upon the expiration of the period allowed for appeal, if no appeal is taken within such period, and a judgment of the United States Court of Claims upon the expiration of the period allowed within which to file a petition for certiorari, if no such petition is duly filed within such period.

⁵¹ The statute states in some detail under what circumstances a claim for refund shall be deemed finally disposed of. See section 820(a)(1)(C). See also Treas. Dec. 4856, art. 820(a)-3, for detailed regulations interpreting this provision.

⁵² The *Conference Report on the Revenue Bill of 1938*, "Statement of the Managers on the Part of the House," on page 58, contains the following statement relative to this provision:

The problems of delimiting the scope of the area within which such a mechanism of adjustment as that provided by section 820 should operate, and of determining the temporal occasions for its operation were among the most difficult, both from a policy and from a technical point of view, which had to be solved in the drafting of the section. The first of these problems concerns the substance of section 820(b). Various criticisms which have been made of that provision, relating both to what it includes and what it fails to include, will be hereinafter considered. Taking the content of section 820(b) either as it stands or as amended in some respects as a *datum*, however, the difficult problem remains of determining what events must occur before the mechanism of adjustment provided in subsections 820(c) and (d) can operate within the area so prescribed. The section is drafted upon the theory that there should be no adjustment until the inconsistent position asserted by the taxpayer or the Commissioner has been successfully maintained, and this theory requires that subsection (b) should not operate until there has been a final "determination" which gives authoritative sanction to the inconsistent action. This solution undoubtedly has certain disadvantages⁵³ but any other solution which does not presuppose some element of final determination sanctioning the inconsistency is exposed to more serious and even fatal objections.⁵⁴

It will be noted that there is real finality under section 820(a) (1) and (2). Theoretically such finality is lacking under section 820(a) (3), since the so-called final disposition of the claim for refund is, as a matter of strict law, not final for a period of two years after pay-

"It is provided that the section will not become operative by reason of determinations made prior to 90 days after the effective date of the Act. This affords taxpayers and the Commissioner a reasonable time to decide whether they wish to discontinue proceedings already begun which may lead to determinations as defined in this section." H. R. REP. NO. 2330, 75th Cong. 3d Sess. (1938).

⁵³ Where the parties do not wish to litigate, a closing agreement with respect to the item or items in question is necessary, except in the case of a final disposition by the Commissioner of a claim for refund, before the section can operate. This limitation excludes cases closed by voluntary settlement and payment of a tax before the issue of a notice of deficiency, unless a closing agreement is entered into or a claim for refund is later prosecuted.

⁵⁴ The most serious objection is that, without some such limitation, there could never be complete assurance that a controversy with respect to an item had been definitely and finally closed. The final determination in the open year performs the essential function of establishing the existence of error on the part of the taxpayer in an earlier year, or perhaps of a related taxpayer in the same year. Without this, the operation of the section would tend to create a vicious circle.

ment of the refund is made.⁵⁵ The percentage of refund cases in which demands or suits for recovery of erroneous refunds are successful is, however, statistically negligible. As a practical matter, there is finality in these cases to so high a degree that it would seem unwarranted to postpone adjustments under subsection (b), thereby increasing considerably the interest burden, until the statutory period of two years on suits for erroneous refunds has expired. It may be that there will be an occasional case in which, after section 820(b) has operated by virtue of administrative allowance of a claim for refund, it will be called into reverse operation subsequently by a successful suit to recover the refund, but the possibility is too slight to be of serious practical importance.

Of much greater practical moment is the question which has been raised whether a determination under section 820(a) (2) includes the closing of cases pending before the Board of Tax Appeals on the basis of stipulations giving effect to settlement agreements negotiated between the taxpayers and the Technical Staff of the Bureau of Internal Revenue. Leaving out of account for the present so-called lump-sum settlements which involve a special problem, it is believed that a reasonable interpretation of the section should lead to an affirmative answer to this question. There is essentially the same reason of policy for including such cases as cases of closing agreements. Moreover, it is the order of the Board entered pursuant to the stipulation which technically gives the latter its legal efficacy. A contrary interpretation would make the section a serious obstacle to the expeditious settlement of many cases without litigation. If there is any widespread doubt as to the meaning of the statute on this point, it should be promptly resolved by a clarifying amendment.

Before passing to a consideration of the merits and defects of section 820 as a solution for the very real problems it is intended to solve and the more important criticisms which have been directed at it, including demands for its complete repeal, some explanation seems necessary of the methods by which the adjustments authorized by subsection (b) are effectuated and the amounts of such adjustments are ascertained.

METHOD OF ADJUSTMENT

Section 820(c) provides that the adjustment authorized in subsection (b) shall be made by assessing and collecting, or refunding

⁵⁵ See section 610, Revenue Act of 1928, as amended. 45 STAT. (1928) 791, 875, 26 U.S.C. (1934) § 1646, as amended 48 STAT. (1934) 756, as amended 49 STAT. (1936) 1744, 26 U.S.C. SUPP. III (1937) § 1646.

or crediting the amount thereof, such amount to be ascertained in the manner provided in subsection (d), in the same manner as if it were a deficiency determined by the Commissioner with respect to the taxpayer as to whom the error was made or an overpayment claimed by such taxpayer, as the case may be, for the taxable year with respect to which the error was made, and as if on the date of the determination specified in subsection (b) one year remained before the expiration of the periods of limitation upon assessment or filing claim for refund for such taxable year.

It will be noted that the amount of the adjustment is not, strictly speaking, either a deficiency or an overpayment in the technical sense of those terms.⁵⁶ Rather, if such amount, when ascertained pursuant to section 820(d) represents an increase in tax, it is to be treated, so far as the mechanics of assessment and collection are concerned, *as if it were a deficiency*, under the law and regulations applicable to the assessment and collection of deficiencies for the taxable year with respect to which such adjustment is made.⁵⁷ The same provisions apply relative to notice of deficiency, waiver, right to petition the Board of Tax Appeals for determination of the correct deficiency, and filing of claim and suit for refund, if the taxpayer elects to pay the deficiency. Similarly, if the amount of the adjustment so ascertained represents a decrease in tax, such amount is to be treated *as if it were an overpayment* claimed by the taxpayer with respect to whom the error was made for the taxable year in which such error occurred, and is recoverable under the law and regulations applicable to overpayments of tax for such taxable year.⁵⁸ Hence, unless the overpayment is refunded by the Commissioner of his own motion, a claim for refund must be filed, and if such claim is denied or is not acted upon within the time prescribed by the applicable statute, the taxpayer must then file suit for refund. The amount of the adjustment will bear interest and be subject to additions to the tax to whatever extent is prescribed by the internal revenue laws applicable to deficiencies and overpayments for the taxable year with respect to which the adjustment is made.⁵⁹

⁵⁶ SEN. REP., *op. cit. supra* note 21, at 52.

In the sections of this article dealing with the method of adjustment and the mechanics for ascertaining the amount of the adjustment, the author has, for reasons of convenience, incorporated much of the material in the regulations, contained in articles 820(c) and (d) of Treas. Dec. 4856, with minor substantive additions and changes in phraseology.

