

**SOCIAL SCIENCE EXPLANATIONS FOR DISPARATE
OUTCOMES IN TAX COURT ABUSE OF DISCRETION
CASES: A TAX JUSTICE PERSPECTIVE**

CHARLES A. BOREK*

I. INTRODUCTION

The subject of taxation is frequently perceived as a primarily technical branch of the law. In the art and science of jurisprudence, tax is thought to be composed of larger doses of the latter than the former. Thus there is less fertile ground for instructive insight into the complex relationships giving rise to valuable discussions of metaphorical concepts such as “justice.”

Most would agree that any relevant view of tax policy must be framed within the parameters of basic justice.¹ When viewed through the tax lens, however, justice appears to be exclusively related to the substantive structure of the statute, and discourse on tax justice invariably focuses on progressivity and equity with respect to tax legislation.² The fact that the

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* Visiting Assistant Professor of Law, University of Baltimore School of Law; J.D., *summa cum laude*, University of Baltimore School of Law; M.B.A., Merrick School of Business, University of Baltimore; B.A., Mary Washington College; C.P.A., State of Maryland. The author wishes to acknowledge the outstanding contributions of his research assistants Tara L. Pehush, Elisa Louise Bob, and Florian Schofer, as well as the valuable comments from his University of Baltimore faculty colleagues Leigh Goodmark, Michele Gilman, and Fred Brown. Finally, the author is eternally grateful for the inspiration received from Professors Jeri Cohen and Tim Brennan of the University of Maryland, Baltimore County.

¹ LIAM MURPHY & THOMAS NAGEL, *THE MYTH OF OWNERSHIP: TAXES AND JUSTICE* 12 (2002) (stating, “It has been recognized for a long time that tax policy must take account of political morality, or justice.”); *see also* Linda Sugin, *Tax Expenditure Analysis and Constitutional Decisions*, 50 *HASTINGS L.J.* 407, 472-74 (1999).

² *See, e.g.*, Walter J. Blum & Harry Kalven, Jr., *The Uneasy Case for Progressive Taxation*, 19 *U. CHI. L. REV.* 417, 480 (1952) (“[I]t is not infrequently urged that ability to pay is the cardinal criterion of tax justice.”); Alfred G. Buehler, *Ability to Pay*, 1 *TAX L. REV.* 243, 243 (1946) (“To many persons ability to pay is synonymous with justice in taxation.”); Amy C. Christian, *The Joint Return Rate Structure: Identifying and Addressing the Gendered Nature of the Tax Law*, 13 *J. L. & POL.* 241 (1997) (discussing inequity in tax rate structures); Joseph M. Dodge, *Accessions to Wealth, Realization of Gross Income, and Dominion and Control: Applying the “Claim of Right Doctrine” to Found Objects, Including Record-Setting Baseballs*, 4 *FLA. TAX REV.* 685, 700-01 (2000) (characterizing
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term is richer and more complex seems to have escaped the academy and the bar to a great extent.³ The prominent justice theorists, when they address taxation at all, do so only obliquely and in terms of larger economic issues.⁴ The emphasis in the tax arena has been on the collective justice of systems rather than on the individualized justice of litigants in a tax forum.

If we are to fully comprehend and evaluate tax justice, we must first grasp the dynamics occurring at the micro-level stage of the adjudicatory process. To achieve such an understanding, scholars have, at various times, used an assortment of social science approaches to gain insight into judicial behavior.⁵ This should not be surprising, as the study of law has

“ability to pay” and the “tax justice norm”); Michael J. Graetz, *The Troubled Marriage of Retirement Security and Tax Policies*, 135 U. PA. L. REV. 851, 861 (1987) (“The ability-to-pay criterion enjoys broad acceptance as a fundamental tenet of tax justice. . . .”); Vada Waters Lindsey, *The Widening Gap Under the Internal Revenue Code: The Need for Renewed Progressivity*, 5 FLA. TAX REV. 1 (2001) (assessing the current Code in light of progressivity principles); John A. Miller, *Rationalizing Injustice: The Supreme Court and the Property Tax*, 22 HOFSTRA L. REV. 79, 125-26 (1993) (discussing the notions of horizontal and vertical equity in tax statutes); Jeffrey A. Schoenblum, *Tax Fairness or Unfairness? A Consideration of the Philosophical Bases for Unequal Taxation of Individuals*, 12 AM. J. TAX POL’Y 221, 233 (1995) (addressing the fairness of progressivity in taxation).

³ There have been a few book-length treatments of the subject that go into depth beyond critical assessments of legislative tax structure. Two recent scholarly contributions to the discussion of tax justice in general are MURPHY & NAGEL, *supra* note 1, and TAX JUSTICE: THE ONGOING DEBATE (Joseph J. Thorndike & Dennis J. Ventry Jr., eds. 2002). While both volumes include analysis of justice in taxation from a variety of perspectives, the emphasis of both works is the underlying policies of the tax statute. For an older treatment of the topic, see RONALD PASQUARIELLO, *TAX JUSTICE: SOCIAL AND MORAL ASPECTS OF AMERICAN TAX POLICY* (1985), which views equity in tax structure from a Christian perspective.

⁴ See, e.g., Linda Sugin, *Theories of Distributive Justice and Limitations on Taxation: What Rawls Demands from Tax Systems*, 72 FORDHAM L. REV. 1991, 1994 (2004) (noting that “Rawls wrote a great deal about economic justice generally, but very little about taxation in particular, and what he did say is puzzling”).

⁵ See, e.g., SUSAN U. PHILIPS, *IDEOLOGY IN THE LANGUAGE OF JUDGES: HOW JUDGES PRACTICE LAW, POLITICS, AND COURTROOM CONTROL* 3-8 (1998) (approaching the topic from an anthropological perspective); Tracey E. George, *Developing a Positive Theory of Decisionmaking on U.S. Courts of Appeals*, 58 OHIO ST. L. J. 1635 (1998) (analyzing political science models of judicial decision-making); Laura E. Little, *Loyalty, Gratitude, and the Federal Judiciary*, 44 AM. U. L. REV. 699 (1995) (examining judicial behavior from a sociological perspective); Jeffrey Evans Stake, *Status and Incentive Aspects of Judicial Decisions*, 79 GEO. L. J. 1447 (1991) (utilizing economic theory to explain judicial

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itself evolved into somewhat of an interdisciplinary effort that is as evidenced by the ubiquitous presence of “law and . . .” courses and degree programs in the law school curriculum.⁶ This trend reveals a growing recognition that the academy has historically divided disciplines into, more or less, arbitrary categories merely for its own convenience. The law, as life itself, is inherently interdisciplinary, and it makes sense to “borrow” approaches from other disciplinary categories to further our understanding of what underlies observed judicial behavior.

This article attempts to explain a particular judicial phenomenon in social science terms, focusing on sociological theory. My point is not to exhaust the variety of social science methodologies that may be used to explain this particular judicial behavior, but rather to demonstrate that because there are a variety of explanations, the behavior itself is ingrained

behavior). Sociological perspectives in particular have drawn the attention of scholars in analyzing many areas of law. See, e.g., NIKLAS LUHMANN, *A SOCIOLOGICAL THEORY OF LAW* (Martin Albrow ed., Elizabeth King & Martin Albrow trans., 1985); F. Patrick Hubbard, *The Physicians' Point of View Concerning Medical Malpractice: A Sociological Perspective on the Symbolic Importance of "Tort Reform,"* 23 GA. L. REV. 295 (1989) (arguing that viewing physicians' certainty of the need for “tort” reform and their simultaneous lack of interest in the effectiveness of such reform from a sociological perspective, it becomes clear that physicians are really protesting a range of changes in the health care system); Lisa J. McIntyre, *A Sociological Perspective on Bankruptcy,* 65 IND. L.J. 123, 123-24 (1989) (introducing a symposium issue on the sociologists' interest in bankruptcy); Logan Everett Sawyer, III, *Jurisdiction, Jurisprudence, and Legal Change: Sociological Jurisprudence and the Road to International Shoe,* 10 GEO. MASON L. REV. 59, 75 (2001) (arguing that the growing awareness of several Supreme Court Justices of a type of “sociological jurisprudence” influenced the outcome of *International Shoe*); Jeffrey W. Stempel, *Politics and Sociology in Federal Civil Rulemaking: Errors of Scope,* 52 ALA. L. REV. 529 (2001) (offering a sociological perspective on rulemaking); Mark C. Suchman, *Working Without a Net: The Sociology of Legal Ethics in Corporate Litigation,* 67 FORDHAM L. REV. 837 (investigating “the normative beliefs and structural mechanisms that sustain . . . the ethical practices of a core segment of the American legal elite”).

⁶ For example, the University of Baltimore School of Law now offers courses in Law and Disabilities, Law and Economics, Law and Education, Law and Medicine, Law and Poverty, Law and Psychiatry, and Law and Social Reform. ‘Law and . . .’ dual-degree programs can be traced to those initiated in 1933 by Yale Law School in collaboration with the Harvard Graduate School of Business Administration. Anita Weinberg & Carol Harding, *Interdisciplinary Teaching and Collaboration in Higher Education: A Concept Whose Time Has Come,* 14 WASH. U. J.L. & POL'Y 15, 21 (2004). “While the program was discontinued in 1938, it established a model for “law and [. . .]” degree programs that now include any variety of dual-degree programs, including law and social work, law and business, law and psychology, and law and political science.” *Id.*

and predictable. By doing so, I posit that there is a fundamental nature to this behavior and that it is not random or accidental.

The embedded nature of the dynamics that work together to produce the results I illustrate below has important implications for the achievement of tax justice. A universal postulate of justice is that of equal treatment in equivalent circumstances. A difference in judicial approach based solely on the social characteristics of the taxpayer is inherently unfair, even if readily explainable by reasons other than intentional, unjustified partiality. If outcomes are rational but unjust, then it behooves us to impose decision mechanisms that overcome whatever it is that promotes the undesirable result.

The particular subjects of my inquiry are Tax Court abuse of discretion cases. By classifying these cases based upon the social and economic categories of the taxpayers involved, a discernable difference is revealed in the degree of deference the court grants to the government's findings. Specifically, institutional (e.g., "corporate") taxpayers regularly enjoy a diminished deferential standard. On the opposite end of the spectrum, individual taxpayers in collection cases are faced with a Tax Court willing to accord great deference to the Internal Revenue Service ("Service"). I propose that this deferential difference is explainable by reference to sociological theory and that neither inadvertence nor intentional bias drives the results observed. Rather, the principles that give rise to these disparate outcomes are of a fundamental nature and implicit in the process itself. As such, any attempt to achieve tax justice by eradicating the fundamental social mechanisms fueling this judicial phenomenon is utterly over-ambitious and doomed to fail. It would be folly to attempt to equalize opportunity by emasculating the inherent superiority of the dominant participant in a given scenario. However, the playing field may be leveled by reformulating the rules of the game to benefit the disadvantaged so as to simulate equality in the process. In the judicial setting, this may be accomplished by modifying the standard of review.

Part II of this Article explores the contours of tax justice. Part III lays the foundation for my recommendations by setting forth the appropriate standards for assessing tax justice in the context of Tax Court adjudication. Part IV sets out the evidence of what I shall refer to as the "deferential difference" by explicating Tax Court applications of the abuse of discretion standard in a variety of settings. Part V contains a detailed explanation of some of the sociological approaches that may be used to demonstrate the expected and institutional nature of this judicial phenomenon. This Part also touches upon thinking found in other social science fields that may be insightful. Part VI contains an illustration of the differing standards of review utilized by the Tax Court in response to varying circumstances. In the conclusion, I offer my suggestion for achieving tax justice by overcoming the deferential difference with

adjustments to the standard of review in collections cases under Internal Revenue Code (“Code”) section 6330.

II. THE CONCEPT OF TAX JUSTICE

Whether analyzing tax justice on the systemic or individual level, a fundamental precept is that of equitable uniformity.⁷ Differentiation in the application of legal standards is tolerable only when a cogent dissimilarity justifying differential treatment has been articulated. Unjustified distinction is the antithesis of fairness and thus frustrates the ability to achieve justice. It is manifestly obvious, for example, that the standard of proof to which a prosecutor or civil plaintiff is subject should not vary with the social or economic status of the moving party. By its nature, justice is of but one form, not dependent on the identity of the one seeking refuge in her embrace. This is no less true in tax matters than in other areas of the law; Lady Justice is not expected to jettison her blindfold simply because tax is the task at hand.

The universality of these principles may lead to the naive conclusion that the topic of tax justice is easily explicated. To the contrary, a comprehensive theory of tax justice is much too vast an undertaking for a single article-length treatment such as this. My task here is much more modest and requires that we first isolate the particular aspect of the tax justice concept that is the subject of my inquiry. In the fifth book of the *Nicomachean Ethics*,⁸ Aristotle classified the concept of justice as being either “distributive” or “corrective.”⁹ The former roughly corresponds to the legislative distribution of rights resulting in the sharing of the benefits and burdens of social cooperation, and the latter roughly corresponds with judicial decision making.¹⁰ While most of the preceding scholarship has addressed tax justice in the distributive sense, this Article is concerned with tax justice in the Aristotelian corrective sense as it is revealed through the decisions of the United States Tax Court, the primary arbiter of federal tax disputes in this country.¹¹ The concept of justice being pursued here

⁷ See JOHN RAWLS, A THEORY OF JUSTICE 10-15 (rev. ed. 1999) [hereinafter RAWLS (rev. ed. 1999)].

⁸ ARISTOTLE, NICOMACHEAN ETHICS (David Ross trans., J. L. Ackrill & J. O. Urmson rev., Oxford World’s Classics 1998) (n.d.).

⁹ J. M. KELLY, A SHORT HISTORY OF WESTERN LEGAL THEORY 26 (1992).

¹⁰ ARISTOTLE, *supra* note 8, at 110-15; see also KELLY, *supra* note 9, at 26-27.

¹¹ Tax controversies may be resolved in federal district courts or the court of federal claims, see I.R.C. § 7429 (2000); 28 U.S.C. § 1346(e) (2000), and even bankruptcy court, see 11 U.S.C. § 505 (2000). However, the Tax Court’s jurisdiction is most wide-ranging and includes the following types of cases: (1) deficiency cases, see I.R.C. §§ 6212 (2000); 6213 (2000), 6901 (2000), TAX CT. R. 13(a); (2) declaratory judgment cases, see I.R.C. § 7428 (2000), 7476 (2000), 7478 (2000), 7479 (2000), TAX CT. R. 210(c); (3) disclosure
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deals with the proper administration of laws, with regard to which the aspirational goal is “the constant and perpetual disposition of legal matters or disputes to render every man his due.”¹²

Furthermore, any examination of tax justice in the context of judicial determinations must necessarily be grounded in the actual experiences of the participants in the process. Determining whether justice is being achieved in this setting requires an analysis of the relational dynamics of sentient and rational beings affected by, and affecting, judicial practices.¹³ Philosophical theory may provide a foundation for our inquiry, but our goal is a systematic analysis of tax justice as it emanates from the courtroom in particular cases.¹⁴

This does not imply that meta-theory is without its place nor that we cannot utilize the underlying concepts promoted by the grand theories of economic justice in this endeavor. The eminent theorist John Rawls, for

actions, *see* I.R.C. § 6110(d)(3) (2000), TAX CT. R. 220(c); (4) judicial review of final partnership administrative adjustments, *see* I.R.C. § 6226 (2000), 6228 (2000), TAX CT. R. 240(c); (5) actions for administrative costs, *see* I.R.C. § 7430 (2000), TAX CT. R. 270(c); (6) action for review of failure to abate interest, *see* I.R.C. § 7430(f) (2000), TAX CT. R. 280(b); (7) actions for redetermination of employment status, *see* I.R.C. § 7436 (2000), TAX CT. R. 290(b); (8) relief from joint and several liability, *see* I.R.C. § 6015(e) (2000), TAX CT. R. 320(b) and; (9) lien and levy actions, *see* I.R.C. §§ 6320(c) (2000), 6330(d) (2000), TAX CT. R. 330(b).

¹² BLACK’S LAW DICTIONARY 864 (6th ed. 1990) (identifying the jurisprudential definition of justice).

¹³ For a sociological evaluation of the concept of discretion in the administration of law, *see* Edward L. Rubin, *Discretion and its Discontents*, 72 CHI.-KENT. L. REV. 1299, 1299 (1997) (“[T]he apparent discretion that legal rules allow administrators is frequently constrained by a dense fabric of custom, norms, training, and informal sanctions.”). Professor Rubin points out that Dworkin’s definition of discretion is directly related to the latter’s theory of judicial decision-making. *Id.* at 1300-01 (discussing RONALD DWORKIN, *TAKING RIGHTS SERIOUSLY* 31 (1978)). Discretion, in Dworkin’s view, is manifest in either a “strong” form, where the decision-maker acts unconstrained by any standards set by some other authority, or a “weak” form, in which the decision-maker is simply vested with decision-making authority. *See id.* at 1301. This discussion may have some useful implications for the judicial phenomenon identified in this Article, but a full integration of the more philosophical and linguistic issues raised by Professor Rubin is beyond the scope of my present purposes. *See also* Keith Hawkins, *The Use of Legal Discretion: Perspectives from Law and Social Science*, in *THE USES OF DISCRETION* 11 (Keith Hawkins ed., 1992) (considering perspectives from law and sociology in addressing decision and rule-making by legal officials).

¹⁴ In this sense, this Article is a continuation of the work begun by others. *See, e.g.*, Assaf Likhovski, *The Duke and the Lady: Helvering v. Gregory and the History of Tax Avoidance Adjudication*, 25 CARDOZO L. REV. 953, 955 (2004).

example, espoused the “difference principle,” which holds that economic differences between “social groups are justified only to the extent that the system that generates those inequalities also does at least as well for the interests of the worst-off group as any alternative system.”¹⁵ Rawls himself conceived of the difference principle as but a component of a larger inquiry and did not develop the concept further in relation to any isolated aspect of tax law.¹⁶ While this elegant approach to economic justice has only been used in the analysis of broader tax policy issues, it is not necessarily bereft of any benefit to those who seek an explanation for judicial, rather than legislative, outcomes in the area of taxation. Judicial decision-making is part of a tax system that may generate economic inequalities, and the essence of the Rawlsian difference principle may help to explain specific judicial phenomena in the context of tax adjudication. For example, the idea of vertical equity in taxation, which demands that a greater relative burden fall upon those taxpayers who have a greater relative ability to bear such a burden,¹⁷ is arguably a manifestation of the difference principle.

Rawls also argued that a good theory of justice must start with our intuitions or considered judgments about what would be fair or just to do in particular cases.¹⁸ To be successful, a theory of justice must do two things. “First, all intuitive judgments and no counter-intuitive judgments should follow from the theory. Second, the theory itself should be independently plausible.”¹⁹ Rawls, however, posits that the first requirement is too strong; in fact, by highlighting “similarities or differences that otherwise would not have appeared to us,” the theory itself may force us to rethink some of our intuitive judgments.²⁰ As the iterative process continues, the theory will have to be adjusted to take account of these revised intuitions.²¹ In this way, Rawls suggests that we will reach a “reflective equilibrium”

¹⁵ MURPHY & NAGEL, *supra* note 1, at 54; *see also* RAWLS (rev. ed. 1999), *supra* note 7, at 47-86.

¹⁶ *See* Sugin, *supra* note 4, at 1999.

¹⁷ *See* Donna M. Byrne, *Progressive Taxation Revisited*, 37 ARIZ. L. REV. 739, 759 (1995) (“[V]ertical equity means that taxpayers with higher incomes should pay tax at higher rates.”); William F. Fox, *The Personal Income Tax as a Component of State Tax Structure*, 39 VAND. L. REV. 1081, 1090 (1986) (“Vertical equity means that people with different taxpaying capacity should pay different taxes.”).

¹⁸ *See* JOHN RAWLS, A THEORY OF JUSTICE 41 (1971) (“No doubt any conception of justice will have to rely on intuition to some degree.”).

¹⁹ Jon Elster, *Some Unresolved Problems in the Theory of Rational Behaviour*, 36 (3) ACTA SOCIOLOGICA 179, 180 (1993), *available at* <http://www.geocities.com/hmelberg/elster/ar93supi.htm>.