⁵⁷ This statement must be read subject to the limitations of section 820(e).

⁵⁸ *Ibid.*

⁵⁹ Treas. Dec. 4856, art. 820(c)-1.

It will also be noted that the Commissioner is allowed by section 820(c) a period of one year from the date of the determination, within which to mail a notice of deficiency in respect of the amount of the adjustment where such amount is treated as if it were a deficiency. It follows that the issuance of such notice, in accordance with the law and regulations applicable to the assessment of deficiencies, will suspend the running of the one-year period of limitation, and likewise, in accordance with the applicable law and regulations governing the collection of deficiencies,⁶⁰ the period of limitation for collection of the amount of the adjustment will commence to run from the date of assessment thereof. Similarly, the taxpayer is allowed a period of one year from the date of the determination within which to file a claim for refund in respect of the amount of the adjustment, where such amount is treated as if it were an overpayment. Moreover, where the amount of such adjustment is treated as if it were a deficiency and the taxpayer chooses to pay such deficiency and contest its validity by way of a claim for refund, the period of limitation upon filing such claim will commence to run from the date of payment.⁶¹

The fact that the statute treats the amount of the adjustment *as if it were* a deficiency or overpayment, as the case may be, merely so far as the procedural mechanics of assessment and collection, interest, and additions to tax are concerned, but carefully refrains from defining such amount as a technical deficiency or overpayment, is very important in its implications. It means that there is no such redetermination of tax liability for the barred year as occurs in the ordinary case where the Commissioner determines a deficiency or a taxpayer asserts a claim for refund with respect to an open year. In the latter cases such redetermination may not only profoundly affect the tax liability for the particular open year but, more or less directly, the tax liability for one or more succeeding taxable years as well. To illustrate, if the Commissioner should determine a deficiency in corporate income tax against a closely held corporation, X, for an open year, say 1937, on the ground of omission to report a large receipt of interest or dividends, and such determination were finally sustained by the Board, the tax consequences thereof to X would not necessarily be confined to increasing the amount of normal tax and undistributed profits surtax it would have to pay for the year 1937, but might include subjecting it to liability for an additional heavy surtax as a

⁶⁰ *Ibid.*

⁶¹ *Ibid.*

domestic personal holding company.⁶² The fact of its classification as a personal holding company in the taxable year 1937 might operate to force *X* into a similar classification in one or more succeeding taxable years and greatly affect its tax liability in such years.⁶³

Suppose, however, in the above case that the statute of limitations had run on the assessment of a true deficiency for 1937, but that section 820(b) enabled the Commissioner to assess and collect the amount of an adjustment for that year based upon *X*'s failure to report the item of interest or dividends, *as if such amount* were a deficiency. Such adjustment for 1937 could not affect the classification of *X* for 1938 or succeeding taxable years.⁶⁴ In other words, the adjustment under section 820 is limited strictly to the correction of the tax effect of the error *for the particular taxable year* in which it occurred.

ASCERTAINMENT OF AMOUNT OF ADJUSTMENT

The mechanics for computing the amount of an adjustment authorized by section 820(b), whether such amount be treated as a deficiency or as an overpayment, are prescribed by section 820(d).⁶⁵ The first essential step is to ascertain the tax previously determined of the taxpayer as to whom the error was made, for the taxable year with respect to which the error was made. Ordinarily this may be the

⁶² This result would follow if the corporation satisfied the stock ownership test and if the inclusion of the interest or dividends in gross income caused it to satisfy the gross income test, the two-fold requisite to classification as a domestic personal holding company. See sections 352 and 354 of Title I, Revenue Act of 1937, amending Title IA of the Revenue Act of 1936. [50 STAT. (1937) 813, 814, 815, 26 U.S.C. SUPP. III (1937) §§ 332, 334.]

⁶³ See section 402(a)(1) of the Revenue Act of 1938 which may operate to produce this effect.

⁶⁴ Indeed, under Treas. Dec. 4856, art. 820(b)-0 (last paragraph), in the case given, the adjustment with respect to the year of the error could not even include any additional personal holding company surtax, otherwise resulting from reclassification on account of the change in its gross income, unless the corporation were taxable as a domestic personal holding company in the year with respect to which the determination was made. Under this interpretation, which seems correct, section 820 may be applied to correct the effect of the error only as to the tax or taxes with respect to which the determination relates. Hence, in our example, if the determination in the later year did not relate to a personal holding company surtax, there could in no event be an adjustment with respect to 1937 to correct an erroneous escape from such surtax in that year.

It should not be forgotten, however, that a determination in an open year may relate to more than one tax. For example, the allowance of a deduction from gross income to a corporation may relate in a particular case to corporate income tax, excess profits tax, and personal holding company surtax.

⁶⁵ See Treas. Dec. 4856, art. 820(d).

amount of tax shown on such taxpayer's return, but, if any changes in that amount have been made, such changes must be taken into account. In such event the tax previously determined will be the tax shown on the return, increased by any amounts previously assessed (or collected without assessment) as deficiencies, and decreased by any amounts previously abated, credited, refunded, or otherwise repaid in respect of such tax. In the event that no amount was shown as the tax upon the return, or that no return was made, the tax previously determined will be the sum of the amounts previously assessed, or collected without assessment, as deficiencies, decreased by any amounts previously abated, credited, or otherwise repaid in respect of such tax. If no return was made and no amount was previously assessed, or collected without assessment with respect to the taxable year in question, there is, of course, no problem under section 820, for the statute has not run upon the assessment as a deficiency of the entire amount of the tax due for such year.

The tax previously determined may consist of a tax for any taxable year commencing after December 31, 1931.⁶⁶ This includes taxes imposed by Title I, subtitle A, section 602 of Title III (excess profits tax), both of the Revenue Act of 1938, and corresponding provisions of prior revenue acts, by Title III of the Revenue Act of 1936 (tax on unjust enrichment), or by any one or more of such provisions.⁶⁷

It should be carefully noted that, with the exception of the items upon which the tax previously determined was based and the item or items with respect to which the error was made, no other item can be taken into account in the computation of the amount of the adjustment.⁶⁸ It follows that, if the treatment of any item upon which the

⁶⁶ Section 820(f) of the Revenue Act of 1938.

⁶⁷ Title III of Revenue Act of 1936: 49 STAT. (1936) 1648, 1734, 26 U. S. C. SUPP. III (1937) § 345. See, however, the important limitation discussed in note 64, *supra*.

⁶⁸ Section 820(e) of the Act expressly so provides. The adjustment is limited strictly to the correction, with respect to the year of the error, of the tax effect attributable solely to the error in respect of the item or items to which the determination relates. The result may be, in a particular case, that a taxpayer may have to pay an additional amount by way of adjustment for the barred year, although a complete re-audit might show that he had already overpaid his tax or, vice versa, may be entitled to an adjustment by way of refund though such a re-audit might show a net deficiency in tax. See the example given on p. 52 of the *Report of the Committee on Finance. SEN. REP., op. cit. supra* note 21.

This effect of the statute has been severely criticized by Mr. Percy W. Phillips in *Tax Clinic Proceedings, op. cit. supra* note 15, at 694. Yet it is entirely consistent with a basic principle upon which section 820 is based, viz., to keep to a minimum any disturbance of the bar of the statute. This requires that, in computing the adjustment for the barred year to correct the tax effect of the error in the treatment of the item or

tax previously determined was based, or if the application of any provision of the internal revenue laws with respect to such tax, depends upon the amount of income, readjustment in these particulars will be required as part of the recomputation in order to conform to the change in the amount of taxable income which results from the correct treatment of the item or items in respect of which the error was made. Such a situation is presented, for instance, when the amount of the tax previously determined for the year in which the error was made was affected by such items as the deduction for charitable contributions, the credit for foreign taxes, the earned income credit, and the deduction for percentage depletion, if the amount of such deduction otherwise allowable has been affected by the statutory provision limiting the percentage depletion allowable to a specified percentage of net income from the property.⁶⁹

If interest or additions to the tax have been collected as a result of the error in the taxable year with respect to which an adjustment is authorized, the amount thereof must be taken into account in computing the amount of the adjustment.⁷⁰

As has been previously pointed out, section 820(f) precludes the making of any adjustment otherwise authorized by section 820(b) if the taxable year in which the error was made began prior to January 1, 1932. Some such time limitation was inevitable as a matter of policy. Otherwise, it was conceivable that section 820(b) might operate to authorize the reopening of taxable years running back to 1913 for the limited correction of errors. The particular date—January 1, 1932—was no doubt decided upon as a reasonable compromise.

CRITICISMS OF SECTION 820—SHOULD IT BE REPEALED?

The enactment of section 820 has given rise to widespread discussion and vigorous controversy. If it has accomplished nothing more,

items to which the determination relates, all inquiries as to the true tax liability for such year should be put aside as irrelevant. The tax previously determined for that year is accepted as correct, except for the particular error adjustment of which is authorized.

If section 820 went beyond this point, it would unquestionably create a serious breach in the statute of limitations.

⁶⁹ See section 113(b)(3) and (4) of the Revenue Act of 1938 and corresponding provisions of prior acts.

A good example to illustrate the operation of section 820(d) involving the necessity of an adjustment on account of a deduction for charitable contributions in computing the adjustment authorized for the year of the error, appears in article 820(d)-1 of Treas. Dec. 4856. Considerations of space preclude the insertion of adequate examples here.

⁷⁰ *Ibid.*

its enactment has served to focus critical interest and attention upon a group of problems, the continued existence of which is a serious blot upon the revenue laws and their administration. Whether or not the substance of section 820 in its present form survives the current demands from some quarters for its repeal and the testing fires of actual experience in its administration, it is essential for a diversity of reasons, some of which transcend the particular merits or demerits of the section itself, that a permanent and generally acceptable solution of the major problem which the new legislation is intended to solve shall be found.

The most formidable attack has come from the Standing Committee on Federal Taxation of the American Bar Association.⁷¹ The character and competence of the committee which prepared the report recommending immediate repeal entitle its views to careful and dispassionate consideration. An effort will therefore be made to analyze in some detail and to evaluate fairly the major criticisms of section 820 contained in the report.

The report recognizes that the aim of section 820 is good and that there is a real problem to be solved, but contends that the section as drawn does not succeed in solving the problem and will give rise to new evils greater than those which it seeks to cure. It insists that an entirely new start must be made, and that new methods which do not seek to cover so much ground must be employed. The report does not specify what the nature of such new methods should be, other than a possible intimation that the committee might regard with favor the application by statute of some principle of estoppel.

It is quite true that section 820 is based upon a philosophy quite different from that which underlies the principle of estoppel. That principle, so far as it can be expressed in a single statement, is, to borrow the language of a learned justice, that "no one shall be permitted to found any claim upon his own inequity or take advantage of his own wrong."⁷² As applied in tax cases, the principle operates to preclude a party (usually the taxpayer) in one year from asserting a right, which he is otherwise entitled to assert, because of his conduct in a prior year. As to the exact form of the conduct which will enable the adverse party to invoke the principle, the cases are very far from

⁷¹ *Report of the Standing Committee on Federal Taxation of the American Bar Association*, submitted at Cleveland, July, 1938, in A. B. A., *ADVANCE PROGRAM INCLUDING COMMITTEE AND SECTION REPORTS* (1938) 89.

⁷² Opinion of Mr. Justice Cardozo in *Stearns v. United States* (1934) 291 U. S. 54, 61.

being in complete agreement.⁷³ The point, however, is that the principle does not open to revision the tax results of such conduct in the prior year; it merely modifies the disposition of the present controversy in which it is successfully invoked. As will have been seen, section 820 proceeds upon a quite different principle.⁷⁴ It presupposes that a current controversy has proceeded to a determination under the law applicable to the taxable year to which the controversy relates, but if such determination adopts the position of a party (whether it be that of the Commissioner or the taxpayer) with respect to an item adverse to the opposing party, and such position is inconsistent with that taken by such party or a related taxpayer, with respect to such item in a barred year, then the section lifts the bar, but only to the extent necessary to permit the consequences of such inconsistent position in the barred year to be corrected.

This difference is of great practical importance, as will appear from a simple illustration. Suppose that *X*, a taxpayer, in his return for the year 1933 claimed and was allowed a deduction on account of certain shares of stock he owned, acquired at a cost of \$20,000, having become worthless. Subsequently it is determined by authoritative decision in some other case that this particular stock issue became worthless in 1934. In the meantime, the period of limitations on the assessment of deficiencies for 1933 has expired, but the year 1934 is still open to claims for refund. *X* promptly files a claim for refund of tax paid in 1934. Let us further assume that *X*'s taxable net income for 1933 was only \$15,000, whereas in 1934 he paid a tax on a net income of \$100,000. Now if a principle of estoppel, whether judicial or statutory, is applied in this case so as to preclude *X* from claiming the deduction for 1934 and for that reason his claim for refund is denied, it is obvious that *X* will have been required to pay an additional tax for that year greatly in excess of the amount of tax pay-

⁷³ Magill, *op. cit. supra* note 19, 164 *et seq.*, points out that the usually accepted analysis requires that some representation of fact be made by the taxpayer; that the Commissioner shall have relied upon it; and that he shall have changed his position to his detriment. See also Maguire and Zimet, *op. cit. supra* note 3, at 1295, 1310, 1315.

Professor Magill's notable book points out some of the dangers inherent in the loose application of the doctrine, and its tendency to blur the outlines of the Supreme Court's own doctrines on the realization of income.