²⁰ *Id.*

²¹ *Id.*

reflecting a comfortable fit between our considered moral intuitions and our moral reasoning.²²

Ultimately, however, an assessment of justice derived through interaction between the taxpayer, the taxing authorities, and the courts is a product more of social interaction than philosophical reflection. Such interactions provide evidence of social structures that have independent significance apart from the individuals that make up their constituent components at any given time. By identifying patterns in these interactions, it is possible to develop a rational framework that gives meaning to the structural mechanisms and, more importantly, helps to explain social action in this context. While it is simple enough to say “if justice is not being done, do justice,” we are hopelessly relegated to ivory tower idealism unless our endeavor is firmly grounded in an understanding of what is taking place on a social level.

III. CRITERIA FOR ASSESSING TAX JUSTICE

Traditional notions of tax justice are founded upon the ideas of horizontal equity and vertical equity.²³ Horizontal equity refers to treating similarly situated taxpayers alike.²⁴ In order to achieve horizontal equity, the tax justice system must avoid arbitrary distinctions among similarly situated taxpayers on the basis of differences in economic status.²⁵ The consequence of a failure to do so is a failure of fairness, an injustice that is likely to undermine confidence in the tax adjudication process and result in a heightened lack of voluntary compliance.²⁶ In the context of Tax Court

²² See RAWLS, *supra* note 18, at 48-51; Elster, *supra* note 19, at 180.

²³ See Jay A. Soled, *A Proposal to Make Credit Shelter Trusts Obsolete*, 51 TAX LAW. 83, 90 (1997) (“Horizontal and vertical equity considerations are the Code’s common benchmarks for measuring fairness.”).

²⁴ See Vada Waters Lindsey, *The Burden of Being Poor: Increased Tax Liability? The Taxation of Self-Help Programs*, 9 KAN. J.L. & PUB. POL’Y 225, 251 n.2 (1999) (“Horizontal equity means that similarly situated individuals should be taxed similarly.”); Christopher T. Nixon, *Should Congress Revise the Tax Code to Extend the Same Tax Benefits to Same-Sex Couples as are Currently Granted to Married Couples?: An Analysis in Light of Horizontal Equity*, 23 S. ILL. U. L. J. 41, 45 (1998) (“Horizontal equity is a tax policy goal of taxing similarly situated taxpayers at a similar rate.”). The concept of horizontal equity is not restricted to considerations of tax justice. For example, the term has also been used in the family law context to mean that non-custodial parents with the same income pay the same amount of child support. See Louise Graham, *The Kentucky Law Survey: Family Law*, 86 KY. L.J. 795, 844 n.268 (1997-1998).

²⁵ Richard Schmalbeck, *Income Averaging After Twenty Years: A Failed Experiment in Horizontal Equity*, 1984 DUKE L.J. 509, 546.

²⁶ See Allen Wallburn, Comment, *Depreciation of Intangibles: An Area of the Tax Law in Need of Change*, 30 SAN DIEGO L. REV. 453, 454-55 (1993) (stating that a “tax law
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cases in which the abuse of discretion standard for reviewing a Service determination is applicable, horizontal equity means that the court's approach to a case should not be different on the basis of the taxpayer's relative economic status or other inconsequential criteria. On the basis of this concept, corporate taxpayers and low income individuals should face the same burden of proving that the agency determination was unreasonable in light of the circumstances, and the court should investigate and analyze the evidence supporting the government's decision with the same vigor.

The federal tax tribunal has recognized that the range of juridical issues to which the horizontal equity concept applies includes both procedural matters and the statutory policy issues that have been the fodder of so much academic debate.²⁷ In *Shea v. Commissioner*,²⁸ for example, Judge Halpern's concurring opinion utilized the concept of horizontal equity in his analysis of a burden of proof issue.²⁹

In *Shea*, the taxpayer, a California resident named John Shea, had filed a joint income tax return with his spouse.³⁰ In the notice of deficiency, the Service indicated that it was changing Shea's filing status from married filing jointly to married filing separately.³¹ California is a community property state, and as such, married taxpayers residing there are generally each required to report one-half of their community income for federal income tax purposes.³² Based on the notice of deficiency, Shea contended that the income generated by his consulting business for the year in question was community income and that he was therefore required to report and be taxed on only one-half of it under general community property law principles.³³ In response, the government invoked its authority under Code section 66(b), which provides:

The Secretary may disallow the benefits of any community property law to any taxpayer with respect to any income if such taxpayer acted as if solely entitled to

that treats similarly situated taxpayers differently will probably be perceived as unfair and will likely lead to increased taxpayer noncompliance").

²⁷ See authorities cited *infra* notes 28-42.

²⁸ 112 T.C. 183 (1999).

²⁹ *Id.* at 206-07 (Halpern, J., concurring).

³⁰ *Id.* at 183, 189.

³¹ *Id.* at 189.

³² *Id.*; see also *United States v. Mitchell*, 403 U.S. 190, 196 (1971) (discussing reporting requirements in community property states); *Drummer v. Comm'r*, 67 T.C.M. (CCH) 2963, 2965 (1994) (citing *Mitchell*, 403 U.S. 190), *aff'd without published opinion*, 68 F.3d 472 (1995).

³³ *Shea*, 112 T.C. at 190 (1999).

such income and failed to notify the taxpayer's spouse before the due date (including extensions) for filing the return for the taxable year in which the income was derived of the nature and amount of such income.³⁴

Shea countered that the government should bear the burden of proof with respect to its reliance on Code section 66(b) because the Service had not made a determination to disallow the benefits of community property law when it issued the notice of deficiency.³⁵ The taxpayer asserted that the issue amounted to a "new matter" and, pursuant to Tax Court Rule 142, the burden of proof shifts to the government with respect to any "new matters."³⁶ The court sided with Shea, disagreeing with the government's position that the invocation of Code section 66(b) was implicit in the notice of deficiency.³⁷ The court noted that the factual basis required to establish the understatement of income is different from the factual basis necessary to establish whether community property law or section 66(b) applies.³⁸ Generally, the only evidence necessary to establish that income is community income is that the income was received by either spouse during the marriage while domiciled in a community property state, whereas whether the Service may apply section 66(b) and disregard community property law in determining a taxpayer's income requires evidence that the taxpayer acted as if he were solely entitled to the income and that he failed to notify his wife of the nature and amount of that income.³⁹ Because there was no evidence that the government considered the application of community property law or Code section 66(b) when it issued the notice of determination, the court held that the use of that theory was not implicit in the notice and thus constituted a "new matter."⁴⁰

Judge Halpern was troubled by the majority's reliance on the government's "intent" in issuing the notice of deficiency.⁴¹ To illustrate his concerns, the judge offered the following hypothetical:

Consider two taxpayers, each with unreported income, each married and filing separately, and each residing in a community property jurisdiction. Each receives an *identical* notice determining a deficiency in income tax on account of the omission of \$100 in gross income. The

³⁴ *Id.* (quoting I.R.C. § 66(b) (2000)).

³⁵ *Id.* at 190-91.

³⁶ *Id.*

³⁷ *Id.* at 191.

³⁸ *Id.* at 192.

³⁹ *Id.* at 193.

⁴⁰ *Id.* at 197.

⁴¹ *Id.* at 206 (Halpern, J., concurring).

notices do not mention section 66(b). Each taxpayer concedes receipt of the \$100 and its taxable nature. Each pleads, nevertheless, that, as the receipt was community property, he is taxable only on one-half. In one case, in determining the deficiency, it was the Commissioner's intention (unexpressed in the notice) to disallow the benefits of community property under section 66(b). In the second case, the Commissioner was unaware that the receipt was community property. He becomes aware only after his right to amend the answer without leave of Court has expired. See Rule 41(a). The Commissioner's awareness may be a factor in determining whether, under Rule 41(a), the Court should give leave to amend the answer to incorporate the new theory. Assuming leave to amend is given, the question of whether the new theory constitutes new matter under Rule 142(a) involves different considerations, viz, whether the new theory is inconsistent with the notice or requires different evidence. Simply stated, *it would violate principles of horizontal equity to place the burden of proof on the taxpayer in the first case and on the Commissioner in the second case, when both taxpayers have identical tax attributes and received identical notices.*⁴²

Vertical equity is thought to be achieved through the concept of progressivity.⁴³ There is a discernable inverse correlation between the actual degree of deference accorded the government by the tax court in abuse of discretion cases and the economic status of the taxpayer; the less economically formidable the taxpayer, the greater the deference given the government. In analyzing the Tax Court adjudication of disputes involving the application of an abuse of discretion standard, a curious "reverse vertical equity," perhaps more appropriately characterized as a vertical *inequity*, emerges.

The federal courts have been notoriously adverse to giving deference to the government in cases involving allocation of income and deductions

⁴² *Id.* at 206-07 (second emphasis added).

⁴³ The presumed justice of progressivity is not universally accepted. Nobel laureate Frederich A. Hayek points out that "progression provides no principle which tells us what the relative burden of different persons ought to be." Jeffery L. Yablon, *As Certain as Death—Quotations About Taxes*, 69 TAX NOTES 1665, 1674 (1995). Hayek's comments, however, focus on the present application of progressivity, not the validity of the underlying concept.

under Code section 482.⁴⁴ What explains this judicial reluctance to defer to the administrative agency in these cases? In a remarkable example of candor, Arthur L. Nims, III, former Chief Judge of the Tax Court, explained it as follows: “[M]any of the cases we’ve been talking about involve hundreds of millions of dollars, . . . [a]nd nothing must be done to undermine [the Tax Court’s] independence.”⁴⁵ Deference, it seems, is an elastic concept that may be stretched to accommodate the concerns of economically capacious taxpayers. The truth of this statement may be illuminated by comparing the courts’ approach to deference when the litigating taxpayer is of more modest economic means.

IV. EVIDENCE OF A DEFERENTIAL DIFFERENCE

A. *The Abuse of Discretion Standard*

A standard of review delineates the function of a tribunal in considering a prior decision in that it establishes the degree of deference that will be afforded the preceding authority.⁴⁶ Ideally, a determination of facts are made on a case-by-case basis and factual issues must necessarily

⁴⁴ See Francis M. Allegra, *Section 482: Mapping the Contours of the Abuse of Discretion Standard of Judicial Review*, 13 VA. TAX REV. 423, 433 (1994) (observing, when the article was written in 1994, that “during the last decade or so the courts have rejected, in whole or in large part, the Commissioner’s section 482 determinations in each of the major cases decided”).

⁴⁵ Arthur L. Nims, III, Remarks Delivered Before the International Fiscal Association, USA Branch 1991 Annual Meeting (Mar. 1, 1991), in 91 TAX NOTES TODAY 51-33, Mar. 6, 1991, LEXIS, Court News Releases, Tax Court; Related-Party Allocations.

⁴⁶ See URSULA BENTELE & EVE CARY, *APPELLATE ADVOCACY: PRINCIPLES AND PRACTICE* 119 (4th ed. 2004). Interestingly, the principal legal dictionaries do not define the term “standard of review.” See BLACK’S LAW DICTIONARY 1412-13 (7th ed. 1999); BALLENTINE’S LAW DICTIONARY 1208-09 (3d ed. 1969). *Mellinkoff’s Dictionary of American Legal Usage* states that standard of review is “a general expression of old and continuing attempts to establish criteria of judicial review . . . of governmental acts affected by flexible constitutional language (e.g., due process); as distinguished from those confined by narrowly drawn provisions (e.g., right to vote at eighteen; Amendment XXVI).” MELLINKOFF’S DICTIONARY OF AMERICAN LEGAL USAGE 612-13 (1992). Even this lexicon, however, acknowledges that “[c]onsensus is lacking both as to the number of criteria and their definition.” *Id.* at 613. The essence of a standard of review is that it constitutes the lens through which a tribunal will evaluate the determination of a prior authority. See, e.g., *Concrete Pipe & Prod. of Cal., Inc. v. Constr. Laborers Pension Trust for S. Cal.*, 508 U.S. 602, 623 (1993) (“[S]tandards of review . . . are normally applied by reviewing courts to determinations of fact made at trial by courts that have made those determinations in an adjudicatory capacity . . .”).

be resolved without the aid of any “cannons” or guiding principles.⁴⁷ The absence of any cannons or guiding principles with which to judge such determinations renders a reviewing body somewhat impotent to properly evaluate the correctness of the result. This individualized nature of factual determinations implies that a highly deferential standard is generally appropriate when the issue being reviewed is factual, as opposed to legal, in character.⁴⁸ This follows from the notion that the first reviewer of facts is in the best position to accurately assess them.⁴⁹

Deference cannot, however, equate to an absolute yielding to the prior judgment, as this would render the concept of deferential review oxymoronic. Rather, deferential review is commonly denoted by the term “abuse of discretion,” which in turn is articulated in a variety of ways by the federal judiciary.⁵⁰

⁴⁷ Arguably, cases decided by a trier of fact based on circumstantial evidence necessitates that certain principles of logic and common sense be used to determine facts in the absence of direct evidence.

⁴⁸ See *Mars Steel Corp. v. Cont’l Bank N. A.*, 880 F.2d 928, 936 (7th Cir. 1989) (“Fact-bound resolutions cannot be made uniform through appellate review, de novo or otherwise.”). The Service’s decision-making with regard to collection activity begins in the aggregate and moves toward case-by-case analysis during the life cycle of a delinquent account. Bryan T. Camp, *Failure of Collection Due Process: The Collection Context*, 2004 TAX NOTES TODAY 169-32, Aug. 31, 2004, LEXSTAT 2004 TNT 169-32. One commentator has argued that the problem with judicial review of collections due process cases (discussed in the next section of this Article) is that it comes too early in the process, before the Service has fully progressed from an aggregate view to an individualized view of the circumstances. See *id.*

⁴⁹ See *Pierce v. Underwood*, 487 U.S. 552, 559-560 (1988) (stating that, “as a matter of the sound administration of justice,” deference was owed to the “judicial actor . . . better positioned than another to decide the issue in question” (quoting *Miller v. Fenton*, 474 U.S. 104, 114 (1985))). In *Pierce*, the Court found that a district court’s determination under the Equal Access to Justice Act (EAJA), that the position of the United States was substantially justified, should be reviewed using an abuse of discretion standard because whether a position is “substantially justified” depends on the particular facts in question. *Id.*; see also *Cooter & Gell v. Hartmarx Corp.*, 496 U.S. 384, 403-04 (1990) (finding that a district court’s determination regarding the imposition of Rule 11 sanctions should be determined by an abuse of discretion standard).

⁵⁰ See, e.g., *Esenwah v. Ashcroft*, 378 F.3d 763, 765 (8th Cir. 2004) (finding that the abuse of discretion standard “is considerably more deferential than the ordinary administrative-law standard that governs our review of agency decisions”); *Diaz-Rivera v. Rivera-Rodriguez*, 377 F.3d 119, 124 (1st Cir. 2004) (stating that “a reviewing court customarily defers to the trial judge, whose intimate knowledge of the nuances of the underlying case uniquely positions him to construct a condign award” (quoting *Gay Officers Action League v. Puerto Rico*, 247 F.3d 288, 292 (1st Cir. 2001))); *Conroy v.*
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Abraham Chevrolet-Tampa, Inc., 375 F.3d 1228, 1232 (11th Cir. 2004) (“In applying this standard, we will affirm a district court’s evidentiary ruling unless the district court has made a ‘clear error of judgment’ or has applied an ‘incorrect legal standard.’” (quoting *Piamba Cortes v. Am. Airlines, Inc.*, 177 F.3d 1272, 1305 (11th Cir. 1999))); *Tesser v. Bd. of Educ.*, 370 F.3d 314, 318 (2d Cir. 2004) (“To find such an abuse, [the court of appeals] must be persuaded that the trial judge acted in an arbitrary and irrational fashion.” (quoting *United States v. Dhinsa*, 243 F.3d 635, 649 (2d Cir. 2001))); *United States v. DeCicco*, 370 F.3d 206, 210 (1st Cir. 2004) (“[A]buse of discretion occurs when a relevant factor deserving significant weight is overlooked, or when an improper factor is accorded significant weight, or when the court considers the appropriate mix of factors, but commits a palpable error of judgment in calibrating the decisional scales.” (quoting *United States v. Gilbert*, 229 F.3d 15, 21 (1st Cir. 2000))); *United States v. Martinez-Martinez*, 369 F.3d 1076, 1082 (9th Cir. 2004) (“The trial court’s findings regarding actual juror bias are reviewed under an extremely deferential standard, and should only be overturned for manifest error or abuse of discretion.”); *Smith v. Cont’l Cas. Co.*, 369 F.3d 412, 417 (4th Cir. 2004) (“Under the abuse of discretion standard, the plan administrator’s decision is reasonable if it is the result of a deliberate, principled reasoning process and if it is supported by substantial evidence.” (quoting *Bernstein v. CapitalCare, Inc.*, 70 F.3d 783, 788 (4th Cir. 1995))); *Templet v. Hydrochem Inc.*, 367 F.3d 473, 477 (5th Cir. 2004) (declaring that under abuse of discretion standard, “the district court’s decision and decision-making process need only be reasonable”); *Aaron v. Target Corp.*, 357 F.3d 768, 774 (8th Cir. 2004) (“The abuse of discretion standard means that a court has a ‘range of choice, and that its decision will not be disturbed as long as it stays within that range and is not influenced by any mistake of law.’ An abuse of discretion occurs if a relevant factor that should have been given significant weight is not considered, if an irrelevant or improper factor is considered and given significant weight, or if a court commits a clear error of judgment in the course of weighing proper factors.” (quoting *Verizon Communication, Inc. v. Inverizon Int’l, Inc.*, 295 F.3d 870, 873 (8th Cir. 2002) (citation omitted))); *Jones v. City of Monroe*, 341 F.3d 474, 476 (6th Cir. 2003) (applying an abuse of discretion standard and stating that “the district court’s determination will be disturbed only if the district court relied upon clearly erroneous findings of fact, improperly applied the governing law, or used an erroneous legal standard”); *Comm’r of the Dep’t. of Planning & Natural Res. v. Esso Standard, Oil S.A., Ltd. (In re Tutu Water Wells CERCLA Litigation)*, 326 F.3d 201, 207 (3d Cir. 2003) (“We will not upset the court’s judgment unless those parties demonstrate the court committed a material error of law or a ‘meaningful error in judgment.’” (quoting *United States v. Cannons Eng’g Corp.*, 899 F.2d 79, 84 (1st Cir. 1990))); *Amorgianos v. Nat’l R.R. Passenger Corp.*, 303 F.3d 256, 265 (2d Cir. 2002) (finding abuse of discretion means “manifestly erroneous” (quoting *McCulloch v. H.B. Fuller Co.*, 61 F.3d 1038, 1042 (2d Cir. 1995))); *Tower Ventures, Inc. v. City of Westfield*, 296 F.3d 43, 46 (1st Cir. 2002) (stating that “a disgruntled litigant bears a heavy burden in attempting to show that an abuse occurred”); *Tolve v. Comm’r*, 31 Fed. Appx. 73, 75 (3d Cir. 2002) (“[A] finding of an abuse of discretion is appropriate only ‘if no reasonable man would adopt the [tax] court’s view. If reasonable men could differ as to the

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The Tax Court has stated that, when reviewing discretionary administrative acts of the Service and using the abuse of discretion standard, agency decisions will not be disturbed unless the determination of the Service is unreasonable, arbitrary, or capricious.⁵¹ Whether the Commissioner has abused his discretion is a question of fact, and the petitioner's burden of proving abuse of discretion is greater than that of the usual preponderance of the evidence.⁵²

propriety of the action taken by the trial court, then it cannot be said that the trial court abused its discretion.” (quoting *Washington v. Philadelphia County Ct. C.P.*, 89 F.3d 1031, 1044 (3d Cir. 1996) (Aldisert, J., concurring and dissenting)); *United States v. Lindberg*, 220 F.3d 1120, 1124 (9th Cir. 2000) (“Under this standard, we will not reverse unless we have a firm conviction that the district court committed a clear error of judgment.”); *Barbour v. Merrill*, 48 F.3d 1270, 1278 (D.C. Cir. 1995) (stating that, in reviewing for an abuse of discretion, the court considers “whether the decision maker failed to consider a relevant factor, whether [the decision maker] relied on an improper factor, and whether the reasons given reasonably support the conclusion” (quoting *Kickapoo Tribe of Indians v. Babbitt*, 43 F.3d 1491, 1497 (D.C. Cir. 1995))); *Rasbury v. IRS (In re Rasbury)*, 24 F.3d 159, 168 (11th Cir. 1994) (asserting that the abuse of discretion standard allows “a range of choice for the district court, so long as that choice does not constitute a clear error of judgment” (quoting *United States v. Kelly*, 888 F.2d 732, 745 (11th Cir. 1989))); *United States v. Hilgefurd*, 7 F.3d 1340, 1345 (7th Cir. 1993) (“Abuse of discretion only occurs when no reasonable person could take the view of the trial court.”); *United States v. Smith*, No. 91-5291, 1992 U.S. App. LEXIS 14444, at *7 (4th Cir. June 19, 1992) (finding that under the abuse of discretion standard, “our inquiry is limited to ‘whether any reasonable person could agree with the district court.’” (quoting *Graefenhain v. Pabst Brewing Co.*, 870 F.2d 1198, 1201 (7th Cir. 1989))); *United States v. Lussier*, 929 F.2d 25, 28 (1st Cir. 1991) (asserting that the district court abuses its broad discretion to grant or deny continuances only on “unreason[able] and arbitrary insistence upon expeditiousness in the face of a justifiable request for delay” (quoting *United States v. Torres*, 793 F.2d 436, 440 (1st Cir. 1986))); *DeFazio v. Sec’y of the Dep’t of Health & Human Servs.*, 40 Fed. Cl. 462, 466 (1998) (“An abuse of discretion may be found when (1) [the decision maker’s] decision is clearly unreasonable, arbitrary, or fanciful; (2) the decision is based on an erroneous conclusion of the law; (3) [the decision maker’s] findings are clearly erroneous; or (4) the record contains no evidence upon which the [decision maker] rationally could have based its decision.”) (quoting *Hendler v. United States*, 952 F.2d 1364, 1380 (Fed. Cir. 1991))).