⁷⁴ This distinction is clearly developed by Mr. Aubrey R. Marrs, Head of the Technical Staff, Bureau of Internal Revenue, in *Tax Clinic Proceedings, op. cit. supra* note 15, at 665, 692. Mr. Marrs's remarks are noteworthy for their analysis of the merits and limitations of the estoppel principle and the advantages of section 820 from the administrative point of view.

ment of which he improperly escaped in 1933. This result will follow in some degree in any such case if there is a difference in rates or in the income position of the taxpayer in the respective taxable years. Under pre-existing law *X* would either suffer this penalty, if he were held to be estopped by his prior conduct, or would obtain a double tax benefit from a single stock loss, if he were held not to be estopped. Such a penalty is not shocking to one's sense of equity if an estoppel is held to exist only where the taxpayer's conduct in 1933 involves some taint of fraud or even actual misrepresentation of fact, though innocent, upon the faith of which the Commissioner has relied and has changed his position. But the result is manifestly unjust if the principle of estoppel is carried beyond those limits upon some vague theory of prevention of double benefits.

Under section 820, in the absence of judicial estoppel,⁷⁵ *X*'s claim for refund for 1934 will be sustained and his tax will thereby be finally determined in accordance with the facts and the law applicable to that year, but an adjustment will be authorized with respect to the particular loss item for the barred year, 1933. Thereby *X* will have enjoyed the tax benefit to which he was legally entitled on account of his stock loss, no more and no less, and the enjoyment of a double benefit will be prevented. To be sure, as is pointed out in the above report, *X* must also pay interest on the amount of the adjustment for 1933, treated as a deficiency, and in cases where the interval between the barred year and the open year amounts to several years, the interest item becomes of sufficient magnitude to upset the balance to some extent. Even so, the taxpayer stands in a better position than he would occupy if a statutory estoppel barred any claim for refund for 1934. The interest requirement also definitely increases what may be termed the prophylactic value of the section, since it will never operate in such cases if the taxpayer, upon due consideration of the consequences, decides to let sleeping dogs lie.

Interest, of course, is also allowed on the amount of an adjustment where it is treated as if it were an overpayment. It is urged by the committee's report that this very interest requirement is likely

⁷⁵ It should be emphasized that section 820 does not override or supersede the principle of estoppel, or check its proper evolution in the courts. On the contrary, the section cannot operate where an estoppel is successfully invoked, since the estoppel precludes a determination sanctioning the inconsistent position. The presence of section 820 in the statute may, however, influence the courts to refuse to find an estoppel in doubtful or borderline cases where an adjustment under the statute would lead to a more equitable result.

to be costly to the government in many cases in which the amount of tax to be collected with respect to the item in the "open year" is less than the amount of the adjustment authorized by the statute in favor of the taxpayer, and that the statute authorizes such adjustment even when the taxpayer has *negligently* allowed the statute to run against him. It is further contended that the Commissioner would be nonetheless obligated to proceed in such cases, even though he realizes the assertion of a deficiency would be costly to the government, since Congress gives the Commissioner no power to remit tax liability and, were he to refrain from asserting such a deficiency, he would be illegally assuming a power which Congress has expressly refused to give to him. This is tantamount to saying that the new statute possesses no prophylactic efficacy, so far as the Commissioner's conduct is concerned.

While there is undoubtedly some force in this criticism, its cogency is considerably weakened by several considerations not mentioned in the report. In the first place, section 820 is not, and was not conceived as, a revenue-raising measure. Hence its merits are not to be weighed primarily in the scale of monetary advantage. Congress has deemed it sound policy, in the interest of equity and fairness in tax administration, to provide a statutory method for relieving taxpayers of double burdens in certain types of cases. Of course equitable treatment of the taxpayer will cost the government money in some cases, but that is not *per se* a sufficient reason for not doing equity. It would hopelessly complicate the administration of a provision, already attacked as too complicated, to condition a taxpayer's right to such relief on proof that he was not negligent in allowing the statutory bar to fall. So far as section 820 operates in the taxpayer's favor, it merely gives him rights he did not heretofore possess. Such rights he can assert or not at his pleasure, within a year after the determination.

In the second place, the criticism must rely for its validity upon the assumption that forbearance by the Commissioner to assert a deficiency in the open year in most of the cases to which section 820 would apply would amount to unlawful assumption of a power to remit tax liability. On the contrary, it is submitted that this does not accord with the practical facts in many cases, where, in advance of a final determination with respect to the "open" year, it is a question of judgment whether the particular item belongs in that year. Where the scales of judgment are otherwise fairly evenly balanced, the Commissioner could scarcely be charged with usurpation of power if the

fact that the taxpayer had already paid a tax were thrown into the scale to tip the balance.⁷⁶ On the other hand, if it is reasonably certain that there is a deficiency in the "open year," the Commissioner ought to assert it and let the results under section 820 take care of themselves. Surely no inequity will thereby be done. It is difficult to believe that the section would be more acceptable to its critics if, in express language, it made it the duty of the Commissioner to forego the assertion of a deficiency in the "open year" with respect to an item, if a nice calculation showed that the taxpayer would be entitled to a larger adjustment on account of such item for the barred year in the event such deficiency was finally sustained.

It is believed, all factors considered, that the principle underlying section 820 is more equitable in its results than a solution based upon a broad statutory estoppel would be. However complicated the provisions of the section as it stands may appear to be, any estoppel provision, if drafted so as to operate with discriminating equity, is likely to be even more so.⁷⁷ For instance, if it is sought equitably to limit the scope of the estoppel in the open year in such manner as merely to offset the tax advantage derived by a party from his inconsistent conduct in the barred year, some mechanics comparable to those contained in section 820(c), (d), and (e) will be found to be essential to measure the advantage. Moreover, estoppel as it has developed in the courts has been a defense available almost exclusively to the government. No such one-sided legislative solution would be acceptable or tolerable. Baffling difficulties will have to be solved if estoppel is to be made to lie against the government. The power to estop the government is one which, from the standpoint of public policy, cannot lightly be vested in subordinate officials of the Bureau of Internal Revenue. Yet a limitation of that power to designated higher officials

⁷⁶ This view derives strong support from various statements in the Finance Committee and Conference Committee reports on section 820 indicating that one of the primary and deliberate purposes of the provision is to discourage both taxpayers and the Commissioner from the inequitable adoption of inconsistent positions by taking the profit out of such inconsistency. Surely Congress must have contemplated that there were many cases in which the Commissioner could refrain from asserting an inconsistent position without violation of his sworn duty to collect the public revenues according to law.

⁷⁷ Mr. Randolph Paul expresses the opinion, in *Tax Clinic Proceedings, op. cit. supra* note 15, at 694, that a cure cannot be effected through the operation of the estoppel principle, that the principle cannot be properly written into a comprehensible statute, and that more can be accomplished by working toward the sensible amendment of section 820.

would in all probability have serious untoward effects in delaying the prompt settlement of cases without the issuance of formal notices of deficiency or legal review.⁷⁸

The chief merit of section 820 is that it is not self-starting, as it were. Except in the limited categories of related taxpayers,⁷⁹ no party is exposed to its operation unless he has maintained successfully to the point of a final determination, with respect to an item in an "open" year, a position inconsistent with the position taken by him with respect to the same item in a barred year, and has thereby obtained a double benefit under the shield of the statutory bar.

It is urged in the report of the Tax Committee, that this theory proceeds upon the unreliable assumption that, whenever the Bureau or the taxpayer adopts a position in a given year inconsistent with that taken in an earlier year, there is always present consciousness of the inconsistency. Of course such an assumption would be contrary to fact in many cases, where the inconsistency might be unconscious or inadvertent. But it is equally true in many other cases that such

⁷⁸ The vast majority of federal tax controversies are settled without personal consideration by the Commissioner or even his chief assistants and without legal review by the Chief Counsel for the Bureau. It is obvious what a clog on settlements there would be under a system of statutory estoppel which could operate against the government only in cases where actual determinations by a few high officials at the top of the administrative pyramid were involved.

⁷⁹ In these limited categories there will be found some element of real identity or community of interest or such closeness of relationship as to create a real possibility of common or collusive action. It must be recognized, however, that there may be some cases in which the statute may work unhappy results where there is real antagonism or diversity of interest between the related taxpayers. The danger that such cases will arise frequently should be minimized by the limitations upon the related taxpayer provisions, but the results of their actual operation should be scrutinized with great care to determine whether the statute is achieving its purposes in such cases to a satisfactory degree.

One situation which has proved very costly to the revenue in the past, which would have been prevented had a statute like section 820(b) (4) been in effect is strikingly illustrated by a bit of history which culminated in the well-known case of *Helvering v. Butterworth* (1933) 290 U. S. 365, the companion case of *Helvering v. Pardee*, *supra* note 35, which overruled *Warner v. Walsh* (C. C. A. 2d, 1926) 15 F. (2d) 367; *Brandeis v. Allen* (D. Neb. 1927) 22 F. (2d) 415, *aff'd*, (C. C. A. 8th, 1928) 29 F. (2d) 363; *United States v. Bolster* (C. C. A. 1st, 1928) 26 F. (2d) 760. See also (1928) 28 Col. L. Rev. 385. The final act in this comedy of errors was the decision of the Supreme Court in the case of *Stone v. White* (1937) 301 U. S. 532. This decision, while it diminished the loss, came too late to prevent large losses to the government by reason of substantial refunds already made to trustees, as a result of the *Butterworth* decision, after the periods of limitation on the assessment of deficiencies against beneficiaries had expired.

See Maguire and Zimet, *op. cit. supra* note 3, at 1318 *et seq.*, for further discussion of the situation in the *Butterworth* case.

inconsistency is conscious and deliberate.⁸⁰ More important, however, is the fact that the statute does not operate upon the mere assertion of an inconsistent position. It only authorizes an adjustment if such inconsistency is successfully maintained and is adopted in the determination with respect to the open year. There is nothing in the law to prevent a person from withdrawing from an inconsistent position where such inconsistency is originally inadvertent and becomes known to him prior to a final determination.⁸¹ It is difficult to believe that there will be many cases in which such an unhappy state of ignorance will continue until it is too late to abandon the inconsistent position. Usually the adverse party will bring the inconsistency into the clear light of day.

A more serious criticism in the report is that it is evident, on a careful reading of the section, that it forces the taxpayer to resist the Commissioner's entirely legal action in claiming a deficiency for the "open year," and that he will lose all rights given him under the section if he does the sensible thing of acquiescing in the Commissioner's current deficiency letter. It is said, in effect, that he must fight the matter through the Board of Tax Appeals to certain defeat in order to obtain a right to a refund, as a reward for his litigiousness. If these allegations were correct, the language of the report describing such an effect as "fantastic," and calculated to establish in the minds of taxpayers "that the tax laws are not based on common sense," would be justified. Unfortunately for the criticism, the allegations ignore one or two indubitable facts. One of these facts is that a final determination which will put the section into operation may be made by a closing agreement. Such a closing agreement under the broad provisions of the 1938 Act⁸² may be entered into at any time. It may cover the entire tax liability for a particular year or years, or may relate

⁸⁰ The so-called "statute of limitations racket" has for years been a common topic of conversation within the Bureau at Washington and among members of the tax bar.

⁸¹ In the *Treasury Department Press Release*, dated August 24, 1938, which announced the approval by the Acting Secretary of the *Regulations* (Treas. Dec. 4856) to carry out the provisions of section 820, appears the following significant statement:

"Mr. Magill also stated that closing agreements would be entered into whenever necessary to effect an adjustment under the section and that so far as possible such adjustment would be expedited by settling the tax liability for the open year and the adjustment for the closed year in one proceeding. *Moreover, it was pointed out that section 820 was designed to provide equitable relief and will not be applied to penalize taxpayers in cases in which an inconsistent position is inadvertently taken and withdrawn prior to a determination.*" (Italics added.)

⁸² *Supra* note 26. For a valuable discussion of the subject, see Wenchel, *The Treasury's New Powers as to Closing Agreements* (1938) 16 TAX MAG. 651.

only to a particular issue or issues or a specific item or items. Indeed, in proper cases, a closing agreement may govern the disposition of the controverted item in the "open year" and the adjustment with respect to the item in the barred year.⁸³ If, therefore, there are no other matters in dispute in the open year which the taxpayer wishes to carry to the Board, and the Commissioner's assertion of the deficiency for such year is clearly legal, a closing agreement is the obvious device to preserve the rights of the taxpayer.⁸⁴ In other cases, where additional items are in controversy so that the liability for the taxable year will be contested in any event, there does not seem to be much point to the above criticism. The items with respect to which there is no controversy can be stipulated and the trial limited to the other issues.⁸⁵

There is, however, one type of case where the existence of section 820 may interpose an obstacle to settlement without litigation. That is a case closed by a so-called "lump sum" settlement. While this form of settlement is not now looked upon with great favor by the Bureau, particular cases are occasionally disposed of in this manner. Since, in the case of such a settlement, the stipulation does not show what disposition is made of each item or issue, it would be difficult or impossible to show that the order entered pursuant to such a stipulation was a final determination with respect to the item as to which a party wished to claim the benefits of the section. Practically, however, it is not believed that there will be a serious decline in the number of lump sum settlements on this account. By virtue of the element of "horse trading" which is inherent in this form of settlement, it is safe to assume that possible rights under section 820 which may be in effect surrendered will enter into the negotiations and calculations antecedent to such settlements.

Finally, it is urged in the report that statutes of repose are based on such practical reasons that exceptions should be rare and should be closely limited in their effect, because the passage of time has numerous important consequences; that statutes of limitation, particularly, should be simple and understandable; that a reading of sec-

⁸³ See Treas. Dec. 4856, art. 820(a)-1.

⁸⁴ This statement assumes, of course, that the Treasury Department is prepared to enter into closing agreements whenever they may be necessary or proper to effectuate adjustments under the statute. The above quotation, *supra* note 81, and the provisions of the *Regulations*, *supra* note 83, indicate that such will be the departmental policy.

⁸⁵ It is assumed by this statement that an order of the Board of Tax Appeals giving effect to a stipulation is a determination within the meaning of section 820(a) (1) (B). As to this question, see the discussion on p. 133, *supra*.

tion 820 shows that it adds new complications to the already involved situation regarding limitations provisions; and that differences of opinion as to its meaning are certain.