⁵¹ *Jonson v. Comm’r*, 118 T.C. 106, 125 (2002); *Patton v. Comm’r*, 116 T.C. 206, 210 (2001); *Buzzetta Constr. Corp. v. Comm’r*, 92 T.C. 641, 648 (1989).

⁵² *Patton*, 116 T.C. at 210; *Buzzetta Constr. Corp.*, 92 T.C. at 648.

B. *The Abuse of Discretion Standard in Cases Involving Corporate Taxpayers*

1. *Code Section 446 Cases*

Most substantive rules found in the Code address either characterization—whether an item is taxable or non-taxable, capital or ordinary in nature, for example,⁵³—or timing—when an item is to be recognized.⁵⁴ Methods of accounting used by a taxpayer to determine the amount of taxable income deal with timing issues.⁵⁵ Code section 446

⁵³ Code sections that address characterization include the following: (1) I.R.C. § 104 (2000) (compensation for injuries or sickness); (2) I.R.C. § 108 (2000) (income from discharge of indebtedness); (3) I.R.C. § 355 (2000) (distribution of stock and securities of a controlled corporation); (4) I.R.C. § 501 (2000) (exemption from tax on corporations, certain trusts, etc); (5) I.R.C. § 721 (2000) (nonrecognition of gain or loss on contribution to partnership); (6) I.R.C. § 1001 (2000) (determination of gain or loss in property transactions); and (7) I.R.C. § 1221 (2000) (definition of a capital asset). Characterization issues are important in taxation as they determine such fundamental questions as whether an item is taxable at all, *see* I.R.C. § 501 (2000), or whether an item will be subject to a special reduced level of taxation, such as the lower capital gains rate, *see* I.R.C. § 1(h) (2000). The courts also have a hand in determining certain characterization issues. For example, it has been judicially determined that a taxpayer is entitled to the deduction for the loss on the sale of capital assets regardless of the motivation of the sale. *See* *Fulton Oil Co. v. Comm’r*, 81 F.2d 330, 331 (9th Cir. 1936). The United States Supreme Court has held that the term “capital asset” does not include accretions to value of capital assets themselves properly attributable to income. *United States v. Midland-Ross Corp.*, 381 U.S. 54, 57 (1965). Further, it has been found that income from a settlement of a claim acquired by a taxpayer as part of the acquisition of business is ordinary income rather than capital gain. *See* *Nahey v. Comm’r*, 196 F.3d 866, 870 (7th Cir. 1999).

⁵⁴ Code sections that address timing included the following: (1) I.R.C. § 167 (2000) (depreciation); (2) I.R.C. § 168 (2000) (start-up expenditures); (4) I.R.C. § 401 (2000) (qualified pension, profit sharing, and stock bonus plans); and (5) I.R.C. § 421 (describing the recognition timing of certain stock options). Timing issues determine when an item, depending on whether income or expense, should be recognized for tax purposes.

⁵⁵ *See* STEPHEN F. GERTZMAN, *FEDERAL TAX ACCOUNTING* ¶ 1.01 (2d ed. 1993) (stating that “[t]ax accounting addresses the question of timing”); Rev. Proc. 91-31, 1991-1 C.B. 566, 567 (“If the accounting practice does not permanently affect the taxpayer’s lifetime taxable income, but does or could change the tax year in which taxable income is reported, it involves timing and is therefore considered a method of accounting.”); *Bank One Corp. v. Comm’r*, 120 T.C. 174, 282 (2003) (interpreting the regulations to construe the reporting of income under code section 475 as a method of accounting when it involves the proper timing of income and expenses); *FPL Group, Inc. v. Comm’r*, 115 T.C. 554, 562 (2000) (“An accounting practice involving the timing of when an item is deducted is
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requires a taxpayer to determine taxable income under the same method of accounting that the taxpayer uses to compute income for financial reporting purposes.⁵⁶ However, the Code goes on to specify that “[i]f no method of accounting has been regularly used by the taxpayer, or if the method used does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Secretary, does clearly reflect income.”⁵⁷ The preceding “anti-abuse provision” has been interpreted as a broad grant of discretion to the Service, both to determine whether an accounting method used by a taxpayer clearly reflects income and, if the Service determines that it does not, to specify the appropriate accounting method.⁵⁸ Thus, Congress has expressly deferred to the Service, within the very language of the Code,

considered a method of accounting”); *Gen. Motors Corp. v. Comm’r*, 112 T.C. 270, 298 (1999) (offering an argument by the Commissioner that regulations, under which timing issues could arise, should be characterized as defining a method of accounting); *Tate & Lyle, Inc. v. Comm’r*, 103 T.C. 656, 668 (1994) (“The accrual and cash methods of accounting (and any combination thereof) are procedures and rules governing the timing of items of income and deductions.”), *rev’d*, 87 F.3d 99 (3d Cir. 1996).

⁵⁶ I.R.C. § 446(a) (2000). For financial accounting purposes, most businesses follow “generally accepted accounting principles,” commonly referred to as “GAAP.” GAAP consists of: (1) practices commonly found in business; (2) the requirements and views of stock exchanges; (3) the regulations and accounting opinions of the Securities and Exchange Commission; (4) authoritative oral or written opinions found in expert testimony, textbooks, and articles; (5) published opinions of the American Accounting Association and the American Institute of Certified Public Accountants; and (6) published guidance by the Financial Accounting Standards Board. JAMES D. COX, *FINANCIAL INFORMATION, ACCOUNTING, AND THE LAW: CASES AND MATERIALS* 6 n.2 (1980); *see also* FINANCIAL ACCOUNTING STANDARDS BOARD, *ACCOUNTING STANDARDS: CURRENT TEXT* (2004). Courts have more succinctly stated that GAAP consists of the official publications of the American Institute of Certified Public Accountants, including Accounting Principles Board opinions, Financial Accounting Standards Board Statements, and Accounting Research Bulletins, or, where there is no official pronouncement, the consensus of the accounting profession as manifested in other sources. *Providence Hosp. v. Shalala*, 52 F.3d 213, 218 n.7 (9th Cir. 1995); *Spokane Valley Gen. Hosp., Inc. v. United States*, 688 F.2d 771, 776 n.4 (U.S. Ct. Cl. 1982) (citing J. BURTON ET AL., *HANDBOOK OF ACCOUNTING AND AUDITING* 45-4-5 (1981)).

⁵⁷ I.R.C. § 446(b) (2000).

⁵⁸ Jennifer C. Root, *The Commissioner’s Clear Reflection of Income Power Under § 446(b) and the Abuse of Discretion Standard of Review: Where has the Rule of Law Gone, and Can We Get it Back?*, 15 AKRON TAX J. 69, 94 (2000); *see also* *Thor Power Tool Co. v. Comm’r*, 439 U.S. 522, 531-32 (1979).

great latitude in determining the appropriate accounting method to be used by taxpayers.⁵⁹

⁵⁹ See, e.g., *Thor Power Tool Co.*, 439 U.S. at 531-33. *Thor Power Tool Co.* revolved around the inventory accounting method used by an Illinois tool maker. *Id.* at 525, 530-31. The company manufactured more replacement parts for discontinued models than its estimate of demand so that it would avoid retooling costs in the event that demand exceeded the estimate. See *id.* at 525-26. Subsequently, the tool maker wrote down the excess inventory, taking a current deduction for the manufacturing cost of items remaining in its inventory. See *id.* at 526. There was no dispute that this practice conformed to GAAP. *Id.* at 530. However, the accounting method used was contrary to that prescribed by the regulations. *Id.* at 533-35 (interpreting Treas. Reg. § 1.471-2 to -4 (1964)). As such, the Supreme Court found the Service's disallowance of the standard GAAP method to be a proper exercise of its discretion, stating, "It is obvious that on [its face, section 446 and the] accompanying Regulations, vest the Commissioner with wide discretion in determining whether a particular method of inventory accounting should be disallowed as not clearly reflective of income." *Id.* at 532; see also *United States v. Catto*, 384 U.S. 102, 114 (1966) (stating that "[i]t is not province of the court to weigh and determine the relative merits of systems of accounting required" by the Service (quoting *Brown v. Helvering*, 291 U.S. 193, 204-05 (1934))); *Comm'r v. Hansen*, 360 U.S. 446, 467 (1959) (stating the Service "has broad powers in determining whether accounting methods used by a taxpayer clearly reflect income"); *Adams v. Comm'r*, 155 F.2d 246, 248 (3d Cir. 1946), *cert. granted*, 329 U.S. 695 (1946), *aff'd*, 331 U.S. 737 (1947) (finding that the court of appeals could not treat as a question of law a dispute over proper accounting procedure for income tax collection purposes); *Hygienic Prods. Co. v. Comm'r*, 111 F.2d 330, 331 (6th Cir. 1940) (declaring the Service "is empowered to make such corrections as are necessary to make the return accurately reflect income"). The expansiveness of the Service's discretion in Code section 446 cases, in light of the *Thor Power Tool* decision, has been amply discussed and critiqued. See, e.g., J.N. Bush et al., *IRS' Tough New Rules Under Thor Power: How They Work: What They Mean, How to Cope*, 52 J. TAX'N 194 (1980) (discussing problems and solutions in relation to accounting methods created by *Thor Power Tool Co.*, as well as subsequent Revenue Rulings and Procedures); Karl S. Coplan, Note, *Protecting the Public Fisc: Fighting Accrual Abuse with Section 446 Discretion*, 83 COLUM. L. REV. 378, 388-405 (1983); John H. Dasburg et al., *Inventory Valuation After Thor Power Tool: Analyzing the S. Ct. Decision and Its Impact*, 50 J. TAX'N 200, 202 (1979); Terry Lantry, Note, *Thor Power Tool Co. v. C.I.R. Further Erodes C.P.A.'s Defense of Observing Professional Standards*, 19 AM. BUS. L.J. 87 (1981) (arguing that after *Thor Power Tools Co.*, GAAP no longer necessarily controls what most clearly reflects income for tax purposes and thus the decision is an erosion of the defense of professional standards in the accounting profession); Joseph B. Mihalov, *Inventory Write-Downs and Thor Power Tool*, 57 TAXES 384, 386-87 (1979) (criticizing the *Thor Power Tool* decision and implying vast discretion of the Service in stating that the decision "should make it clear to all taxpayers that GAAP will never determine a taxpayer's taxable income if it means that the IRS has to wait a second longer for its tax"); Root, *supra* note 58, at 102-03; Gary Stadtmauer, Note, (continued)

One might, therefore, characterize Code section 446(b) as authorization for the Service to unilaterally prescribe the appropriate accounting methods for taxpayers, subject only to the most constrained form of judicial review. Cases in which the Tax Court finds an abuse of discretion in this context, however, are not difficult to find. For example, in *RACMP Enterprises v. Commissioner*,⁶⁰ the taxpayer was a contractor that used concrete, sand, drain rock, and various hardware items delivered to its various work sites to install building foundations, driveways, and sidewalks.⁶¹ RACMP Enterprises used the so-called “cash method” of accounting and reported payments that it actually received from developers during the taxable year as income and took a deduction for the cost of materials for which payments actually were made. It did not report, as payments, that it did not receive as income, nor did it deduct the cost of materials for which payment had not been made during the taxable year.⁶² The Service’s objection to this method of accounting was founded on Code section 471, which grants the Service the authority to determine when “inventory” accounting should be used by a taxpayer.⁶³

Generally Accepted Accounting Principles as a Reflection of Income: Thor Power Tool Company v. Commissioner of Internal Revenue, 9 CAP. U.L. REV. 775 (1980) (stating that “[i]n determining which method clearly reflects taxable income the Commissioner can ignore basic tenants of financial accounting and employ arbitrary and unreasonable standards for detecting taxpayer manipulation of inventory write-down methods”); William R. Sutherland, *Tax Treatment of Inventory Write-Downs after Thor Power Tool*, 29 TUL. TAX INST. 9 (1980); Rowland J. Young, *Supreme Court Report*, 65 A.B.A. J. 448, 462 (1979).

⁶⁰ 114 T.C. 211 (2000).

⁶¹ *See id.* at 212.

⁶² *Id.* at 217-18.

⁶³ I.R.C. § 471(a) (2000). This Code section provides,

Whenever in the opinion of the Secretary the use of inventories is necessary in order clearly to determine the income of any taxpayer, inventories shall be taken by such taxpayer on such basis as the Secretary may prescribe as conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting the income.

Id. With inventory accounting, deduction of cost of goods is made only when the goods are sold, not necessarily in the year of acquisition, and the cost incurred in purchasing or producing the inventory must be accounted for using the accrual method, not on a cash basis. GERTZMAN, *supra* note 55, at ¶ 6.01. In *RACMP*, the taxpayer reported \$64,806 of taxable income using the cash method, whereas under the accrual method of accounting its taxable income would have been \$267,428. *RACMP Enters., Inc.*, 114 T.C. at 217-18.

Rather than deferring to the Service's determination, the court chose to investigate the legislative history of the predecessor of Code section 471 to determine the underlying legislative policy rationale.⁶⁴ In formulating a rule applicable to the case at hand, the court relied on distinctions between sellers of inventory and providers of services. These distinctions were made in the context of the Uniform Commercial Code, the Uniform Sales Act, the statute of frauds, and the Robinson-Patman Antidiscrimination Act.⁶⁵ The court concluded that "the essence of petitioner's typical contract with its clients was for the provision of services, not for the sale of personal property,"⁶⁶ and therefore the Service's determination that the taxpayer's method of accounting did not produce a clear reflection of income was an abuse of discretion.⁶⁷ The court's resort to legislative history, analogy to non-tax areas of law, and detailed analysis of the taxpayer's business practices is more consistent with a *de novo* standard of review⁶⁸ than with a deferential standard, as Judge Gerber pointed in dissent.⁶⁹

⁶⁴ *RACMP Enters., Inc.*, 114 T.C. at 222 n.5.

⁶⁵ *Id.* at 222-23. The court's emphasis on non-tax law is arguably misplaced, as each of the legal areas referred to have purposes clearly distinct from, and unrelated to, the purpose of Code section 446.

⁶⁶ *Id.* at 224.

⁶⁷ *Id.* at 234. It should be noted that Judges Marvel, Cohen, Ruwe, Halpern, Thornton, and Gerber dissented, the latter commenting,

The majority's limited focus represents only a portion of the standard to be considered in order to decide this issue. Petitioner's burden (heavier than normal) is to show that respondent's determination is in error; i.e., that respondent abused his discretion by determining that petitioner's method does not clearly reflect income. Petitioner cannot carry that burden by the simple expedient of contending that the materials it uses to produce finished sidewalks, driveways, and foundations should be labeled as supplies consumed. It must also show that its method of accounting clearly reflected income and that respondent's determination was clearly unlawful or plainly arbitrary. Based on the facts of this case, petitioner has failed to carry its burden.

Id. at 236 (Gerber, J., dissenting). Judge Halpern also authored a dissenting opinion, but his disagreement with the majority was focused more on the majority's analysis of the facts than its level of deference. *Id.* at 252-59 (Halpern, J., dissenting).

⁶⁸ The term *de novo* literally means "anew" or "afresh." BLACK'S LAW DICTIONARY 435 (6th ed. 1990). When a court reviews the rulings or decision of a trial court *de novo*, it generally gives little or no deference to the trial judge. It has been said that *de novo* review requires "an independent determination of a controversy that accords *no deference* to any prior resolution of the same controversy." *United States v. Raddatz*, 447 U.S. 667, 690

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The Service is not compelled to honor a taxpayer's accounting method simply because it is within the permissible bounds of generally accepted accounting principles.⁷⁰ Sometimes the goals of financial and tax accounting are at odds.⁷¹ For example, tax accounting generally requires that payments received for services to be performed in the future must be included in gross income in the taxable year of receipt.⁷² However, the

(1980) (Stewart, J., dissenting) (emphasis added). Thus, de novo review might be viewed as the opposite of the abuse of discretion standard. *Allegra*, *supra* note 44, at 470-71 (“[A]t the polar opposite of de novo review, we reencounter the abuse of discretion standard.”); *see also* *Bose Corp. v. Consumers Union of United States, Inc.*, 466 U.S. 485, 501 (1984) (“The difference between the two rules, however, is much more than a mere matter of degree.”); *Chandler v. City of Dallas*, 958 F.2d 85, 89 (5th Cir. 1992) (“[W]e are not constrained by the deferential standard of reviewing only for clear error.”); *Dunn v. Phoenix Newspapers, Inc.*, 735 F.2d 1184, 1186 (9th Cir. 1984); 5 JACOB A. STEIN ET AL., *ADMINISTRATIVE LAW* § 51.01[2], at 51-44 (1992 ed. Supp. 1991) (“Considered comparatively, the standard for de novo review affords a court the broadest scope of review.”).

⁶⁹ *RACMP Enters., Inc.*, 114 T.C. at 251-52 (Gerber, J., dissenting).

⁷⁰ *Comm’r v. Idaho Power Co.*, 418 U.S. 1, 15 (1974) (“[M]erely because the method of accounting a taxpayer employs is in accordance with generally accepted accounting procedures, this ‘is not to hold that for income tax purposes it so clearly reflects income as to be binding on the Treasury.’” (quoting *Am. Auto. Ass’n v. United States*, 367 U.S. 687, 693 (1961))).

⁷¹ The Court has long recognized that financial accounting and income tax accounting methods have different objectives. *See Thor Power Tool Co. v. Comm’r*, 439 U.S. 522, 542-43 (1979). In *Thor Power Tool Co.*, the court stated,

The primary goal of financial accounting is to provide useful information to management, shareholders, creditors, and others properly interested; the major responsibility of the accountant is to protect these parties from being misled. The primary goal of the income tax system, in contrast, is the equitable collection of revenue; the major responsibility of the Internal Revenue Service is to protect the public fisc. . . . Given this diversity, even contrariety, of objectives, any presumptive equivalency between tax and financial accounting would be unacceptable.

Id.