One may feel much sympathy with these observations without agreeing with the conclusion that section 820 should be repealed. Unquestionably the statute is complicated, as amendments to the revenue acts in the interests of greater equity are likely to be,⁸⁶ and close analysis is necessary to an understanding of the details of its operation. No doubt, like other new statutory provisions, it will result in some new litigation. Further study, with the benefit of a reasonable period of experience in its actual operation, may point the way to desirable amendments of the statute, broadening its scope at some points and perhaps narrowing it at others. Clarification or simplification of its phraseology may be found possible, though the prospect is not hopeful in view of the intricate nature of the subject matter upon which it operates.

It is submitted, however, that nothing short of congressional conviction that the real and very serious problems which called the new statute into being are impossible of solution by legislative means would justify its complete repeal before it has had a fair trial. Given fair and intelligent administration of the statute by the Bureau of Internal Revenue, in the light of its equitable purposes, which is essential to its satisfactory operation, it may well become a keystone of a series of badly needed reforms in the administration of the income tax law. Hence the importance of the statute far transcends the particular problems at which it is immediately directed. Its repeal without trial might well set back for many years some of the reforms referred to. The burden may properly be placed upon those demanding the statute's repeal definitely to show that its retention will breed more litigation than it will prevent, and that the difficulties it creates outweigh the contributions which the statute can make to the removal of inequities and the facilitation of other needed reforms in income tax administration.

It is familiar knowledge that among the provisions of the income tax law most productive of litigation and dissatisfaction among taxpayers is that relating to the deduction of losses on account of stocks becoming worthless.⁸⁷ Many of the difficulties here are inherent in

⁸⁶ See Clinic discussion, in *Proceedings of the Sixth Tax Clinic of the American Bar Association* (1938) 16 TAX MAG. 279.

⁸⁷ Section 23(g), the Revenue Act of 1938, and corresponding provisions of prior acts.

the subject-matter. Nevertheless, they could be greatly mitigated if the Bureau of Internal Revenue were to adopt the practice of publishing, as promptly as proper fact investigation and consideration will permit, general rulings determining the year in which particular issues of corporate securities had become worthless. While taxpayers would not be precluded from questioning such rulings in Board or court litigation, they would at least know that their deductions would not be disallowed by the Bureau if taken in accordance with the published ruling. The generality of the ruling would ordinarily provide considerable assurance that the administrative determination of the year of worthlessness had not been governed primarily by revenue considerations.⁸⁸ Why has such a beneficent and sensible practice not been heretofore generally adopted? Principally because of the ever-present possibility of serious loss to the revenue if such a general ruling were successfully attacked in the Board or the courts by some dissatisfied taxpayer and the loss finally held deductible in a year subsequent to that designated in the ruling, after the statute had run on the assessment of deficiencies for such year against the large number of taxpayers allowed to take deductions in accordance with the ruling. If section 820 should remain in the law, this peril is reduced to a negligible quantity and there is no reason why the most cautious administrator should hesitate to adopt this desirable practice.

The same type of administrative psychology is at least partially responsible for the administrative evil of so-called double disallowance of deductions. Deductions are often disallowed in a particular year merely because there is sufficient doubt as to that year being the right one to create apprehension that a deduction with respect to the same item may be successfully claimed by the taxpayer again in a subsequent year.⁸⁹ Section 820 destroys the substance of such apprehension and should within a reasonable time radically alter such psychology. Therefore, even though the new statute, as now drawn, does not provide a direct remedy for this evil, its tendency should be gradually to ameliorate it in future years.

The phenomenon of maintenance of inconsistent positions by the Bureau is by no means limited to the allowance or disallowance of

⁸⁸ It is recognized that this assurance could not be absolute in all borderline cases, as where the ownership of the particular stock issue was concentrated in the hands of a few identified persons or there was a sharp difference in rate schedules as between two years. Usually, however, it would be a matter of guesswork as to the comparative tax effect of throwing the loss into one year or another by general ruling.

⁸⁹ See Marrs, *op. cit. supra* note 15, at 665.

deductions. It has become increasingly difficult, for instance, to induce the Bureau to announce and maintain a consistent position with respect to the taxable status of particular corporate reorganizations, where the issues presented by them have not been definitely resolved by Supreme Court decisions. Hence there arises the unedifying spectacle of the Bureau insisting that gain realized by certain stockholders on exchanges consummated in a reorganization is recognizable, that losses realized by other stockholders are not, and that the basis of securities or property received in such reorganization is a substituted basis or fair-market value, according to which may happen to be favorable to the revenue in the particular case. Yet it would be extremely unfair to attribute such unpleasant phenomena chiefly to bureaucratic arbitrariness and perversity. They are the product of sad experience through the years with the dangers to the revenue, under short and rigid statutes of limitation, of premature administrative commitment. As long as the chief source of such dangers continues to exist, the administrative technique of "heads I win, tails you lose" will continue to be applied in such cases, pending final adjudication of the doubtful issues. In the meantime, litigation is multiplied and administrative delay and confusion follow in its train.

Section 820, particularly subsection (b)(5), together with the broader powers created by sections 801 and 802 of the 1938 Act, relating to closing agreements, represents a significant direct attack upon the source of this evil. The continued existence of section 820 should greatly facilitate the use of closing agreements to stabilize as quickly as possible the tax status of such transactions as corporate reorganizations and other exchanges, where the number of taxpayers involved is so large as to render it impracticable to make all of them parties to closing agreements. The emasculation or repeal of section 820 will unquestionably tend to devitalize this promising reform. For similar reasons the tendency of repeal would be seriously to hinder the development, even on a limited scale, of a system of declaratory administrative rulings upon which taxpayers could rely with some confidence in planning their transactions.⁹⁰

Finally, section 820 should in some cases facilitate the more active use of the important and beneficent power vested in the Secretary, or in the Commissioner with the approval of the Secretary, by section

⁹⁰ See remarks of Hon. John P. Wenchel, Chief Counsel, Bureau of Internal Revenue, relative to declaratory rulings, in *Tax Clinic Proceedings*, *op. cit. supra* note 15, at 697.

1108(a) of the Revenue Act of 1926, as amended by section 506 of the 1934 Act, to "prescribe the extent, if any, to which any ruling, regulation, or Treasury Decision, relating to the internal revenue laws, shall be applied without retroactive effect," by discouraging any tendency to make profitable use of inconsistencies in the regulations, as between different periods, which result from the exercise of this power.⁹¹

POSSIBLE DEFECTS OF SECTION 820

Nothing that has been said is intended to imply an opinion that section 820 in its present form is free from imperfections or that constructive amendments of it should not be entertained and carefully considered on their merits.⁹² On the contrary, it would be indeed a miracle if the first concrete legislative effort, however carefully drawn, to solve a set of problems so difficult should prove to be more than a substantial initial step forward toward an ultimate satisfactory solution. A number of suggestions have already been made relative to desirable amendments. Some of these suggestions will now be briefly considered.