⁷² *See* Treas. Reg. § 1.446-1(c)(1)(i) (as amended in 2004). Although the regulations specify that, generally, income and expenses are included or deducted in the year of actual receipt or payment, *id.*, there are several exceptions that apply to cash basis taxpayers. For example, farming operations must be accounted for on the accrual basis. I.R.C. § 447(a) (2000). The accrual basis is also mandated for interest on certain deferred

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matching principle of financial accounting may compel postponement of recognition to the year in which the services are actually performed.⁷³

The Service issued a Revenue Procedure in 1971 in order to reconcile the tax and financial accounting treatment of such payments so as to facilitate reporting and verification, while at the same time avoiding extended deferral of gross income recognition.⁷⁴ That guidance provides that “[a]n accrual method taxpayer who receives a payment for services to be performed . . . in the future and who includes such payment in gross income in the year of receipt is using a proper method of accounting.”⁷⁵ It goes on to provide that

[a]n accrual method taxpayer who, pursuant to an agreement (written or otherwise), receives a payment in one taxable year for services, where all of the services under such agreement are required by the agreement as it exists at the end of the taxable year of receipt to be performed by him before the end of the next succeeding taxable year, may include such payment in gross income as earned through the performance of the services.”⁷⁶

In 1980, a credit card issuing, Florida bank, began “to charge each cardholder an annual membership fee (sometimes referred to simply as annual fee) of \$15, irrespective of the cardholder’s credit line, usage, or account balance, if any, carried over from month to month.”⁷⁷ The annual fee was refundable to the cardholder if the cardholder cancelled the card for any reason.⁷⁸ The refund was a prorated amount of the annual fee, based on the number of months remaining in the 12-month period for which the annual fee was charged.⁷⁹ For both financial accounting and tax reporting purposes, the bank ratably allocated its annual fees over 12 months.⁸⁰ The Service determined that the annual credit card fees did not

payments, I.R.C. § 467(a) (2000), as well as for the recognition of original issue discounts, I.R.C. §§ 1271-1274 (2000).

⁷³ The matching principle means that for financial accounting purposes, expenses should be recognized in the same accounting period in which the income they were intended to generate is recognized. FINANCIAL ACCOUNTING STANDARDS BOARD, FINANCIAL ACCOUNTING FOUNDATION, STATEMENT OF FINANCIAL ACCOUNTING CONCEPTS NO. 6: ELEMENTS OF FINANCIAL STATEMENTS 50-52 (1985).

⁷⁴ Rev. Proc. 71-21, 1971-2 C.B. 549.

⁷⁵ *Id.*

⁷⁶ *Id.*

⁷⁷ *Barnett Banks v. Comm’r*, 106 T.C. 103, 107 (1996)

⁷⁸ *Id.*

⁷⁹ *Id.*

⁸⁰ *Id.* at 109.

represent a payment for services under the cardholder agreement, and thus the exception to immediate recognition permitted by Revenue Procedure 71-21 did not apply.⁸¹ Although the court acknowledged that this was a factual issue, it declined to defer to the Service's judgment and reversed the government's determination.⁸²

In another case decided the same year, the Service determined that deposits made by residents to a continuing care retirement community should be characterized as advance payments for services.⁸³ The Tax Court again declined to defer to the Service's judgment, preferring instead to base its decision on the court's independent review and evaluation of the facts.⁸⁴ In *Hamilton Industries, Inc. v. Commissioner*,⁸⁵ the Service determined that a corporate taxpayer's method of accounting for its inventory, under the dollar value LIFO method, did not result in a clear reflection of income because inventory purchased in two corporate acquisitions should not have been included in the same pool or item categories as inventory manufactured after the acquisition.⁸⁶ The Tax Court decided that because its evaluation of the corporate taxpayer's accounting treatment was favorable, the Service should be found to have abused its discretion by requiring a change in accounting method.⁸⁷

⁸¹ *Id.* at 113.

⁸² *Id.*

⁸³ *Highland Farms, Inc. v. Comm'r*, 106 T.C. 237, 238, 250 (1996).

⁸⁴ *See id.* at 252.

⁸⁵ 97 T.C. 120 (1991).

⁸⁶ *Id.* at 132.

⁸⁷ *See id.* at 134-35. As in the other cases discussed *supra*, the Tax Court engaged in a somewhat detailed analysis of the facts:

[P]etitioner acquired all of the inventory, comprising raw materials, work-in-process, and finished products, of its targets as part of the acquisition of the assets of such businesses. The character and class of the purchased inventory was the same as that subsequently manufactured by petitioner. Petitioner continued old Mayline's and Two Rivers' businesses, and the acquisition of the finished inventory, which was an integral part of the ongoing operations of such businesses, was essential to such continuation. The isolated purchases of inventory occurring as part of larger business acquisitions did not render petitioner the type of "dual-function entity" that the taxpayer in *Amity Leather Products* was rendered. Petitioner therefore should not be subjected to the separate pooling requirement of the regulations. Accordingly, we hold that requiring separate pools would distort income, and that use of a single pool "serves the overriding purpose of the LIFO regulations, which is to match current costs against current

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In a case involving accounting for revenue by a group of regulated public utility companies, the Tax Court again refused to defer to the Service.⁸⁸ The taxpayers in that case billed customers monthly or bimonthly, depending on the class of service and related meter reading and billing cycle.⁸⁹ The companies did not read all customer meters on the last day of each month; rather, they assigned a certain bimonthly date to each customer for meter reading purposes and estimated the meter reading for interim months.⁹⁰ “The assigned date on which a customer’s meter was read, or was estimated for interim months, where applicable, is referred to herein as the ‘cycle meter reading date.’”⁹¹ The utility companies

deducted for Federal income tax purposes the cost of producing and delivering gas and electricity delivered after the last meter reading date in the year through the end of the year, but did not deduct the cost of meter reading and billing for such gas and electricity as these activities had not been performed by the end of the year. In contrast with the method of accounting used for Federal income tax purposes, [the taxpayers] recorded estimated unbilled revenue at the end of each year for . . . financial accounting purposes⁹²

The methods of accounting used for tax purposes and financial reporting were both generally accepted practices employed in the utility industry for financial accounting purposes.⁹³ “[T]he majority of major public utilities [however,] did not . . . accrue as revenue gas or electricity delivered to the customer subsequent to the last cycle meter reading of the year.”⁹⁴

The Service conceded that

if [the taxpayers] had also employed the cycle meter reading method of accounting for . . . financial accounting purposes, [it] would have accepted that method of accounting as clearly reflecting [the companies’] income for Federal income tax purposes and would not have

income.” Consequently, we find that respondent abused his discretion and hold for petitioner on the inventory “pooling” issue.

Id. (citations omitted).

⁸⁸ Orange & Rockland Utils., Inc. v. Comm’r, 86 T.C. 199, 201, 215 (1986).

⁸⁹ See *id.* at 201.

⁹⁰ *Id.* at 202.

⁹¹ *Id.*

⁹² *Id.* at 203.

⁹³ *Id.* at 205.

⁹⁴ *Id.*

required [a] change [in] their method of accounting to one that would require the accrual as income of gas and electricity delivered to customers subsequent to the last cycle meter reading of the year.⁹⁵

However, the Service argued that where such conformity between financial and tax accounting is absent, the cycle meter reading method fails to clearly reflect income.⁹⁶ Furthermore, the Service posited that the cycle meter reading method of accounting is a hybrid method of accounting that is not specifically permitted under code section 446(c).⁹⁷ Specifically, the Service advanced the theory “that the cycle meter reading method of accounting [represented] a variation . . . of an accrual method of

⁹⁵ *Id.* at 205, 206.

⁹⁶ *Id.* at 206 (relying on Rev. Rul. 72-114, 1972-1 C.B. 124).

⁹⁷ *See id.* at 208. The Code section relied upon by the Service provides that “a taxpayer may compute taxable income under any of the following methods of accounting: (1) the cash receipts and disbursements method; (2) an accrual method; (3) any other method permitted by this chapter; or (4) any combination of the foregoing methods permitted under regulations prescribed by the Secretary,” subject to the Service’s discretion to determine which method clearly reflects income. I.R.C. § 446(c) (2000). The regulations provide that “[g]enerally, under an accrual method, income is to be included for the taxable year when all the events have occurred that fix the right to receive the income and the amount [thereof] can be determined with reasonable accuracy.” Treas. Reg. §1.446(c)(1)(ii) (A) (as amended in 2004). The Service argued that

(1) [The taxpayers’] unbilled revenue [was] currently accruable under the all events test within the meaning of [Treas. Reg. §1.446-1(c)(1)(ii)]; (2) Because [the taxpayers] [did] not accrue unbilled revenue for tax purposes, the cycle meter reading method [was] not a specifically permitted method of accounting described in the Internal Revenue Code and regulations thereunder; (3) [The Service] may authorize the use of a method of accounting not otherwise described in the Internal Revenue Code and regulations thereunder if, in the opinion of the Commissioner, such method clearly reflects income; . . . (4) The imposition of a condition of conformity between tax and financial accounting [was] a proper exercise of [the Service’s] broad discretion within [Treas. Reg. §] 1.446-1(c)(2)(ii) . . . and [was] necessary to insure that the cycle meter reading method of accounting clearly reflects income; [and] (5) Since [the taxpayers] use[d] a method which accrues unbilled revenue for financial statement purposes and use[d] the cycle meter reading method for tax purposes, [their] method of accounting fail[ed] to clearly reflect income.

accounting within the meaning of Code section 446(c)(4) and that [the Service's] imposition of the conformity requirement, in order to insure the clear reflection of income, was a proper exercise of [its] authority under [the regulations].⁹⁸

Although the issue presented required application of technical accrual accounting principles and interpretation of the relevant regulations,⁹⁹ the court chose not to defer to the Service. Instead, it relied on its own independent analysis, stating that

all events which fixed [the utility companies'] right to receive unbilled December revenue had not occurred as of December 31 of each year in issue. Consequently, [the court held that] the cycle meter reading method of accounting was a permissible method of accrual accounting within the meaning of [the regulations], and [that the Service] abused [its] discretion by requiring [the taxpayers] to adopt a method of accounting other than the cycle meter reading method of accounting for tax purposes.¹⁰⁰

From the cases described above, it appears that the Tax Court's departure from deference is not confined to situations involving primarily findings of fact, nor to technical applications of accounting and regulatory principles.¹⁰¹ While there have been many cases where the court has

⁹⁸ *Id.* at 210.

⁹⁹ *Id.* The court noted,

The issue as to whether the cycle meter reading method of accounting is a permissible method of accounting must focus upon the determination as to whether such method is consistent with the regulations. . . . [T]he cycle meter reading method of accounting which operates to defer unbilled December revenue, will be a permissible method of accrual accounting within section 446(c)(2) if all events which fix petitioners' right to receive such unbilled revenue have not occurred as of December 31 of each year in issue or the amount thereof cannot be determined with reasonable accuracy.

Id.

¹⁰⁰ *Id.* at 215.

¹⁰¹ Other cases in which the Tax Court has refused to defer to the Service's determination under Code section 446 include the following: *Bank One Corp. v. Comm'r*, 120 T.C. 174, 183 (2003) (concluding that both the taxpayer's mark-to-market method of tax accounting for income from financial instrument swaps and the Service's accounting method failed to reflect the income clearly, and sending the case back to the parties for recomputation); *Brush Wellman, Inc. v. Comm'r*, 79 T.C. 160, 182 (1982) (finding the
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agreed with the Service's determination under its authority contained in Code section 446, even in those cases the court generally engages in a detailed analysis¹⁰² and does not simply defer to the administrative agency,

taxpayer's "practical capacity approach" provides a coherent approach to the full absorption regulations consistent with prior judicial interpretation, therefore the Service abused its discretion); *Peninsula Steel Prods. & Equip. Co. v. Comm'r*, 78 T.C. 1029, 1058 (1982); *Sol C. Siegel Prods., Inc. v. Comm'r*, 46 T.C. 15, 25 (1966) (concluding that the service failed to show that the taxpayer's accounting method did not clearly reflect income); *Vandra Bros. Constr. Co. v. Comm'r*, 80 T.C.M. (CCH) 125, 128 (2000) (concluding that the Service abused its discretion by requiring government contractor to change from the cash method of accounting); *Gen. Dynamics Corp. v. Comm'r*, 74 T.C.M. (CCH) 632, 651 (1997) (concluding that the Service's decision to sever a defense contractor's contract into annual parts for accounting purposes was arbitrary and capricious); *Galedrige Constr. v. Comm'r*, 73 T.C.M. (CCH) 2838, 2846 (1997) (holding that the Service's determination that taxpayer's use of the cash method of accounting did not produce a clear reflection of income was an abuse of discretion); *Kroger Co. v. Comm'r*, 73 T.C.M. (CCH) 1637, 1650 (1997) (concluding that the Service abused its "discretion in determining that [a] retailer's shrinkage method [did] not clearly reflect income because the retailers' shrinkage method more clearly reflect[ed] income when compared to [the Service's] method based on an allocation of cross-year inventory shrinkage losses as a function of time"); *Hosp. Corp. of Am. v. Comm'r*, 71 T.C.M. (CCH) 2319, 2335-37 (1996) (concluding that the Service abused its discretion by requiring a hospital to use the accrual method of accounting); *Honeywell, Inc. v. Comm'r*, 64 T.C.M. (CCH) 437, 449 (1992) (concluding that it was an abuse of discretion within the meaning of section 446 for the Service to require taxpayer to treat as inventory its pool of rotatable parts).

¹⁰² See, e.g., *Exxon Mobil Corp. v. Comm'r*, 114 T.C. 293 (2000) (holding that the taxpayer failed to satisfy the all-events test of expense accrual); *USFreightways Corp. v. Comm'r*, 113 T.C. 329 (1999) (finding that taxpayer utilizing the accrual method was not entitled to deduct costs benefiting future tax periods in the year of payment), *rev'd and remanded*, 270 F.3d 1137 (7th Cir. 2001); *Mountain State Ford Truck Sales, Inc. v. Comm'r*, 112 T.C. 58 (1999) (agreeing with the Service that use of replacement cost, instead of actual cost, in valuing parts inventory under LIFO method did not clearly reflect its income); *Consol. Mfg. v. Comm'r*, 111 T.C. 1 (1998) (finding that the Service did not abuse its discretion in determining that an automobile parts remanufacturer's LIFO method did not clearly reflect its income), *aff'd in part, rev'd in part*, 249 F.3d 1231 (10th Cir. 2001); *Signet Banking Corp. v. Comm'r*, 106 T.C. 117 (1996) (holding, under facts similar to *Barnett Banks v. Comm'r*, 106 T.C. 103 (1996) (*see supra* text accompanying notes 78-83), that the Service did not abuse its discretion in requiring current recognition of income, the principle difference being that the fee was not refundable in *Signet Banking Corp.* as it was in *Barnett Banks*), *aff'd*, 118 F.3d 239 (4th Cir. 1997); *First Nat'l Bank v. Comm'r*, 88 T.C. 1069 (1987) (concluding that the Service's "disallowance of the [inventory] writedown does not constitute an abuse of discretion and is sustained accordingly."); *Rockwell Int'l Corp. v. Comm'r*, 77 T.C. 780, 832 (1981) (concluding that the Service's

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as one might expect from the legislature's seemingly sweeping delegation of authority.¹⁰³

2. Code Section 482 Cases

In contrast to the accounting provisions of Code section 446, Code section 482 empowers the Service to allocate income, deductions, and credits between two or more controlled entities when necessary to prevent tax evasion or to clearly reflect income.¹⁰⁴ Although not limited to reallocations of income by international corporations, the provision was enacted, in part, due to the recognition by Congress that corporations may

disallowance of an inventory writedown with respect to a defense subcontract should be upheld because the taxpayer failed to produce sufficient evidence to demonstrate that the value of the inventory was less than its actual cost), *aff'd*, 694 F.2d 60 (3d Cir. 1982); *Brooks-Massey Dodge, Inc. v. Comm'r*, 60 T.C. 884 (1973) (concluding that the auto dealer's method of accounting and valuation for discount holdbacks and used car inventory did not properly reflect income as determined by the Service); *All-Steel Equip., Inc. v. Comm'r*, 54 T.C. 1749 (1970) (finding that petitioner's valuation of its inventory under the prime cost method did not clearly reflect its income), *aff'd in part, rev'd in part*, 467 F.2d 1184 (7th Cir. 1972), *acq. in result in part*, 1978-2 C.B. 1, and *nonacq. in part*, 1978-2 C.B. 3; *Photo-Sonics, Inc. v. Comm'r*, 42 T.C. 926 (1964) (sustaining the Service's determination that a taxpayer's inventory valuation did not conform to accepted accounting standards for a manufacturing concern); *Sunoco, Inc. v. Comm'r*, 87 T.C.M. (CCH) 937 (2004) (agreeing with Service's characterization of accounting method change); *Nemetschek N. Am., Inc. v. Comm'r*, 82 T.C.M. (CCH) 827 (2001) (sustaining the Service's accounting method change); *Cross Oil Co. v. Comm'r*, 81 T.C.M. (CCH) 1682 (2001) (concluding that the Service did not abuse its discretion by requiring taxpayer to change from the cash method of accounting to the accrual method).

¹⁰³ See sources cited *supra* note 59.

¹⁰⁴ I.R.C. § 482 (2000). This provision states,

In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses. In the case of any transfer (or license) of intangible property (within the meaning of section 936(h)(3)(B)), the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible.

Id.

easily shift their income among various countries in order to achieve favorable tax results.¹⁰⁵ Like Code section 446, Code section 482 grants the Service broad discretion.¹⁰⁶

In early cases involving what is now Code section 482, the Tax Court and its predecessor readily deferred to the Service.¹⁰⁷ By the 1980's, however, a discernable trend in the opposite direction had developed.¹⁰⁸

¹⁰⁵ The main objective of section 482 is to “place a controlled taxpayer on a tax parity with an uncontrolled taxpayer, by determining, according to the standard of an uncontrolled taxpayer, the true taxable income from the property and business of a controlled taxpayer.” *Comm’r v. First Sec. Bank of Utah*, 405 U.S. 394, 400 (1972) (quoting *Treas. Reg. § 1.482-1(b)(1)* (1971) with approval) (currently, similar language of the regulation can be found at *Treas. Reg. § 1.482-1(a)(1)* (as amended in 2003)); *see also E.I. Du Pont de Nemours & Co. v. United States*, 608 F.2d 445, 449-50 (1979); *Allegra*, *supra* note 44, at 428.

¹⁰⁶ *E.g.*, *Altama Delta Corp. v. Comm’r*, 104 T.C. 424, 457 (1995) (“The Commissioner also has broad discretion in her application of section 482, and her determination will be upheld unless the taxpayer shows it to be arbitrary, capricious, or unreasonable.” (citing *Seagate Tech., Inc. v. Comm’r*, 102 T.C. 149, 164 (1994), *acq. in result*, 1995-2 C.B. 1, 5; *Sundstrand Corp. v. Comm’r*, 96 T.C. 226, 353 (1991); *Paccar, Inc. v. Comm’r*, 85 T.C. 754, 787 (1985), *aff’d*, 849 F.2d 393 (9th Cir. 1988), *acq.*, 1987-2 C.B. 1); *Dolese v. Comm’r*, 82 T.C. 830, 838 (1984) (“Section 482 grants the Commissioner broad discretion to scrutinize closely transactions between mutually controlled taxpayers and, to allocate items of income, deductions, and credits where necessary to prevent the evasion of taxes or to ensure the clear reflection of each taxpayer’s income.” (citing *Spicer Theatre, Inc. v. Comm’r*, 346 F.2d 704, 706 (6th Cir. 1965), *acq.*, 1966-2 C.B. 4, *and acq.*, 1966-2 C.B. 7; *Ballentine Motor Co. v. Comm’r*, 321 F.2d 796, 800 (4th Cir. 1963); *Foster v. Comm’r*, 80 T.C. 34, 142-43 (1983), *aff’d and vacated in part by* 756 F.2d 1430 (9th Cir. 1985))), *aff’d*, 811 F.2d 543 (10th Cir. 1987).

¹⁰⁷ *See Boyer v. Comm’r*, 58 T.C. 316, 327-28 (1972) (“Here it is clearly evident that the Commissioner did not abuse his discretionary authority when we consider his determination in light of the factors upon which he based the allocation.”); *Welworth Realty Co. v. Comm’r*, 40 B.T.A. 97, 101 (1939) (concluding that the record failed to establish that the Services’ determination was arbitrary), *acq.*, 1939-2 C.B. 39; *Asiatic Petroleum Co. v. Comm’r*, 31 B.T.A. 1152, 1157-58 (1935) (finding no abuse of discretion for the allocation of income as the Commissioner found necessary), *aff’d*, 79 F.2d 234 (2d Cir. 1935). For further discussion, see Michael Abrutyn, *The Quest for Comparables in Section 482 Cases*, 2 INT’L TAX J. 318, 320-22 (1976), and the cases cited therein.

¹⁰⁸ *See Allegra*, *supra* note 44, at 433 (commenting that “[i]ndeed, during the last decade or so the courts have rejected, in whole or in large part, the Commissioner’s section 482 determinations in each of the major cases decided”). In decisions involving Code section 482, as applied in cases of corporate tax avoidance through “transfer pricing,” the Tax Court became less deferential to IRS determinations in the 1980s. *Id.* at 433 & nn.25-26. In early cases, the courts construed the Code’s language, which authorizes the

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Commissioner to make adjustments “if he determines . . . necessary,” as giving the Commissioner broad discretion. *Id.* at 440 & n.47 (citing *Asiatic Petroleum Co.*, 31 B.T.A. at 1157; *Remco S.S. Co. v. Comm’r*, 30 B.T.A. 579, 582-83 (1934), *aff’d*, 82 F.2d 988 (9th Cir. 1936), *acq.*, 1934-2 C.B. 4, and *acq.*, 1934-2 C.B. 15; *Crossett W. Co. v. Comm’r*, 73 F.2d 307, 308 (3d Cir. 1934); *Nowland Realty Co. v. Comm’r*, 47 F.2d 1018, 1021 (7th Cir. 1931)). Since the 1980s, “the courts have rejected, in whole or in large part, the Commissioner’s section 482 determinations in each of the major cases decided.” *Id.* at 433. Congress enacted section 482’s predecessor, section 45 of the Revenue Act of 1928, to empower the Commissioner “to ‘prevent evasion (by the shifting of profits, the making of fictitious sales, and other methods frequently adopted for the purpose of ‘milking’), and in order clearly to reflect their true tax liability’” *Id.* at 438. The statute’s legislative history affirms the view that “Congress intended to confer broad discretion on the Commissioner.” *Id.* at 441. Shortly after it was enacted, the statute was attacked as delegating too much discretion to the Commissioner. Congress rejected demands to eliminate or constrain the Commissioner’s discretion in 1934, 1948, and 1951. *Id.* In 1954, Congress incorporated section 482 without substantial change from section 45 into the Internal Revenue Code. *Id.* at 442 & n.53. In 1955 and 1962, Congress rejected amendments to section 482 aimed at stemming particular abuses on grounds that the statute already provided the Secretary of the Treasury ample authority to deal with such abuses. *Id.* at 443. Currently, to ensure that the United States tax base is not arbitrarily depleted, section 482 allows the Commissioner “to allocate income, deductions, and credits between two or more controlled entities when necessary to prevent tax evasion or clearly reflect income.” *Id.* at 429. A passage from *Grenada Industries, Inc. v. Commissioner* characterizes the court’s early view of the Commissioner’s discretion:

It has been said many times that the Commissioner has considerable discretion in applying section 45, and that the determinations required of him under the statute must be sustained unless that discretion has been abused. Our review of those determinations is not *de novo*, and we may reverse them only where the taxpayer proves that they are unreasonable, arbitrary, or capricious.

17 T.C. 231, 255 (1951), *aff’d*, 202 F.2d 873 (5th Cir. 1953), *acq. in part*, 1952-2 C.B. 2 and *acq.*, 1972-2 C.B. 2. In 1968, in response to a Senate Finance Committee directive, the Treasury promulgated regulations “for the allocation of income and deductions in cases involving foreign income.” Allegra, *supra* note 44, at 447 (quoting H.R. CONF. REP. NO. 87-2508, at 3739 (1962)). The Treasury regulations continued to envision that “the Commissioner would retain substantial discretion” in decision-making. *Id.* at 449. The regulations directed that allocation “sh[ould] be determined with reference to the substance of the particular transactions” involved and should result in any adjustment that was “appropriate under the circumstances.” Treas. Reg. § 1.482-1(d)(1) (1968). But “[t]he detailed nature of the 1968 . . . regulations . . . has undeniably functioned as a double-edged sword in that the courts have frequently wielded those regulations to invalidate the Commissioner’s determinations under the statute.” Allegra, *supra* note 44, at 453 & n.95.
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The situation had gotten so troubling that Congress felt compelled to accuse the federal courts, in general, of in not applying the abuse of discretion standard in these cases, but instead applying a standard of judicial review that gave “little deference to the Commissioner and permit[ed] the court[s] to effectively substitute its own judgment for that of the Commissioner.”¹⁰⁹ Although the failure of the federal courts, in general, to allow the expected deference to the Service in Code section 482 cases has been well documented by others,¹¹⁰ it would be useful to illustrate this trend with some examples.

In *Seagate Technology, Inc. v. Commissioner*,¹¹¹ the Tax Court was faced with several distinct transfer pricing issues arising out of reallocations made by the Service, pursuant to its authority under Code section 482, between the taxpayer and its foreign subsidiary.¹¹² Despite

The notion that “a trial court must conduct either a clearly erroneous review of the Commissioner’s determinations or, even less appropriately, a de novo review of the facts underlying that determination” took hold in decisions reviewing price transfers. *Id.* at 496. The “judicial accident” that first gave rise to this is traced to *Advance Machinery Exchange, Inc. v. Commissioner*. See *id.* at 494 (citing *Advance Mach. Exch. v. Comm’r*, 196 F.2d 1006 (2d Cir. 1952) (stating that the question of “[w]hether the Tax Court was correct in allocating income to the petitioner under § 45, I.R.C. is essentially one of fact and the decision below must be affirmed if supported by substantial evidence.” (quoting *Advance Mach. Exch.*, 196 F.2d at 1007-08 (emphasis added))). *Bausch & Lomb, Inc. v. Commissioner*, 92 T.C. 525 (1989), *aff’d*, 933 F.2d 1084 (2d Cir. 1991), exemplifies the current standard employed in reviewing Commissioner’s determinations in transfer pricing cases. Allegra, *supra* note 44, at 496-97, 500. In *Bausch & Lomb*, the Tax Court noted that “[w]hether [the Commissioner] has exceeded his discretion is a question of fact.” Allegra, *supra* note 44, at 497 (quoting *Bausch & Lomb*, 92 T.C. at 582).

¹⁰⁹ Allegra, *supra* note 44, at 434; James R. Mogle, *Intercompany Transfer Pricing in the 1990’s: Trading Old Lamps for New Ones*, 69 TAXES 961, 964 (1991) (“Despite this theoretical deference afforded the IRS, it is not at all clear that, in practice, recent cases have imposed such a heavy burden on taxpayers.”).

¹¹⁰ See generally Allegra, *supra* note 44, at 433-34 & nn. 25-26; see also James P. Fuller, *Section 482: Revisited Again*, 45 TAX L. REV. 421 (1990) (discussing the outcome of several cases involving section 482 and related issues); Michael Avramovich, Note, *Intercompany Transfer Pricing Regulations Under Internal Revenue Code Section 482: The Noose Tightens on Multinational Corporations*, 28 J. MARSHALL L. REV. 915, 945-56 (1995); Josh O. Ungerman, Comment, *The White Paper: The Stealth Bomber of the Section 482 Arsenal*, 42 S.W. L.J. 1107, 1114-18 (1989).

¹¹¹ 102 T.C. 149 (1994), *acq. in result*, 1995-2 C.B. 1.

¹¹² *Id.* at 156. In addition to deciding whether the Service’s reallocations of gross income under section 482 for the years in issue were arbitrary, capricious, or unreasonable, the court addressed the following issues:

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the deferential standard of that Code section and the complex factual analysis required,¹¹³ the Tax Court did not defer to a majority of the allocations of income and expense made by the Service,¹¹⁴ criticizing the

[1.] whether [the Service] should bear the burden of proof for any of the issues involved in the . . . case; [2.] whether petitioner Seagate Technology, Inc. (hereinafter referred to as Seagate Scotts Valley), paid Seagate Technology Singapore, Pte. Ltd. (Seagate Singapore), a wholly owned subsidiary of Seagate Scotts Valley, arm's-length prices for component parts; [3.] whether Seagate Scotts Valley paid Seagate Singapore arm's-length prices for completed disk drives; [4.] whether Seagate Singapore paid Seagate Scotts Valley arm's-length royalties for the use of certain intangibles; [5.] whether the royalty fee Seagate Singapore paid Seagate Scotts Valley for disk drives covered under a section 367 private letter ruling applie[d] to all such disk drives shipped to the United States, regardless of where title passed; [6.] whether the procurement services fees Seagate Singapore paid Seagate Scotts Valley were arm's length; [7.] whether the consideration Seagate Singapore paid Seagate Scotts Valley pursuant to a cost-sharing agreement was arm's length; and [8.] whether Seagate Scotts Valley [was] entitled to offsets for warranty payments Seagate Singapore paid to Seagate Scotts Valley.

Id.

¹¹³ The court's opinion is over 150 pages long, begins with a table of contents, and is segmented into ten different parts.

¹¹⁴ *Id.* at 164. (“[W]e conclude that respondent’s reallocations are arbitrary, capricious, and unreasonable.”). The Service determined that Seagate Scotts Valley transferred parts and components to Seagate Singapore for use in the assembly of disk drives at less than arms’s length prices. *Id.* at 165. In anticipation that it’s position might not be upheld, the Service included several alternative arguments on Form 4549-B, Income Tax Examination Changes, attached to the notice of deficiency. *Id.* For example, the Service stated,

In the alternative, should the above determination not be upheld, it is determined that . . . [Seagate Scotts Valley] performed services for, or on behalf of, Seagate Singapore in procuring, processing, storing, and transferring parts and components for, or on behalf of, Seagate Singapore. . . .

In the further alternative, should the above determinations not be upheld, it is determined under I.R.C. section 482 that an amount equal to the costs or deductions incurred during the 1986 fiscal year for the above services is allocated to . . . [Seagate Scotts Valley] from Seagate Singapore.

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computational methodology employed by the Service.¹¹⁵ In an evaluative posture reminiscent of *Bank One Corp. v. Commissioner*,¹¹⁶ the court rejected both the taxpayer's and the government's calculations.¹¹⁷ Rather

Id. (alteration in original). The Service further determined that the taxpayer failed to provide adequate substantiation for the following contentions:

(1) That patents, sales contracts and all of the other items of intangible property described in the undated document entitled "Property Transfer Agreement" were transferred to Seagate Singapore from . . . [Seagate Scotts Valley]. And further, if such intangible property was transferred, that it was transferred as of September 30, 1983, as alleged in the undated document entitled "Property Transfer Agreement";

(2) That the undated document entitled "Research and Development Cost-sharing Agreement" [was] bona fide under the standards of Treas. Regulation Section 1.482-2(d)(4). And further, if the Research and Development Cost-sharing Agreement [was] bona fide, that Seagate Singapore was granted the right to sell products either directly, or indirectly through . . . [Seagate Scotts Valley], into the geographic area allocated to . . . [Seagate Scotts Valley].

(3) That during the fiscal year 1986 Seagate Singapore should [have been] treated as having engaged in sales outside of the United States for purposes of the February 27, 1985 Section 367 Ruling or for purposes of analyzing functions, risks and intangibles under I.R.C. section 482; and

(4) That expenses relating to manufacturing, purchasing, quality assurance, warranty, general and administrative, research and development, marketing and sales were shared by . . . [Seagate Scotts Valley] and Seagate Singapore on an arm's-length basis.

Id. at 165-66 (some alteration in original). These allocations were "based upon an analysis of respective functions performed, intangibles used and developed, services performed and received and risks incurred. Further, as an independent basis for the determination, an analysis of comparative profit, expenses incurred and financial returns of both . . . [Seagate Scotts Valley] and Seagate Singapore was performed" by the Service. *Id.* at 166 (alteration in original).

¹¹⁵ See, e.g., *id.* at 225 (criticizing the Service for not following the resale price method described in the regulations).

¹¹⁶ 120 T.C. 174, 330-31 (2003) (rejecting both the Service's and the taxpayer's method of accounting for swaps of financial instruments).

¹¹⁷ See, e.g., *Seagate*, 102 T.C. at 195 (rejecting the methods used by both parties to complete reasonable transfer prices).

than remand for additional computations as in *Bank One Corp.*, however, Judge Wells chose instead to rely on his own analysis.¹¹⁸

In another case,¹¹⁹ National Semiconductor Corporation's United States manufacturing operations incurred substantial operating losses from sales to the company's Asian subsidiaries¹²⁰ while the Asian companies reported net profits.¹²¹ As it had done in *Seagate Technology*, the Tax Court found flaws in both the Service's determination and the taxpayer's position, holding that neither party had introduced satisfactory evidence of comparable selling prices to unaffiliated parties.¹²² As in the previously

¹¹⁸ *Id.* The court observed,

We have considered the other arguments raised by the parties and find them unpersuasive. . . . [W]e have concluded that petitioner and respondent have failed to establish reasonable transfer prices for the component parts Seagate Singapore sold to Seagate Scotts Valley under the CUP or cost-plus methodologies advanced by their experts. We further conclude that the record does not contain sufficient information from which we can derive a reasonable transfer price under the CUP, resale price, or cost-plus methods as described in section 1.482-2(e)(2), (3), and (4), Income Tax Regs. . . .

Unfortunately, the record does not provide sufficient evidence to establish an appropriate gross profit percentage under the method described in section 1.482-2(e)(4), Income Tax Regs. Consequently, we make our best estimate of the appropriate transfer prices for the component parts on the basis of the available record.

Id.

¹¹⁹ Nat'l Semiconductor Corp. v. Comm'r, 67 T.C.M. (CCH) 2849 (1994).

¹²⁰ *Id.* at 2858. "The Asian subsidiaries performed semiconductor packaging and associated activities at several plants in Malaysia, Singapore, Hong Kong, Thailand, Indonesia, and the Philippines." *Id.* at 2855.

¹²¹ *Id.* at 2858. The U.S. manufacturing enterprise's losses from its wafer fabrication activities ranged from \$27.1 million to \$295.2 million, and its

weighted average return on operating assets was negative 25.68 percent over the years in issue. Even including its distribution margins, under its transfer pricing system, [the taxpayer] reported, over the years in issue, income of only \$11.8 million for the components packaged by the Asian subsidiaries while the Asian subsidiaries reported, over the years in issue, income of \$182.8 million.

Id.

¹²² *Id.* at 2873-74.

described case, the court conducted its own evaluation using the expert financial and economic testimony introduced by the parties.¹²³

This pattern of Tax Court behavior, where the court rejects both parties' arguments and constructs its own solution, seems to occur with some frequency in Code section 482 cases.¹²⁴ The court itself has acknowledged this and offered an explanation, describing its predicament in Code section 482 cases as "to put it mildly, frustrating."¹²⁵ The court lamented that in the typical Code section 482 case, both the Service and the taxpayer spend most of the time at trial attacking the other party's allocation formula rather than establishing the soundness of its own formula.¹²⁶ In pursuing this path, Judge Tannenwald¹²⁷ observed,

[U]nduly long and unnecessarily complicated trial record[s] ha[ve] been created, replete with bickerings between counsel over unimportant and often irrelevant evidentiary questions and a continuance of the "play your cards close to the chest" attitude of petitioner's counsel and the lack of focus on the part of respondent's counsel exhibited during the discovery process.¹²⁸

In Judge Tannenwald's opinion, this appears to reflect a strategy of "telling the judge as little as possible" in Code section 482 cases.¹²⁹ The judge went on to describe the situation in the following terms:

¹²³ See *id.*

¹²⁴ In addition to the cases described above, see *American Terrazzo Strip Co. v. Commissioner*, 56 T.C. 961 (1971), *acq.*, 1973-2 C.B. 1, stating,

Since petitioner concedes that some reallocation of income is necessary and respondent's determinations in the notices of deficiency are manifestly wrong, the duty rests with the Court to find the arm's-length price for the standard strip and rods and to make any other reallocations that may be required clearly to reflect petitioner's income. In making these findings, we must use our best judgment in the light of all the evidence.

Id. at 973; see also *H Group Holding, Inc. v. Comm'r*, 78 T.C.M. (CCH) 533, 551-51 (1999) (explaining that to determine whether the tax commissioner's allocation was reasonable, the court must focus on the reasonableness of the result and could allocate income among commonly controlled corporations to attain parity with uncontrolled, unrelated taxpayers).

¹²⁵ *Perkin-Elmer Corp. v. Comm'r*, 66 T.C.M. (CCH) 634, 657 (1993).

¹²⁶ *Id.*

¹²⁷ *Id.* at 635.

¹²⁸ *Id.* at 657.

¹²⁹ *Id.*

Thus, in the final analysis, the Court is left to its own devices without the usual anchor of decision, namely that, if the taxpayer fails to carry its burden of proof, the deficiency is sustained. The Court must find a formula, without the benefit of sufficient help from the parties as to what that formula might be. In a section 482 case, this task usually requires the Court to find a middle ground

¹³⁰
.....

What seems to escape the Tax Court, as evidenced by these comments, is that the court is supposed to apply a deferential standard in these cases and that it should not feel compelled to find a formula on its own. Even Judge Tannenwald acknowledges the Tax Court's "inevitable lack of knowledge of the realities of the workings of a specific industry and of the business world generally, including particularly the international competitive atmosphere which those realities reflect."¹³¹

Contrary to the impression that one might gain from the foregoing cases, however, the Tax Court does not always engage in its own independent computations when declining to defer to the Service in Code section 482 cases. In *Ciba-Geigy Corp. v. Commissioner*,¹³² the Tax Court found that the taxpayer had satisfied its heavy burden of proving that the Service's reduction of the royalty paid to its parent company, in exchange for a licensing agreement to manufacture and sell patented herbicides, from ten percent to six percent constituted an abuse of discretion.¹³³ The Service argued that under the criteria then contained in the regulations,¹³⁴ "a rate of royalty in an amount less than the 10 percent claimed by [taxpayer] would have been arrived at in arm's-length negotiations between unrelated parties."¹³⁵ While not resorting to independent calculation of the proper royalty amount, the court made exhaustive findings of fact based upon a lengthy trial to determine the appropriate rate of royalty to be paid by the taxpayer to its Swiss parent under certain licensing agreements.¹³⁶

As might be expected where the court is to be deferential to the Service's findings, the Service unwisely anticipated that the court would apply a rather generalized facts and circumstance approach to conclude

¹³⁰ *Id.*

¹³¹ *Perkin-Elmer Corp.*, 66 T.C.M. at 657.

¹³² 85 T.C. 172 (1985), *acq.*, 1987-2 C.B. 1.

¹³³ *Id.* at 175, 236-37.

¹³⁴ See Treas. Reg. § 1.482-2(d)(2) (1985).

¹³⁵ *Ciba-Geigy Corp.*, 85 T.C. at 220.

¹³⁶ *Id.* at 217.

that the Service did not abuse its discretion.¹³⁷ For example, the Service arrived at its proposed six percent royalty rate by analyzing the facts in light of industry averages.¹³⁸ To the contrary, the court pursued a precise analysis of the facts under the relevant part of Code section 482 regulations, concluding instead that a closer scrutiny of the facts made the Service's position unsupportable.¹³⁹

The Tax Court has also shown that even when it is basically in agreement with the Service with respect to reallocation under Code section 482, it is reluctant to grant total deference. In a case in which the Service sought to reallocate all of a foreign subsidiary's net income to its United States parent corporation,¹⁴⁰ the court characterized the government's position as an abuse of discretion,¹⁴¹ even though it ultimately held that a reallocation of three-fourths of the income was proper.¹⁴² In *Morrison v. Commissioner*,¹⁴³ the court refused to defer to the Service's reallocation, characterizing it as arbitrary and capricious, but then partially sustained the Service's position.¹⁴⁴

¹³⁷ See *id.* at 222.

¹³⁸ See *id.* at 223. In its brief, the Service referred to an "industry norm of about 5 percent." *Id.*

¹³⁹ *Id.* at 222.

¹⁴⁰ See *Hosp. Corp. of Am. v. Comm'r*, 81 T.C. 520, 575 (1983), *nonacq.*, 1987-2 C.B. 1.

¹⁴¹ *Id.* at 594-95.

¹⁴² *Id.* at 601. The court seemed hostile to the Service's contention that the foreign subsidiary was a "sham" corporation:

By allocating 100 percent of LTD's taxable income to petitioner, respondent has attempted in still another fashion to resurrect his argument that LTD is a "sham" corporation that should not be recognized for tax purposes. Respondent's argument under all of the theories that he has presented is that petitioner could as well have done the things that LTD did and therefore could have received all earnings from the King Faisal Hospital management contract. Since petitioner could have had these earnings, respondent would make it so by exercising his authority under section 482.