Perhaps the most common and important of these is that the statute should be amended to extend relief to taxpayers who have been victims of the so-called practice of double disallowance of deductions or credits. It is contended that, although it is the professed purpose of section 820 to administer even-handed justice as between taxpayers and the government, the statute as now drawn fails to accomplish this result as long as no remedy is afforded for the double disallowance cases, particularly in view of the remedy given to the government in the cases covered by section 820(b)(3). Although it is true that these double disallowance cases do not, as a matter of strict analysis, involve the element of double burden upon the taxpayer re-

⁹¹ 44 STAT. (1926) 9, 114, as amended 48 STAT. (1934) 680, 757. See Paul, *Federal Tax Compromises* appearing in his *SELECTED STUDIES IN FEDERAL TAXATION*, SECOND SERIES (1938) 53, 76 *et seq.*, particularly 94-99, for a valuable discussion of the possible uses of this statutory provision.

⁹² See *Proposed Changes in the Federal Revenue Law*, a memorandum submitted to the Treasury Department under date of September 1, 1938, by the Committee on Federal Taxation, American Institute of Accountants, at p. 25. It is stated that, although the replies to the questionnaire circulated among certified public accountants and others indicated a preponderance of opinion in favor of striking section 820 from the law until it can be redrafted, the committee believes it to be the consensus that the basic intent of the provision should be made effective. The report contains several constructive criticisms and suggestions for amendment.

sulting from a rigid statute of limitations,⁹³ as do those covered by section 820(b) (1), it is also true that the cases in which an adjustment is authorized by section 820(b) (3) do not involve a double benefit to the taxpayer comparable to the double benefit which section 820(b) (2) seeks to prevent.

It is impossible to escape the conclusion that there is merit in this suggestion. A remedy for the "double disallowance" evil should, if possible, be found. If the technical difficulties, which are very great, should prove insuperable, section 820(b) (3) should probably be limited or repealed. It is not true, however, that the 1938 Act has done nothing to ameliorate this evil for the future. As has been pointed out, the protection afforded to the revenue by section 820(b) (2) should have a marked tendency to modify the present over-cautious administrative attitude toward the allowance of certain deductions in the year in which they are first claimed. If such a change in attitude occurs, many claimed deductions will be allowed henceforth under circumstances in which they have been disallowed in the past. Also, the enlarged scope given to closing agreements under the present Act affords a device, if it is widely employed, by which taxpayers who acquiesce in the disallowance of deductions in a particular year may be protected from the possibility that such deductions may subsequently be thrown back into that year after the statute has tolled, as the result of an administrative change of front.⁹⁴ But neither of these possibilities provides a certain and specific remedy for the evil in the future nor helps at all as to prior years running back to 1932 which are already barred. Such an adequate remedy would contribute tremendously to confidence on the part of the great body of taxpayers in the fairness of income tax administration.

The technical difficulties in the way of a solution along the lines of section 820 are, however, very real. The failure to solve them in the drafting of the section was not due to any lack of effort upon the part of the draftsmen. It should not be forgotten that the section was drafted upon the principle that the basic policy of the statutes of limitation should not be impaired. Save at the expense of a departure fatal to that principle, a remedy by way of adjustment for an earlier barred year in which a deduction had been claimed and disallowed could not be authorized merely because a determination sanctioned a disallowance of the same deduction in a subsequent year, unless such

⁹³ See p. 116, *supra*.

⁹⁴ See Marrs, *op. cit.* *supra* note 15, at 692.

earlier year was the correct year. It might well be that the Commissioner's action in both years was legally correct and that there was no inconsistency on his part. The final determination in the later year would not ordinarily include a finding as to the year in which the deduction was allowable.⁹⁵ Indeed the taxpayer might have claimed a deduction with respect to the same item in three or more years, two or more of which were barred by limitation at the time of the determination with respect to the open year. In that event, what would determine the year with respect to which an adjustment should be made?

A possible key to the solution of this difficulty may be a statutory provision which would enable taxpayers in cases of this sort to obtain from the Board, on the basis of evidence submitted for such purpose, when its determination sustains the disallowance of the deduction or credit in the open year, a determination of the year in which the deduction or credit is allowable, except where the taxpayer and the Commissioner stipulate the proper year, in which event the stipulation might be given the legal effect of a determination. Only in the event, however, that the deduction had been claimed and disallowed in the return for that year should an adjustment be authorized. To go further would be to emasculate the statute of limitations in such cases.

Serious consideration should be given to the question whether the adjustment otherwise authorized by section 820 should not be allowed, where the bar to the correction of the error in the earlier year is not a provision of the internal revenue laws but the judicial doctrine of *res judicata*. The question is important chiefly in cases where related taxpayers are involved. There is a definite possibility of conflict in judicial holdings as to the proper treatment of the same item in two cases for the same or different taxable years, in one of which only the taxpayer, and the other only a related taxpayer is a party.

It has been noted that section 820 authorizes adjustment in the liability of one taxpayer by reason of the inconsistencies of a related taxpayer sanctioned by a determination. It has been suggested,⁹⁶ contrary to the interpretation of the section promulgated in the Treasury Regulations,⁹⁷ that the authority for such adjustment should expressly be confined (except in the husband-and-wife status) solely to

⁹⁵ It is true that a similar difficulty may arise in some cases governed by section 820(b)(3). Such cases, however, are likely to be relatively few in number and the difficulties of determination somewhat less great, but the differences are only of degree.

⁹⁶ *Supra* note 92.

⁹⁷ Treas. Dec. 4856, art. 820(a)-4.

transactions growing out of the relationship, and possible only by reason of the existence of the relationship. It is recognized that there is occasion for such adjustment in certain situations. While the statute already contains substantial protective limitations upon the operation of the related taxpayer provisions,⁹⁸ it is believed there is sufficient merit in this suggestion to warrant its careful consideration and that such an additional limitation, if the husband and wife relation is excepted, would not defeat the essential purposes of the provisions in question.

Another criticism made of the statute is that it operates only where there is a determination with respect to an item in an open year, and that this automatically excludes from its benefits a very large portion of all returns filed, since, in most cases, there is no closing agreement, refund claim, or judicial contest.⁹⁹ It is true that the tax liability has been closed in a vast majority of past cases by the acceptance of the return or the voluntary acknowledgment of additional tax or refund and, ultimately, by the running of the statutes of limitation. There are, however, very good reasons which have been explained¹⁰⁰ why the mechanism of section 820 is geared to a determination sanctioning an inconsistent position, and why the definition of determination requires some element of finality. It is believed that great caution should be exercised in broadening the statute in these respects, at least until a body of experience has been accumulated within its present relatively restricted scope of operation. In the meantime, an enlarged use of closing agreements is capable of providing the requisite determination in many cases involving inconsistency which are closed by voluntary settlement.¹⁰¹

Another criticism is based upon the fact that section 820 contains no definition of the important term "item." Definitions of statutory terms are, of course, *prima facie* desirable. Unfortunately, some concepts do not lend themselves to adequate abstract definition. The term "item" happens to be one of them. But it is not believed that the absence of a formal definition will be a serious obstacle to the practical understanding and application of the term. The same term has

⁹⁸ *Supra* note 48.