Id. at 595. The court goes on to say, however, that "[e]ven though we have rejected respondent's 100-percent allocation of taxable income from LTD to petitioner, the evidence indicates overwhelmingly that an allocation is necessary and proper in this case." *Id.* at 596. Ultimately, the court held that the Service only erred in its reallocation of twenty-five percent of the net income of the subsidiary. *Id.* at 602.

¹⁴³ 82 T.C.M. (P-H) 2719 (1982).

¹⁴⁴ *Id.* at 2731. The court stated as follows:

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In other cases, the court simply disagrees with the Service's approach. For example, in *Westreco, Inc. v. Commissioner*,¹⁴⁵ the court found that the Service's reallocation of income from a parent corporation to its subsidiary was arbitrary and capricious because it was based on the rate of return earned by a strictly statistical sample of comparable firms.¹⁴⁶

In its first taxable year ended April 30, 1974, a period which covered one month, the corporation paid no salary to Mr. Morrison. However, in its fiscal year 1975 the corporation paid Mr. Morrison \$2,000 more in salary and made \$1,750 more in pension plan contributions than it did in its following two fiscal years 1976 and 1977, thus sufficiently making up, in our view, for the fact that no salary was paid him for the corporation's first taxable year. Thus, we conclude that no reallocation in such year pursuant to section 482 would be in order. We thus find respondent's actions in reallocating the corporation's income in its fiscal years 1974, 1975 and 1976, to be arbitrary, capricious, and unreasonable. Such reallocations made by respondent constituted an abuse of his discretion and were improper.

Id. (citation omitted). The court, however, went on to observe:

The corporation's return for its fiscal year 1977 discloses \$112,913 of consulting service income and \$27,928 of taxable income. In our view, with this improvement in receipts and income, the parties, in an arm's length transaction, would have substantially increased the compensation of the officer responsible for the increase. We therefore sustain respondent's reallocation for the year 1977 to the extent of \$20,000. Reallocation in this amount is necessary in order that the compensation furnished Mr. Morrison reflects an arm's length amount. Since the corporation reports its income on a fiscal year basis and Mr. Morrison reports his income on a calendar year basis, it is necessary to divide this reallocation from the corporation between Mr. Morrison's calendar years 1976 and 1977. Respondent reallocated \$64,500 of the corporation's income for its fiscal year ended April 30, 1977, to Mr. Morrison. Of this amount, he allocated \$4,000 to Mr. Morrison's calendar year 1977 and the balance to his 1976 calendar year. We conclude that the \$4,000 allocation to 1977 is reasonable on the basis of the record and sustain this allocation by respondent.

Id.

¹⁴⁵ 1992 T.C.M. (RIA) 2875 (1992).

¹⁴⁶ *See id.* at 2892-94. The court noted,

[I]t is apparent by the admission of respondent's own experts, that petitioner is within an acceptable range when the measurement is made

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3. *Other Tax Court Abuse of Discretion Cases Involving Corporate Taxpayers*

Code section 845 gives the Secretary discretion to allocate, recharacterize, or adjust the reported income of a party to a reinsurance agreement when it is determined that the reinsurance contract results in an improper reflection of taxable income.¹⁴⁷ In cases under that Code section, the court is compelled to apply a deferential standard of review because the statutory text confers broad discretionary powers on the Commissioner, similar to the grant of discretion under Code section 482.¹⁴⁸ In *Trans City Life Insurance Co. v. Commissioner*, an insurance company assumed liability on insurance policies through a retrocession agreement with an unrelated party, Guardian Life.¹⁴⁹ The idea behind this agreement was to structure the transaction so that Trans City would be qualified as a life insurance company for tax purposes, thus availing itself of the benefits under Code section 806.¹⁵⁰ Based on its discretionary authority granted by

using publicly traded corporations which are presumably dealing at arm's length. We agree with this admission of respondent's experts and the conclusion of Dr. Chandler (petitioner's expert) that petitioner's fees from Nestec were comparable to fees between uncontrolled corporations. As a result, no recollection is warranted, and, thus, there is no deficiency in petitioner's Federal income tax.

Id. at 2896.

¹⁴⁷ I.R.C. § 845(a) (2000).

¹⁴⁸ *Trans City Life Ins. Co. v. Comm'r*, 106 T.C. 274, 303-04 (1996), *nonacq.*, 1998-1 I.R.B.5, *and nonacq.*, 1997-2C.B1.

¹⁴⁹ *Id.* at 283.

Reinsurance is an agreement between an initial insurer (the ceding company) and a second insurer (the reinsurer), under which the ceding company passes to the reinsurer some or all of the risks that the ceding company assumes through the direct underwriting of insurance policies. Generally, the ceding company and the reinsurer share profits from the reinsured policies, and the reinsurer agrees to reimburse the ceding company for some of the claims that the ceding company pays on those policies. A reinsurer may pass on (retrocede) its position on reinsurance to a third insurer. This type of agreement is called a retrocession agreement, and the third insurer is called a retrocessionaire.

Id. at 278-79; *see also* ROBERT H. JERRY, II, UNDERSTANDING INSURANCE LAW 898 (2d ed. 1996).

¹⁵⁰ *Trans City Life Ins. Co.*, 106 T.C. at 286, 298. In order to be considered a life insurance company, Trans City needed to be able to include the reserves associated with the
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the Code,¹⁵¹ the Service determined that the transaction between Guardian Life and Trans City Life had a significant tax avoidance effect because the risks transferred to Trans City Life were not commensurate with the tax benefits derived by Trans City Life.¹⁵²

Judge Laro¹⁵³ observed that this case involved “the complex and esoteric world of insurance law”¹⁵⁴ and that the task of the court was merely to determine if the Service had abused its discretion in finding a significant tax avoidance effect under the facts presented.¹⁵⁵ In doing so the court felt compelled to examine “volumes of filings, reams of trial testimony, boxes of exhibits, and assorted expert reports.”¹⁵⁶

C. *The Abuse of Discretion Standard in Cases Involving Individual Taxpayers*

1. *Tax Court Review of Collections Cases*

If the taxpayer fails to meet the Commissioner’s demand for payment of her tax liability, all property and rights to property of a taxpayer become subject to a lien in favor of the United States on the date a tax liability is assessed against the taxpayer.¹⁵⁷ If any person who is liable to pay any tax neglects or refuses to do so within ten days after notice and demand, the Service is authorized to collect such tax by levying upon property belonging to the taxpayer.¹⁵⁸ Before levying, however, the Service must give the taxpayer at least thirty days notice of their intent to levy. That

agreement in its life ratio. *Id.* at 286. If considered a life insurance company, Trans City would be eligible for the “small life insurance company deduction” of Code section 806, which the Service had identified as a tax avoidance technique under the facts of the case. *Id.* at 298.

¹⁵¹ See I.R.C. § 845 (2000). I.R.C. § 845(b) provides,

If the Secretary determines that any reinsurance contract has a significant tax avoidance effect on any party to such contract, the Secretary may make proper adjustments with respect to such party to eliminate such tax avoidance effect (including treating such contract with respect to such party as terminated on December 31 of each year and reinstated on January 1 of the next year).

Id. § 845(b).

¹⁵² *Trans City Life Ins. Co.*, 106 T.C. at 301.

¹⁵³ *Id.* at 275.

¹⁵⁴ *Id.* at 297.

¹⁵⁵ *Id.* at 298.

¹⁵⁶ *Id.*

¹⁵⁷ I.R.C. §§ 6321-6322 (2000).

¹⁵⁸ I.R.C. § 6331(a) (2000).

notice must describe the taxpayer's right to request administrative review regarding collection action.¹⁵⁹ If such a request is made within the thirty day period, the taxpayer will be granted a hearing with an Appeals Officer of the Service with regard to a levy notice.¹⁶⁰ Furthermore, until a Notice of Federal Tax Lien¹⁶¹ is filed, the lien is without validity and priority against certain persons such as judgment lien creditors of the taxpayer.¹⁶² After the Secretary files the Notice of Federal Tax Lien, the Service must provide the taxpayer with written notice of the filing, informing the taxpayer of her right to request an administrative hearing on the matter.¹⁶³ This hearing, whether pursuant to a Notice of Intent to Levy or a written notice that a Notice of Federal Tax Lien has been filed, is referred to as a "Collections Due Process Hearing."¹⁶⁴ At a Collections Due Process hearing, the taxpayer may raise certain matters set forth in section 6330(c)(2), including challenges to the appropriateness of the government's collection actions¹⁶⁵ and, if the taxpayer did not receive a statutory notice of deficiency or did not otherwise have an opportunity to dispute the tax liability, challenges to the underlying liability.¹⁶⁶ Most

¹⁵⁹ I.R.C. § 6330(a) (2000).

¹⁶⁰ I.R.C. § 6330(b)(1) (2000).

¹⁶¹ The Code imposes a lien on all of the taxpayer's assets upon demand and failure to pay. I.R.C. § 6321 (2000). That lien is not public, however, and is only known to the Service and the taxpayer until the Service files a Notice of Federal Tax Lien as provided in I.R.C. § 6323(a),(f) (2000).

¹⁶² I.R.C. § 6323(a)(2000); *see also* Richardson v. Comm'r, 85 T.C.M. (CCH) 1417, 1419 (2003).

¹⁶³ I.R.C. § 6320(a)(1), (3)(B) (2000). I.R.C. § 6320(c) requires that the administrative hearing be conducted pursuant to section 6330(c), (d), and (e). I.R.C. § 6320(c) (2000).

¹⁶⁴ In the Internal Revenue Service Restructuring and Reform Act of 1998 (RRA 1998), Pub. L. 105-206, 112 Stat. 685, 746-47 (1998), Congress enacted new sections 6320 (pertaining to liens) and 6330 (pertaining to levies) to provide due process protections for taxpayers in tax collection matters. *Id.* Although the Service routinely grants Appeals Office reviews of collection activity, the importance of qualifying a hearing as a Collections Due Process hearing is that the hearing officer's determination is then subject to judicial appeal. *See* I.R.C. § 6330(d) (2000).

¹⁶⁵ I.R.C. § 6330(c)(2)(A)(ii) (2000).

¹⁶⁶ I.R.C. § 6330(c)(2)(B) (2000). I.R.C. section (c)(2) provides.

(A) In general.

The person may raise at the hearing any relevant issue relating to the unpaid tax or proposed levy, including—

- (i) appropriate spousal defenses;
- (ii) challenges to the appropriateness of collection actions; and

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commonly, the taxpayer proposes a collection alternative, such as an offer-in-compromise¹⁶⁷ or installment agreement.¹⁶⁸ The reviewing officer must obtain verification that the requirements of any applicable law or administrative procedure have been met.¹⁶⁹ In making a determination, the officer must take into consideration verification, any issues raised by the taxpayer, and whether the proposed collection action balances the need for the efficient collection of taxes with the legitimate concern of the taxpayer that any collection action be no more intrusive than necessary.¹⁷⁰

(iii) offers of collection alternatives, which may include the posting of a bond, the substitution of other assets, an installment agreement, or an offer-in-compromise.

(B) Underlying liability.

The person may also raise at the hearing challenges to the existence or amount of the underlying tax liability for any tax period if the person did not receive any statutory notice of deficiency for such tax liability or did not otherwise have an opportunity to dispute such tax liability.

Id.

¹⁶⁷ The Code provides the Service with authority to compromise tax liabilities. I.R.C. § 7122(a) (2000). The traditional grounds for an offer-in-compromise had been doubt as to liability and doubt as to collectibility. Treas. Reg. § 301.7122-1(b)(1), (2) (as amended in 2002). The passage of the Internal Revenue Service Restructuring and Reform Act of 1998 (RRA 1998), Pub. L. 105-206, § 3462(a), 112 Stat. 685 (1998), which added section 7122(c) to the Code, resulted in the issuance of new regulations substantially changing offer-in-compromise procedures found in section 7122. Offers in compromise can now be considered for the “promotion of effective tax administration” if collection of the full liability will create economic hardship or exceptional circumstances exist such that collection of the full liability will be detrimental to voluntary compliance by taxpayers and compromise of the liability will not undermine compliance by taxpayers with tax laws. Treas. Reg. § 301.7122-1(b)(3) (as amended in 2002). The addition of this category allows factors such as advanced age and serious illness to be considered to determine if economic hardship existed. Internal Revenue Manual (CCH) § 5.8.11.2.1. In addition, the Service announced it would allow, in appropriate cases, a short-term payment option that gives taxpayers up to two years to pay the entire amount offered. Internal Revenue Manual (CCH) § 5.8.1.3.5 (superseded by Internal Revenue Manual (CCH) § 5.8.1.9.4 (2004)).

¹⁶⁸ The Service is authorized to enter into written agreements with taxpayers under which the taxpayer is allowed to satisfy the tax liability in installment payments. I.R.C. § 6159(a) (2000).

¹⁶⁹ I.R.C. § 6330(c)(1) (2000).

¹⁷⁰ *Id.* § 6330(c)(3). One of the rare cases in which the last requirement (balancing the need for the efficient collection of taxes with the legitimate concern that collection activity be no more intrusive than necessary) was specifically addressed was *Londono v. Commissioner*, 85 T.C.M. (CCH) 1121 (2003). In *Londono*, the taxpayer had a long history
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Following the hearing, the hearing officer is required to issue a notice of determination regarding the proposed collection action or the disputed Notice of Federal Tax Lien.¹⁷¹

Within thirty days of the issuance of the notice of determination, the taxpayer may appeal that determination to the United States Tax Court, or if the Tax Court lacks jurisdiction over the underlying tax liability, to the proper federal district court.¹⁷² Although the Code itself does not prescribe the standard of review that the court is to apply in reviewing the Service's administrative determinations, based on the legislative history of Code section 6330, the Tax Court has determined that where the validity of the underlying tax liability is properly at issue, the court will review the matter on a de novo basis, and where the validity of the underlying tax liability is not properly at issue, the court will review the Service's administrative determination only for abuse of discretion.¹⁷³

of non-compliance with the tax laws, *id.* at 1122, and this was specifically cited by the Service as a reason the balance tilted in favor of enforced collection action, *id.* at 1123. The court stated,

The proposed levy action is appropriate in your case. It balances the need of the government to efficiently collect taxes with your concerns of intrusiveness. Your past compliance history does not demonstrate a good faith effort to comply with the tax laws other than by enforcement actions such as the proposed levy.

Id. The court also offered another rationale in this regard in *Wilborn v. Commissioner*, No. 6805-025 T.C. Summary Opinion 2003-152, 2003 Tax Ct. Summary LEXIS 155, at *1 (Oct. 15, 2003), wherein it stated "the filing of a lien properly balance[d] the competing concerns of efficient collection and intrusiveness" where the taxpayer failed to offer any definite collection alternatives. *Id.* at * 14.

¹⁷¹ I.R.C. § 6330(a) (2000).

¹⁷² *Id.* § 6330(d)(1). The notice of determination may only be contested in the Tax Court if that court otherwise has jurisdiction over the underlying tax liability. *Van Es v. Comm'r*, 115 T.C. 324, 328 (2000).

¹⁷³ The legislative history contained in the House Conference Report regarding H.R. 2676, which was eventually enacted as the Internal Revenue Service Restructuring and Reform Act of 1998, Pub. L. 105-206, 112 Stat. 685 (1998), states as follows:

The conferees expect the appeals officer will prepare a written determination addressing the issues presented by the taxpayer and considered at the hearing. . . . Where the validity of the tax liability was properly at issue in the hearing, and where the determination with regard to the tax liability is a part of the appeal, no levy may take place during the pendency of the appeal. The amount of the tax liability will in such cases be reviewed by the appropriate court on a de novo basis.

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The Tax Court's approach to these types of abuse of discretion cases seem diametrically opposed to the court's attitude regarding abuse of discretion in corporate taxpayer cases, as described above. Since the enactment of Code section 6330 in 1998, there have been approximately 200 cases decided by the Tax Court in which the court reviewed the Service's CDP determination on the basis of abuse of discretion.¹⁷⁴ In many cases, the taxpayer is simply a tax protester¹⁷⁵ who is using the CDP process as a forum for expressing his or her anti-tax views.¹⁷⁶ In a few of

Where the validity of the tax liability is not properly part of the appeal, the taxpayer may challenge the determination of the appeals officer for abuse of discretion.

H. CONF. REP. NO. 105-599, at 266 (1998). The Tax Court has affirmatively adopted this legislative suggestion. *Sego v. Comm'r*, 114 T.C. 604, 610 (2000); *Goza v. Comm'r*, 114 T.C. 176, 181 (2000). While no federal appellate courts have yet addressed the application of the abuse of discretion standard in cases arising under Code section 6330, several district courts have adopted the abuse of discretion standard in these cases. *See, e.g., Dudley's Commercial & Indus. Coating, Inc. v. Comm'r*, 292 F. Supp. 2d 976, 985 (M.D. Tenn. 2003).

¹⁷⁴ Specifically, 197 cases were identified using two separate Lexis searches of Tax Court cases through September 1, 2004. One search used the terms "(collection due process or CDP) and discretion" and the other "(collection due process or CDP) and (offer in compromise or OIC)." Cases arising under I.R.C. section 6330 are hereinafter referred to as "CDP cases."

¹⁷⁵ "Tax protesters" are individuals who believe that they are not subject to taxation, usually on some contrived constitutional grounds. Common tax protester arguments include the following:

- (1) . . . the sixteenth amendment to the constitution was improperly ratified and therefore never came into being;
- (2) . . . the sixteenth amendment is unconstitutional generally;
- (3) . . . the income tax violates the takings clause of the fifth amendment;
- (4) . . . the tax laws are unconstitutional;
- (5) . . . wages are not income and therefore are not subject to federal income tax laws;
- (6) . . . filing a tax return violates the privilege against self-incrimination; and
- (7) . . . Federal Reserve Notes do not constitute cash or income.

United States v. Cheek, 882 F.2d 1263, 1269 n.2 (7th Cir. 1989), *vacated by*, 498 U.S. 192 (1991).

¹⁷⁶ *See, e.g., Nestor v. Comm'r*, 118 T.C. 162, 167 (2002); *Goza v. Comm'r*, 114 T.C. 176, 182-83 (2000); *Bourbeau v. Comm'r*, 85 T.C.M. (CCH) 1205, 1207 (2003);

(continued)

these cases, the taxpayer's only argument related to the accuracy of the underlying liability, even though the jurisdictional prerequisites that would have allowed such arguments were absent,¹⁷⁷ or the underlying tax liability is properly at issue, but the taxpayer provides no support for his or her contention that the liability is incorrect.¹⁷⁸ Needless to say, the taxpayer has not prevailed in any of the tax protester cases or cases where the underlying liability was either raised improperly or was unsupported by any evidence.¹⁷⁹

In some cases, objective criteria exist for making a determination regarding abuse of discretion. The Tax Court has held, for example, that it was clearly not an abuse of discretion for the Service to decline to accept an offer in compromise as a collection alternative if the taxpayer had not

Robinson v. Comm'r, 85 T.C.M. (CCH) 1026, 1028 (2003); Keown v. Comm'r, 85 T.C.M. (CCH) 1003, 1004 (2003); Smith v. Comm'r, 85 T.C.M. (CCH) 889, 892 (2003); Young v. Comm'r, 85 T.C.M. (CCH) 739, 740 (2003); Tapio v. Comm'r, 83 T.C.M. (CCH) 1786, 1787 (2002); Watson v. Comm'r, 82 T.C.M. (CCH) 412, 414 (2001).

¹⁷⁷ See, e.g., Bethea v. Comm'r, 86 T.C.M. (CCH) 403, 405 (2003); Smith v. Comm'r, 86 T.C.M. (CCH) 62, 63 (2003); Struhar v. Comm'r, 85 T.C.M. (CCH) 1350, 1351 (2003); Orr v. Comm'r, 85 T.C.M. (CCH) 1319, 1320 (2003); Burton v. Comm'r, 85 T.C.M. (CCH) 1203, 1205 (2003); Stark v. Comm'r, 85 T.C.M. (CCH) 898, 900 (2003); Moore v. Comm'r, 85 T.C.M. (CCH) 727, 728 (2003); Gunderson v. Comm'r, 83 T.C.M. (CCH) 1143, 1144 (2002); Hoffman v. Comm'r, 79 T.C.M. (CCH) 2220, 2221 (2000). The underlying liability can be reviewed in a CDP hearing only if the taxpayer did not receive a statutory notice of deficiency or did not otherwise have an opportunity to dispute the tax liability. I.R.C. § 6330(c)(2)(B) (2000). In each case cited, the taxpayer had received a notice of deficiency and had previously had the opportunity to contest the merits of the liability in an appropriate forum.

¹⁷⁸ See, e.g., Rivera v. Comm'r, 85 T.C.M. (CCH) 832, 834-35 (2003), *aff'd*, 102 Fed. Appx. 594 (2004). In *Rivera*, the Service conceded that it did not send a notice of deficiency to the taxpayer and that the taxpayer did not otherwise have an opportunity to dispute his tax liability. *Id.* at 834. However, the liability in question was self-assessed on the taxpayer's own returns, and he did not present any evidence or credible testimony disputing the amount of the underlying tax liabilities. See *id.* at 834-35. In a subsequent decision, the Tax Court affirmed that a taxpayer is entitled to dispute a liability, even if it was self-assessed. *Montgomery v. Comm'r*, [2004] Stand. Fed. Tax Rep. (CCH) 4277, 4278-79 (Jan. 22, 2004) (to be published at 122 T.C.I (2004)). In some cases, the court is compelled to find against taxpayers because they simply offer no evidence to support their contentions that the Service officials abused their discretion. For instance, in *Galvin v. Commissioner*, 86 T.C.M. (CCH) 353 (2003), the taxpayer presented no financial evidence that could persuade the court that an installment agreement was an appropriate alternative to enforced collection, see *id.* at 354, much less that the Settlement Officer abused his discretion, *id.* at 355.

¹⁷⁹ See cases cited *supra* notes 177-78.

filed all required income tax returns.¹⁸⁰ Sometimes the taxpayer's argument is fundamentally flawed.¹⁸¹ In *Oyer v. Commissioner*,¹⁸² the Service asserted transferee liability against several taxpayers.¹⁸³ The Tax Court entered stipulated decisions¹⁸⁴ in the transferee cases, determining that each petitioner was liable for the assessed taxes pursuant to Code section 6901.¹⁸⁵ Subsequently, the petitioners submitted offers in compromise based on doubt as to liability.¹⁸⁶ The Service rejected each offer on the grounds that the transferee liabilities had been conclusively determined by the stipulated decisions and that petitioners were not in compliance with their respective income tax filing requirements.¹⁸⁷ While

¹⁸⁰ *Rodriguez v. Comm'r*, 85 T.C.M. (CCH) 1414, 1417 (2003). The Tax Court found, "The decision not to accept the offer in compromise submitted by [the taxpayer] on account of her failure to file all required returns was an entirely reasonable exercise of the Commissioner's discretion in administering the offer in compromise program." *Id.* In this case, although the petitioner asserted that she had filed the returns in question, Service records showed no returns being filed for a period of more than ten years, and two Service employees testified at trial that each had searched the government's records and found no filed returns. *Id.* Although the petitioner submitted some of the missing returns at the CDP hearing, the returns submitted did not contain original signatures. *Id.* The Internal Revenue Manual specifies that offers in compromise will not be processed if the taxpayer has failed to file all required returns. Internal Revenue Manual §§ 5.8.3.3(2), (4). This criteria seems objectively reasonable on at least two bases. First, before the taxpayer has filed all required returns, the total tax liability cannot be established, and an offer in compromise may not resolve all of the outstanding issues, thereby frustrating the purpose of giving the taxpayer a "fresh start." Second, the granting of an offer in compromise is a matter of administrative grace that allows a taxpayer, in some circumstances, to escape a legitimate tax liability and the filing requirement is a legal obligation. It seems reasonable to require that the taxpayer be in compliance with related legal obligations before being eligible for this extraordinary remedy.

¹⁸¹ For example, in *Bethea*, 86 T.C.M. at 403, the taxpayer made various procedural arguments that were without merit, such as that the Service was required to produce a copy of Form 23C to prove a valid assessment had been made. *Id.* at 405.

¹⁸² 86 T.C.M. (CCH) 1510 (2003).

¹⁸³ *Id.* at 1511. Transferee liability refers to the statutorily imposed liability of a transferee of assets for the transferor's unpaid tax liability. I.R.C. § 6901 (2000). Generally, the same assessment and collection procedures used for the initial tax liability apply to the imposition of transferee liability as well. *Id.* § 6901(a).

¹⁸⁴ Tax Court Rule 122 allows the Tax Court to decide a case based on the submissions of the parties where a trial is not needed for the submission of evidence. TAX CT. RUL. 122(a).

¹⁸⁵ *See Oyer*, 86 T.C.M. at 1511.

¹⁸⁶ *Id.*

¹⁸⁷ *Id.* at 1512.

the court did identify the specific filing requirement failure, the existence of a prior stipulated decision regarding the liability certainly provided a sufficient objective basis for reasonably rejecting an offer based on doubt as to liability.¹⁸⁸

However, even when there is no serious defect in the taxpayer's argument and the Service acts without substantial justification, the Tax Court has expressed a reluctance to label the Service's position an abuse of discretion.¹⁸⁹ For example, in *Harrell v. Commissioner*,¹⁹⁰ a CDP case arising at a time when the law governing dischargeability of taxes in bankruptcy was still the subject of conflicting opinions in the federal appellate courts,¹⁹¹ an Appeals Officer refused to accept a taxpayer's doubt

¹⁸⁸ See *id.* at 1513.

¹⁸⁹ The Tax Court's seeming hostility toward taxpayers who claim an abuse of discretion in CDP cases may be best illustrated in *Godwin v. Commissioner*, 86 T.C.M. (CCH) 451 (2003). In that case, the taxpayer failed to include a claim of abuse of discretion in his petition, as required by Tax Court Rule 331(b)(4). *Id.* at 457. Because of this, the taxpayer conceded the abuse of discretion issue. *Id.* Nonetheless, the court felt constrained to add to its already somewhat lengthy opinion its admonition that it would not have allowed an abuse of discretion claim in any event. *Id.*

¹⁹⁰ 86 T.C.M. (CCH) 378 (2003).

¹⁹¹ *Id.* at 383. Before 1966, taxes could not be discharged in bankruptcy. 11 U.S.C. §§ 35(a)(1), 104(a)(4) (1964). In 1966, Congress amended the bankruptcy code and provided that taxes could be discharged in a chapter 7 case, subject to a three-year "look back" provision limiting dischargeability to taxes that became legally due and owing within three years preceding bankruptcy. Act of July 5, 1966, Pub. L. No. 89-496, § 2, 80 Stat. 270 (1966) (codified at 11 U.S.C. § 523 (2000)). In 1978, Congress modified the three year look back period to begin with the date of the return instead of the due date of the taxes and added a new exception to dischargeability for taxes assessed within 240 days before the filing of a bankruptcy petition. 11 U.S.C. § 507(a)(8)(A)(i) & (ii) (2004). The legislative body, however, apparently never considered whether the look back period should be tolled with respect to successive bankruptcy filings. Subsequently, six circuits decided that the look back period should automatically be equitably tolled by prior bankruptcy filings. *Young v. United States (In re Young)*, 233 F.3d 56, 59-60 (1st Cir. 2000), *cert. granted* 533 U.S. 976 (2001), *aff'd*, 535 U.S. 43 (2002); *Waugh v. IRS (In re Waugh)*, 109 F.3d 489, 491-93 (8th Cir. 1997); *In re Taylor*, 81 F.3d 20, 22-24 (3d Cir. 1996); *United States v. Richards (In re Richards)*, 994 F.2d 763, 765-66 (10th Cir. 1993); *West v. United States (In re West)*, 5 F.3d 423, 426-27 (9th Cir. 1993); *Montoya v. United States (In re Montoya)*, 965 F.2d 554, 556-58 (7th Cir. 1992). However, prior to the affirmation of the *Young* case by the Supreme Court (and while the matter at issue here was being considered by the Service), three circuits held that the look back period should not be automatically tolled by a prior bankruptcy proceeding, but rather that equitable considerations should be applied on a case-by-case basis. *Palmer v. United States (In re Palmer)*, 219 F.3d 580, 586 (6th Cir. (continued)

as to liability and offer in compromise based on the questionable legal conclusion that the taxes could not be discharged.¹⁹² Instead, the Appeals Officer insisted that the taxpayer enter into an installment agreement to pay the liability as the only acceptable collection alternative.¹⁹³ Understandably, the taxpayer refused to enter into an installment agreement to pay a liability, which he believed was not legally enforceable.¹⁹⁴ Although feeling constrained under the circumstances to remand the case back to the Service for further consideration of collection alternatives, the Tax Court expressed its distaste for finding an abuse of discretion in such cases.¹⁹⁵ In similar cases the court has refused remand.¹⁹⁶

Given this judicial attitude, it is hardly astonishing that only three CDP cases have been decided in favor of the taxpayer,¹⁹⁷ although nearly 200

2000); *Morgan v. United States (In re Morgan)*, 182 F.3d 775, 779-80 (11th Cir. 1999); *Quenzer v. United States (In re Quenzer)*, 19 F.3d 163, 165 (5th Cir. 1993).

¹⁹² *Harrell*, 86 T.C.M. at 383.

¹⁹³ *See id.*

¹⁹⁴ *See id.* Even Judge Nims, writing for the Tax Court, acknowledged that

at the time petitioners rejected [the Appeals Officer's] suggested installment agreement, and at the time the Notice of Determination was issued, there was sufficient reason to raise a doubt as to petitioners' tax liabilities for 1991, 1992, and 1993, so as to justify petitioners' rejection of an installment agreement based in part upon a concession of the 1991-93 liabilities.

Id.

¹⁹⁵ *See id.* (“[W]e are reluctant to label respondent’s issuance of the Notice of Determination an abuse of discretion based upon a somewhat technical reason . . .”).

¹⁹⁶ In *Martin v. Commissioner*, 86 T.C.M. (CCH) 446 (2003), the taxpayer advanced the argument that the taxes being asserted had been unlawfully assessed after the statute of limitations on assessment had expired. *Id.* at 447. The taxpayer’s counsel asserted that an agreement had been reached with the Appeals Officer that an installment agreement would be explored as a collection alternative if it was determined that the taxes had been properly assessed. *Id.* at 449. The court, however, concluded that the taxpayer was entitled to only one CDP hearing, and since a notice of determination had been issued before the taxpayer submitted the financial information necessary to consider an installment agreement, the court refused to remand for further administrative proceedings under Code section 6330, *id.* at 450.

¹⁹⁷ In addition to the *Harrell* case, the taxpayer was successful in *Keene v. Commissioner*, 121 T.C. 8 (2003), and *Montgomery v. Commissioner*, [2004] Stand. Fed. Tax Rep. (CCH) 4277 (Jan. 22, 2004) (to be published at 122 T.C. 1 (2004)). In *Keene*, the taxpayer successfully argued that the taxpayer was entitled to audiotape his CDP hearing pursuant to Code section 7521(a)(1). *Keene*, 121 T.C. at 14, 16. Section 7521(a)(1) of the

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CDP cases have been heard by the Tax Court since 2000.¹⁹⁸ In one case the court summarily dismissed the arguments of the taxpayer¹⁹⁹ even though the Service itself conceded that it had erred in not allowing the taxpayer to address the underlying liability at the hearing.²⁰⁰ In other cases the court simply asserts that the Service acted correctly without any discussion of the relevant facts. Particularly illuminating are the cases in which the taxpayer submits an offer in compromise, based on doubt as to collectibility, as a collection alternative in the context of a CDP hearing. The Tax Court has time and again indicated that it has no interest in thoughtfully reviewing the basis of the Service's denial of such offers.²⁰¹

Code provides that, upon the advance request of a taxpayer, an Internal Revenue Service officer or employee must permit the taxpayer to make an audio recording of "any in-person interview . . . relating to the determination or collection of any tax." I.R.C. § 7521(a)(1) (2000). Thus, it would have been difficult for the court to conclude that the Service's refusal to allow such a recording was not an abuse of discretion in light of the government's rather "tenuous and unpersuasive" contention that a CDP hearing was not an "interview" for this purpose. See *Keene*, 121 T.C. at 16. *Montgomery* involved a taxpayer's contention that the taxpayer was entitled to dispute a tax liability at a CDP hearing regardless of how the liability was assessed. See [2004] Fed. Stand. Tax Rep. 4277-78. In that case, the liability was actually the result of a so-called "self assessment," i.e., based on the taxpayer's own filed return. *Id.* at 4278. At the CDP, the Appeals Officer refused to consider arguments that the liability was incorrect. See *id.* at 4278-80. A divided Tax Court concluded that the liability could be disputed even if emanating from the taxpayer's own return, as the controlling statutory language focuses on whether the person had a prior opportunity to dispute the tax liability, as is not limited by the originating source of the liability. *Id.* at 4280.

¹⁹⁸ See *supra* note 175. To date, all of the CDP cases heard by the Tax Court have involved claims of abuse of discretion made by individual taxpayers.

¹⁹⁹ See *Craig v. Comm'r*, 119 T.C. 252, 261-264 (2002).

²⁰⁰ *Id.* at 261. ("Whereas the Appeals [O]fficer did not allow petitioner to raise at the equivalent hearing the underlying tax liability for that year, respondent now recognizes that it was error to do so. . . .").

²⁰¹ This is not always the case. In *Conlon v. Comm'r*, T.C. Summary Opinion 2003-135, 2003 Tax Ct. Summary LEXIS 137, at *1 (Sept. 29, 2003), Judge Armen, *id.* at *1, delineated the financial information provided by the taxpayers, which clearly demonstrated that the amount offered was well below the reasonable collection potential. *Id.* at *12. Specifically, the taxpayers in *Conlon* indicated that they had approximately \$425,000 of equity in assets and more than \$500 a month in net income, *id.* at *5, yet only offered \$8,026 (the original amount of the assessed liability) on an outstanding balance of approximately \$21,000, *id.* at *3, 12. In *Ashley v. Comm'r*, 84 T.C.M. (CCH) 558 (2002), the taxpayer was having an unrelated dispute with the government over payment of a disability award and believed that the tax due should be offset by the amount he believed was owed to him. *Id.* at 558-59. Judge Chiechi, *id.* at 558, carefully considered the
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A case in point is *Neugebauer v. Commissioner*.²⁰² The only issue raised by the taxpayer at the CDP hearing was his inability to pay the liability in full.²⁰³ As a collection alternative, the taxpayer submitted an offer in compromise based on doubt as to collectibility and a financial information statement.²⁰⁴ The appeals officer determined that the offer in compromise should be rejected on the basis that the offer and supporting financial information were incomplete.²⁰⁵ The court, however, did not indicate what was missing and made no effort to review the reasonableness of the determination that the information provided was incomplete.²⁰⁶ Instead, the court merely concluded that the appeals officer “addressed” the taxpayer’s request for a collection alternative by “reviewing the information submitted, explaining that it was incomplete, and asking for additional information.”²⁰⁷ Without developing the facts further, the court categorically stated that the taxpayer failed to submit a properly completed offer and did not supply the required financial information, and therefore, subsequently concluded the denial was not an abuse of discretion.²⁰⁸ Furthermore, without any additional facts regarding the conduct of the hearing or the basis of the Appeals Officer’s determination, the court concluded that “the Appeals officer properly balanced the need for efficient collection of taxes through the proposed levy against the concern that any collection action be no more intrusive than necessary.”²⁰⁹

taxpayer’s financial information in some detail before holding that the Service had not abused its discretion in rejecting the offer, *id.* at 560-61.

²⁰² 86 T.C.M. (CCH) 467 (2003) (referred to as *Neugebauer II*); *see also* *Neugebauer v. Comm’r*, 86 T.C.M. (CCH) 394 (2003) (referred to as *Neugebauer I*). Although the accompanying text refers to just one case, *Neugebauer II*, these two companion cases are related and virtually identical. At issue in *Neugebauer I* was the joint liability of Carl and Lisa Neugebauer for tax years 1994 and 1995. *Neugebauer*, 86 T.C.M. at 394. *Neugebauer II* involved the individual liability of Carl Neugebauer for tax year 1989. *Neugebauer*, 86 T.C.M. at 467. The issue in both cases was whether the Service had abused its discretion in rejecting the taxpayers’ offer in compromise. *Neugebauer*, 86 T.C.M. at 395; *Neugebauer II*, 86 T.C.M. at 468. Presumably, since the taxpayers were a married couple and the cases were contemporaneous, the financial information at issue was the same in both cases. Both cases were heard by Judge Laro, and the opinions in each case are virtually identical. *Neugebauer*, 86 T.C.M. at 394; *Neugebauer II*, 86 T.C.M. at 467. For convenience, the accompanying discussion will cite only to *Neugebauer II*.

²⁰³ *Neugebauer II*, 86 T.C.M. at 468.

²⁰⁴ *See id.* at 467.

²⁰⁵ *Id.*

²⁰⁶ *See id.* at 468.

²⁰⁷ *Id.*

²⁰⁸ *Id.*

²⁰⁹ *Id.*

The existence of a genuine factual dispute regarding the calculation of income and expenses has not dissuaded the court from granting great deference to the Service's position in CDP hearings.²¹⁰ In one case, the Service contended that because the Appeals officer articulated reasons for her determination, there could be no abuse of discretion.²¹¹ Despite the fact that the taxpayer asserted that the Appeals officer had relied on erroneous calculations by the revenue officer with respect to petitioner's monthly income, the court, without a substantive discussion of the merits of the taxpayer's allegations, stated that it could find no abuse of discretion.²¹² The implication is that *any* articulated reason for rejection of an offer will be sufficient to avoid an abuse of discretion challenge.²¹³ If this is the case, the deferential standard is completely disemboweled and the notion that the taxpayer is entitled to judicial review under Code section 6330 is rendered meaningless.

In *Wall v. Commissioner*,²¹⁴ an elderly couple²¹⁵ attempted to enter into an installment agreement, which the Service rejected as being inadequate.²¹⁶ In support of their position that the installment agreement represented the maximum amount that the taxpayer could afford to pay, the couple cited that (a) the Service overstated the amount of the taxpayers' income in prior years, (b) their income was subject to change due to their ages and the temporary nature of the husband's employment, and (c) their expenses were likely to increase in light of certain medical conditions from which they suffered.²¹⁷ In response, Judge Goldberg²¹⁸ simply stated that "[w]e need not address the individual amounts which entered into respondent's calculation" and concluded that there was no abuse of discretion.²¹⁹

²¹⁰ See, e.g., *Van Vlaenderen v. Comm'r*, 86 T.C.M. (CCH) 736, 737-38 (2003).

²¹¹ *Id.* at 738.

²¹² See *id.*

²¹³ This may be implied from the fact that the Service specifically equated "articulated reasons" for rejection of the offer with the absence of an abuse of discretion, a characterization the Tax Court did not challenge and apparently accepted. *Id.*

²¹⁴ T.C. Summary Opinion 2003-165, 2003 Tax Ct. Summary LEXIS 168, at *1 (Dec. 11, 2003).

²¹⁵ The opinion in the case does not state the taxpayers' respective ages, but does indicate that they were receiving social security benefits. *Id.* at *2.

²¹⁶ *Id.* at *6.

²¹⁷ *Id.* at *7.

²¹⁸ *Id.* at *1.

²¹⁹ *Id.* at *7.

While it is hardly novel to posit that the response time of the Service tends toward the sluggish,²²⁰ the Tax Court seems to be quite taken aback whenever it perceives taxpayer delay and sometimes uses that perceived offense as an additional basis for deference.²²¹ In June of 2001, Stephen Mitchell Day of Castleton, Virginia, timely requested a CDP hearing with regard to a notice of intent to levy on the basis that the collection action would impose severe economic hardship on him.²²² Over seven months later, the Service responded to Mr. Day and informed him that the hearing would take place one month later.²²³ In order to properly prepare for the hearing, the taxpayer requested, and was granted, an extension of time.²²⁴

²²⁰ For example, the bankruptcy court has noted that the three-year time period for allowing the Service to assess deficiencies, as provided by I.R.C. section 6501(a) (2000), and reiterated by the Bankruptcy Code, 11 U.S.C. section 523(a)(7) (2000), were intended to take account of the slow workings of the agency. *See* *Molina v. United States (In re Molina)*, 99 B.R. 792, 795 (S.D. Ohio 1988) (“Since enforcement of the tax laws against delinquent tax debtors takes time, Congress, through section 523, intended to give the taxing authority at least three full years to pursue such debtors.” (quoting *Brickley v. United States (In re Brickley)*, 70 B.R. 113, 115-16 (B.A.P. 9th Cir. 1986))).