⁹⁹ *Supra* note 92.

¹⁰⁰ See discussion on p. 132, and note 54, *supra*.

¹⁰¹ Such enlarged use may impose a considerable additional administrative burden upon the Treasury Department, but it is a burden which must be assumed if section 820 is to function with maximum equity to taxpayers.

been used elsewhere in the income tax law without formal definition¹⁰² and has caused no trouble. Moreover, the numerous examples in the committee reports on the section and in the regulations promulgated thereunder provide sufficient practical understanding of its meaning.

Section 820 (b) (5) has been criticized because it authorizes an adjustment with respect to a barred year against (or in favor of) a taxpayer where the inconsistent position has been successfully maintained in another year not by the taxpayer himself but by some successor in title (ordinarily a donee) who is required by law to take such taxpayer's basis. While it naturally seems rather startling to impose obligations upon or vest rights in a person because of the conduct of another over which such person may not in particular cases be able to exercise control, it is also apparent that the provision in question would be of doubtful practical value if its operation could be avoided by the simple expedient of giving away the property or transferring it to a controlled corporation. A possible compromise, at the expense of further complicating an already complicated statute, would be to limit the application of this phase of section 820(b) (5) to cases in which the transferee required to take the taxpayer's basis is a controlled corporation or a relative of the taxpayer. It is possible also, although the author is skeptical on this point, that the cases covered by this subsection, which deals generally with basis problems, could be more equitably solved by some method of statutory estoppel.¹⁰³ In order for such a method to work, however, it would be necessary, for the same reasons indicated above, to extend the scope of the estoppel to donees and other transferees required to use a carry-over basis.

Limitations of space do not permit specific mention or detailed analysis of other amendments of section 820 which have been proposed.¹⁰⁴ Most of them, if adopted, would extend the operation of the statute to situations which possibly are not now covered by it. While they no doubt possess some merit and should be considered, it is submitted that it would be the part of wisdom to adopt a conservative policy toward changes expanding the scope of the statute until adequate administrative experience under its present provisions can be accumulated. With the exception of the double deduction situation, the major substantive problems seem to be fairly well covered. Sec-

¹⁰² For instance, section 42, the Revenue Act of 1938, and corresponding provisions of prior acts.

¹⁰³ Marrs, *supra* note 15, at 693.

¹⁰⁴ See the remarks of Mr. E. J. Keelan, Jr., in *Tax Clinic Proceedings*, *op. cit.* *supra* note 15, at 664-665, and those of Mr. Aubrey R. Marrs, *ibid.* at 692-693.

tion 820 cannot fairly be expected to cure all the ills of income tax administration. It ought not to be loaded down with too much baggage until it has had a fair chance to demonstrate in actual operation whether or not its principles and mechanics of operation are valid and practical.¹⁰⁵

CONCLUSION

The administration of the income tax has revealed the existence of many grave inequities and hardships, both to taxpayers and the public revenues, attributable to the operation of rigid statutes of limitation and other provisions of the internal revenue laws which ordinarily preclude the revision of tax liability beyond a relatively short period in the past. The courts have sought, but not very successfully, to ameliorate these evils by invoking some principle in the nature of estoppel. The statutes of limitations are based upon a sound and necessary public policy and their essential function as statutes of

¹⁰⁵ Nothing has been said in the body of the article as to possible constitutional questions which may arise in the application of section 820. Doubts have been expressed as to the constitutional power of Congress to lift the bar of an unequivocal statute of limitations, of a judicial decision, or of a closing agreement with respect to past years and also as to the validity of the related taxpayer provisions. See the remarks of Messrs. Jacob S. Seidman and Percy W. Phillips in *Tax Clinic Proceedings, op. cit. supra* note 15, at 693-694. The first issue could arise, of course, only in cases where the statute had run or a closing agreement had been executed or a proceeding before the Board with respect to an earlier year had gone to final decision prior to the effective date of the act. Even in these cases it is not believed the issue has much merit, at least where the operation of the statute against a taxpayer results from his own inconsistent conduct after the effective date of the Act. Surely no constitutionally vested right is impaired by legislation whose purpose is to prevent an inequitable use of a statutory bar. *Cf.* the language of the opinion of Mr. Justice Stone in *McEachern v. Rose, supra* note 18, where the court reluctantly reached what it apparently regarded as an inequitable result under the compulsion of sections 607 and 609 of the 1928 Act, a compulsion now removed in such cases by section 820(b)(3). To the extent section 820 merely grants relief to taxpayers in cases where no relief was heretofore available, no constitutional question could possibly arise.

The issue is not so clear in the cases where the bar is lifted against one taxpayer because of the inconsistent conduct of a related taxpayer or, under section 820(b)(5), of a successor in title. As to those cases arising under section 820(b)(4) which are similar to the situation presented in *Stone v. White, supra* note 79, there can be no real question as to the statute's validity. If the Supreme Court was sufficiently impressed by the equities to grant the government relief in that case on a non-statutory ground of equitable recoupment, it would be extremely unlikely to hold that Congress has exceeded its power by legislation intended to provide similar relief, merely because of differences in mechanics. In view of the relatively limited scope of the related taxpayer provisions and the statutory safeguards on their operation, it is not believed the courts will hold them, at least in any important respect, to exceed the bounds of reasonable legislation to correct undoubted evils.

repose should not be materially impaired. Their use, however, as a shield behind which inequitable double benefits may be obtained and double burdens imposed, is a perversion of their proper purpose. Such use should be prevented if a method of prevention can be found which does not too seriously impair their essential function, which tends to diminish in the net the volume of controversy and litigation, and which improves the equity of income tax administration.

Section 820 of the Revenue Act of 1938 is the first major legislative effort in this direction. Its provisions are complicated and will no doubt be the source of some new litigation, but its operation may prevent far more litigation than it produces. Its complications are inevitable in view of the intricacy of the subject matter with which it deals. A comparison of the new statute with possible alternative solutions based upon some principle of estoppel justifies the conclusion that it provides the simpler and more equitable form of remedy. Some of the major criticisms levelled at the statute appear upon analysis to be exaggerated or not sufficiently supported by the facts. The weight of other criticisms cannot be finally determined except in the light of actual experience in the administration of the statute. The principal substantive defect of the statute appears to be its failure to provide an adequate remedy for the so-called administrative evil of double disallowance of deductions and credits. Every effort should be made to overcome the real technical difficulties standing in the way of a solution of this problem.

Section 820 is important because of its relation to other badly needed reforms in tax administration, as well as the problems at which it is immediately directed. It should be refined and perfected by well-considered amendments but a conservative policy should be pursued in extending the scope of its application until it has been sufficiently tested in the fires of experience. The statute's ultimate fate should depend upon a balancing of its advantages and disadvantages, as proved by actual experience, but it should be given a fair opportunity to justify its existence. Current demands for its complete repeal seem insufficiently supported and should be rejected.

Arthur H. Kent.