²²¹ *See, e.g.,* *Day v. Comm’r*, 87 T.C.M. (CCH) 949, 951 (2004). In fairness, it should be noted that there have also been many occasions when the taxpayer was unreasonably uncooperative and later sought redress for the resulting delay. *See, e.g.,* *Leineweber v. Comm’r*, 87 T.C.M. (CCH) 824, 824-25 (2004). In *Leineweber*, the taxpayer, contemporaneously with his timely request for a CDP hearing, also requested the assistance of the Taxpayer Advocate and his congressional representative. *Id.* at 824. The record in that case revealed that the taxpayer continuously attempted to avoid the CDP hearing through appeal to the offices of the Taxpayer Advocate and his congressional representative. *Id.* at 824-25. For instance, the taxpayer insisted that a representative from each office be present at the CDP hearing, although, apparently, both offices declined. *See id.* at 825. In response to requests from the Appeals Officer to schedule a hearing date, the taxpayer did not communicate with the Appeals Officer, but instead sent a letter to the Taxpayer Advocate. *Id.* In *Pless v. Commissioner*, 87 T.C.M. (CCH) 845 (2004), the taxpayers were repeatedly asked to schedule an appointment, but they failed to do so. *Id.* at 846. Eventually the taxpayers offered two possible dates, both of which were Saturdays, when the Appeals Office was closed. *Id.* The Appeals Officer offered to let Mr. and Ms. Pless pick a date for the hearing, but they asked that it be postponed for a month. *Id.* The Appeals Officer honored this request, but the taxpayers then wrote that that date chosen was not convenient, and they suggested no alternative. *Id.* Thereafter, the Appeals Officer tried to telephone and write to the taxpayers to schedule an appointment, but to no avail. *Id.* at 847.

²²² *Day*, 87 T.C.M. at 949. In the request for a CDP hearing, Mr. Day noted that the proposed levy “will result in taxpayer’s income being cut by 50%.” *Id.*

²²³ *Id.*

²²⁴ *Id.* at 950.

The taxpayer did not hear from the Service until almost four months later when he received a letter informing him that the matter was being transferred to the Appeals Office in Houston, Texas and that his hearing would be conducted via telephone two months hence.²²⁵ Mr. Day objected to the transfer of the case, as he wished to meet face-to-face with the Appeals Officer.²²⁶

Several months later, the Service contacted the taxpayer to inform him that his CDP hearing would be conducted in Washington, D.C. on November 21, 2002, nearly one and a half years after he initially requested the hearing and within just a few days of the Thanksgiving holiday.²²⁷ Because his representative was in California on vacation until after the holiday, Mr. Day again asked for the hearing to be rescheduled.²²⁸ The Settlement Officer, to whom the case had been assigned, refused this request and issued a notice of determination indicating the Service's intent to proceed with collection activity.²²⁹ Citing the fact that the hearing had been "twice postponed at [Mr. Day's] request," the Tax Court concluded that the taxpayer had been afforded a proper opportunity for a hearing and that the Service did not abuse its discretion with respect to any of the matters in issue.²³⁰

In another case, when taxpayer Karl Vossbrinck was contacted about scheduling the CDP hearing he requested, he indicated that he believed that his tax returns had been erroneously filed as if his income was that of an employee instead of a self-employed individual.²³¹ The taxpayer requested a delay in the hearing to afford him time to seek a private letter ruling.²³² As evidence of his intent, the taxpayer sent a draft of his private

²²⁵ *Id.*

²²⁶ *Id.*

²²⁷ *Id.*

²²⁸ *Id.*

²²⁹ *Id.*

²³⁰ *Id.* at 951.

²³¹ *Vossbrinck v. Comm'r*, 83 T.C.M. (CCH) 1474, 1475 (2002). Mr. Vossbrinck provided computer consulting services to various entities. *Id.* Although the case is silent in this regard, it is assumed that treating his income as coming from self employment would have allowed for a variety of business deductions not available to employees. The Code allows a deduction for all ordinary and necessary expenses related to carrying on a trade or business. I.R.C. § 162(a) (2000). However, employees can only deduct unreimbursed business related expenses if they itemize and such expenses, along with other miscellaneous itemized deductions, exceed 2% of their adjusted gross income. I.R.C. § 162(a)(2) (2000).

²³² A private letter ruling is a written statement issued by the Service to a particular taxpayer stating the Service's position with respect to the tax treatment of a given set of facts. Treas. Reg. § 601.201(a)(2) (as amended in 2002). The Code authorizes the Service to issue such rulings, *see* I.R.C. § 7805(a) (2000), and each year the Service announces its

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letter ruling request to the Appeals Officer within a week.²³³ At trial, Mr. Vossbrinck testified that someone at the Service subsequently advised him that it would be better to submit a request to the examination division for a determination of his employment status rather than to seek a private letter ruling.²³⁴ The taxpayer took this advice,²³⁵ and the examination division subsequently ruled that Mr. Vossbrinck should be treated as an employee rather than as a self-employed individual.²³⁶ Feeling that the Service's examination personnel "[did] not have as much latitude in deciding employment status and that he would have been successful in seeking a private letter ruling because the individuals who consider rulings have a broader spectrum of matter they can consider in the process,"²³⁷ Vossbrinck requested a continued delay so that he could now seek the private letter ruling.²³⁸ Although the taxpayer did, in fact, subsequently seek a private letter ruling, the Tax Court found that the Service did not abuse its discretion in denying a further continuance of the CDP hearing.²³⁹ In fact, the Tax Court has not set any parameters for assessing the

criteria and procedures for issuing rulings by way of a Revenue Procedure. *See, e.g.*, Rev. Proc. 2004-1, 2004-1 I.R.B. 1; 1 Rev. Proc. 2003-1, 2003-1 C.B. 1.

²³³ *Vossbrinck*, 83 T.C.M. at 1475. It should be noted that, for reasons described *infra*, the taxpayer did not actually file this ruling request as indicated.

²³⁴ *Id.* at 1476 n.1. The court discounted this assertion, stating that Vossbrinck did not show "a sufficient factual predicate for his argument." *Id.* However, the court went on to state that

even if petitioner had shown that he had received the alleged advice from someone in respondent's office, petitioner was not forced to seek one type of relief rather than another. It was his choice to seek an examination of his employment status, rather than seeking a ruling during the time allotted.

Id.

²³⁵ *Id.* at 1476. Although the court discounted Vossbrinck's testimony, *see* discussion *supra* note 234, it is reasonable that a taxpayer might choose to first seek a determination in this manner, as the Service charges significant user fees in connection with the issuance of private letter rulings. For example, currently the user fee for a private letter ruling may be as much as \$6,000. Rev. Proc. 2004-1, 2004-1 I.R.B. 1.

²³⁶ *Vossbrinck*, 83 T.C.M. at 1476.

²³⁷ *Id.* at 1476 n.1.

²³⁸ *See id.* at 1476 & n.1.

²³⁹ *Id.* at 1476.

reasonableness of the Service in giving taxpayers time to prepare financial information.²⁴⁰

*Roman v. Commissioner*²⁴¹ involved what could hardly be characterized as taxpayer delay. In that case the taxpayer submitted an offer in compromise as a collection alternative pursuant to a CDP hearing.²⁴² During discussions with the taxpayer's representative, the Settlement Officer imposed certain deadlines for the receipt of information that the taxpayer substantially met.²⁴³ At one point, the taxpayer's representative apologized for his failure to meet a self-imposed deadline due to trial commitments.²⁴⁴ After a few weeks and apparently with no further communication to either the taxpayer or his representative, the Settlement Officer issued an adverse notice of determination.²⁴⁵ Despite the fact that the taxpayer was offering to pay a substantial portion of the liability and that the delay in transmitting paperwork was admittedly due to his representative's trial schedule, the Tax Court held that "while petitioner may have preferred more time to provide the materials requested, respondent's conduct in these circumstances can hardly be characterized as arbitrary, capricious, or without sound basis in fact or law."²⁴⁶

The purpose of settling any legal obligation for less than the amount owed is to attain economic efficiency. In considering whether or not to settle a tax obligation for less than its full amount, the only relevant financial information is the amount, given the circumstances, that the government can reasonably expect to collect from the taxpayer prior to the expiration of the statutorily limited period for collections. The amount offered in settlement relative to the tax liability, as well as other factors

²⁴⁰ See *Wells v. Comm'r*, 86 T.C.M. (CCH) 227, 229 (2003). In *Wells*, the court concluded that four months was a reasonable amount of time to allow petitioner to submit his financial information. *Id.*

²⁴¹ 87 T.C.M. (CCH) 835 (2004).

²⁴² *Id.* at 835. "The offer in compromise proposed to pay a total of \$15,000[, or approximately 30% of the outstanding balance,] by remitting \$5,000 within 90 days of acceptance and the balance in 10 monthly installments of \$ 1,000." *Id.*

²⁴³ *Id.* For instance, a letter dated January 21, 2003 stated, "Please see that I receive the requested information no later than February 18, 2003. Failure to submit the information may result in the recommendation that your client's offer be rejected without further consideration." *Id.* On February 18, 2003, the taxpayer's attorney hand-delivered documents in response to the January 21, 2003 letter. *Id.*

²⁴⁴ *Id.* at 836. When the settlement officer requested further documentation, the taxpayer's attorney suggested that he would try to submit the requested material on March 25. *Id.* Unable to do so, the attorney contacted the settlement officer on March 26 to explain the circumstances. *Id.*

²⁴⁵ *Id.*

²⁴⁶ *Id.* at 837.

unrelated to the taxpayer's ability to pay, should be inconsequential in this analysis.²⁴⁷ Nonetheless, when the amount offered by the taxpayer is diminutive compared to the liability, both the tax court and the federal district courts routinely use that factor to further justify deference to the Service.²⁴⁸

In marginal cases the Tax Court has consistently shown great deference to the Service's determinations related to CDP hearings. For example, the Tax Court has concluded that it is not an abuse of discretion to refuse to meet with the taxpayer at a location more convenient to the taxpayer's home and the location of his evidence.²⁴⁹

2. *Tax Court Review of Innocent Spouse "Equitable Relief" Determinations*

Spouses are allowed to file a single, joint tax return, combining the income, deductions, and reportable items of both individuals.²⁵⁰ When a joint return is filed, both spouses are jointly and severally liable for any tax

²⁴⁷ One exception is the taxpayer's noncompliance with filing requirements.

²⁴⁸ See *Splawn v. United States*, 94 A.F.T.R.2d 2004-5628, 2004-5632 (E.D. Tenn. 2004), available at 2004 WL 2051220 (E.D. Tenn. Aug. 3, 2004). In *Splawn*, the court noted:

In the absence of additional evidence or argument in support of [the taxpayer's] position that the appeals officer failed to consider [whether any proposed collection action balances the need for the efficient collection of taxes with the legitimate concern of the person that any collection action be no more intrusive than necessary], this Court will not conclude that the IRS abuses its discretion when rejecting an offer in compromise of \$5,000 for a debt of \$ 118,179.99, a mere four percent of the amount owed").

Id.

²⁴⁹ See *Katz v. Comm'r*, 115 T.C. 329, 336-37 (2000). In this case, the closest Appeals Office was more than an hour away from the taxpayer's residence, and the taxpayer wished to present witnesses to support his arguments who could not travel to the closest Appeals Office. *Id.* at 332, 336-37. The Tax Court, citing *Davis v. Commissioner*, 115 T.C. 35, 41 (2000), concluded that the taxpayer enjoyed no right to present witnesses at the CDP hearing, so his arguments were moot. *Katz*, 115 T.C. at 337.

²⁵⁰ See I.R.C. § 6013(a) (2000). This provision was enacted primarily to equalize the treatment of taxpayers in common law and community property states. It permits couples in common law states to split income between themselves and thus to diminish tax liability in same manner as couples were able to do in community property states wherein each spouse was deemed entitled to one-half of all income irrespective of amount earned by or accruing to each. *Bertucci v. United States*, 146 F. Supp. 949, 950 (Ct. Cl. 1957); *McClure v. United States*, 228 F.2d 322, 325 (4th Cir. 1955).

related to that return.²⁵¹ Needless to say this liability rule could result in rather harsh consequences in some instances.²⁵² Thus, Congress saw it fit to ameliorate those consequences, in certain situations, when it enacted the predecessor to current code, section 6015.²⁵³ Congress modified and

²⁵¹ I.R.C. § 6013(d)(3) (2000). An assessment made against one spouse pursuant to the liability related to a joint return does not bar the Service from taking collection action against the other spouse, and the fact that the Service has chosen to pursue only one spouse at first does not act as a waiver of the government's ability to pursue the other spouse. *Dolan v. Comm'r*, 44 T.C. 420, 426 (1965). Likewise, the Service's settlement of a tax liability with a husband who has received a bankruptcy discharge does not fix the amount of taxpayer's joint liability. Where, only one spouse seeks bankruptcy relief, the Service may proceed against the other spouse separately. *Kroh v. Comm'r*, 98 T.C. 383, 396-97 (1992). However, a joint filer is not necessarily liable for half of a civil fraud penalty imposed on one spouse solely because she made a joint return. *Romanelli v. Comm'r*, 466 F.2d 872 (7th Cir. 1972).

²⁵² Historically, the majority of innocent spouse cases involve attempts to collect a joint liability from women. Jessica Luby Angney, Note, *It's New but Is It Improved?: The New "Innocent Spouse" Provision*, 47 CLEV. ST. L. REV. 603, 609 (1999). Commentators have observed that joint liability is contrary to fairness and ability-to-pay norms, in that joint and several liability allows the collection of taxes from either person, regardless of that person's culpability for the deficiency. *Id.* at 610. Others have pointed out that since men usually are the higher income earners, the cost of joint liability is usually born by the wrong spouse. Richard C.E. Beck, *The Innocent Spouse Problem: Joint and Several Liability for Income Taxes Should Be Repealed*, 43 VAND. L. REV. 317, 376 (1990); see generally Marjorie E. Kornhauser, *Love, Money, and the I.R.S.: Family, Income-Sharing, and the Joint Income Tax Return*, 45 HASTINGS L.J. 63 (1993); C. Ian McLachlan, *Spousal Liability and Federal Income Taxes*, 10 J. AM. ACAD. MATRIMONIAL LAW. 65, 69 (1993); Stephen A. Zorn, *Innocent Spouses, Reasonable Women and Divorce: The Gap Between Reality and the Internal Revenue Code*, 3 MICH. J. GENDER & L. 421 (1996); Lisa K. Edison-Smith, Note, *"If You Love Me, You'll Sign My Tax Return:" Spousal Joint and Several Liability for Federal Income Taxes and the "Innocent Spouse" Exception*, 18 HAMLINE L. REV. 102 (1994).

²⁵³ Congress originally enacted innocent spouse relief in 1971 by adding section 6013 to the Code. Act of Jan. 12, 1971, Pub. L. No. 91-679, 84 Stat. 2063 (1971). In its original form in the 1971 Act, the statute provides that section 6013(e)(1) would read as follows:

(1) In general.—Under regulations prescribed by the Secretary or his delegate, if—

(A) a joint return has been made under this section for a taxable year and on such return there was omitted from gross income an amount properly includable therein which is attributable to one

(continued)

liberalized innocent spouse relief as part of the Service Restructuring and Reform Act of 1998.²⁵⁴

Under current law, innocent spouse cases may come before the Tax Court when a joint filer raises the claim as an affirmative defense in a petition for re-determination of a deficiency.²⁵⁵ Additionally, the court has jurisdiction to hear appeals of unfavorable determinations independent of a deficiency case.²⁵⁶ Under the original innocent spouse provision, the Tax Court ruled that a spouse seeking relief had the burden of proving each element of Code section 6013(e) by a preponderance of the evidence.²⁵⁷

spouse and which is in excess of 25 percent of the amount of gross income stated in the return,

(B) the other spouse establishes that in signing the return he or she did not know of, and had no reason to know of, such omission, and

(C) taking into account whether or not the other spouse significantly benefited directly or indirectly from the items omitted from gross income and taking into account all other facts and circumstances, it is inequitable to hold the other spouse liable for the deficiency in tax for such taxable year attributable to such omission, then the other spouse shall be relieved of liability for tax (including interest, penalties, and other amounts) for such taxable year to the extent that such liability is attributable to such omission from gross income.

Id.

²⁵⁴ Internal Revenue Service Restructuring and Reform Act of 1998, Pub. L. No. 105-206, 112 Stat. 685 (1998). The statute repealed the old provision of Code section 6013(e) and replaced it with a new Code section 6015, which provides for three distinct types of relief. *Id.* The relief formerly available under repealed Code section 6013(e) is now available under new Code section 6015(c). I.R.C. § 6015(c) (2000). Additionally, taxpayers may now also avail themselves of separation of “liability” and “equitable” relief. I.R.C. § 6015(b), (f) (2000).

²⁵⁵ See I.R.C. § 6213(a) (2000). The Tax Court has jurisdiction to review innocent spouse claims in this context because once the deficiency is properly before the court, affirmative defenses are within Tax Court’s general jurisdiction and an innocent spouse claim is an affirmative defense. *Butler v. Comm’r*, 114 T.C. 276, 290 (2000). Furthermore, the Tax Court has specifically ruled that its jurisdiction extends to cases arising under the equitable relief provisions of the new Code section 6015(f). *Fernandez v. Comm’r*, 114 T.C. 324 *passim* (2000).

²⁵⁶ I.R.C. § 6015(e)(2000). The Tax Court has ruled that it has jurisdiction to review a denial of innocent spouse relief on equitable grounds independent of any deficiency proceeding. *Ewing v. Comm’r*, 118 T.C. 494, 506 (2002).

²⁵⁷ *Stevens v. Comm’r*, 872 F.2d 1499, 1504 (11th Cir. 1989) (“The taxpayer bears the burden of proving each of these elements by a preponderance of the evidence.”); *Craig*
(continued)

That burden is still statutorily mandated for one of the three types of innocent spouse relief now available.²⁵⁸ However, with respect to equitable relief now available under Code section 6015(f),²⁵⁹ the abuse of discretion standard applies.²⁶⁰

When reviewing the equitable relief cases applying the abuse of discretion standard that has been decided by the Tax Court since the enactment of the new provisions, a striking contrast to the collection cases can be gleaned. While there have been some equitable relief cases in which the court summarily defers to the Service,²⁶¹ those cases have

D. Bell, *Need-to-Know Divorce Tax Law for Legal Assistance Officers*, 177 MIL. L. REV. 213, 326 (2003) (observing that “[c]ases applying former I.R.C. § 6013(e) uniformly held that the requesting spouse had the burden of proving each element of the innocent spouse defense by a preponderance of the evidence.”); *see also* Purcell v. Comm’r, 826 F.2d 470, 473 (6th Cir. 1987); Shea v. Comm’r, 780 F.2d 561, 565 (6th Cir. 1986); Adams v. Commissioner, 60 T.C. 300, 303 (1973) (“In order to be relieved from liability as an ‘innocent spouse’ petitioner must shoulder the burden of proving that the three conditions of section 6013(e) are met”); Sonnenborn v. Comm’r, 57 T.C. 373, 381 (1971).

²⁵⁸ I.R.C. § 6015(c)(2) (2000); *see generally supra* note 257 and accompanying text (discussing currently available innocent spouse relief).

²⁵⁹ I.R.C. § 6015(f) (2000). The equitable relief provision states as follows:

Under procedures prescribed by the Secretary, if—

(1) taking into account all the facts and circumstances, it is inequitable to hold the individual liable for any unpaid tax or any deficiency (or any portion of either); and

(2) relief is not available to such individual under subsection (b) or (c),

the Secretary may relieve such individual of such liability.

Id.

²⁶⁰ Jonson v. Comm’r, 118 T.C. 106, 125 (2002), *aff’d*, 353 F.3d 1181 (10th Cir. 2003); Cheshire v. Comm’r, 115 T.C. 183, 198 (2000), *aff’d*, 282 F.3d 326 (5th Cir. 2002); Butler v. Comm’r, 114 T.C. 276, 292 (2000). The rationale for the application of the abuse of discretion standard in this context emanates from the jurisdictional provisions contained in Code section 6015, which states that a taxpayer against whom a deficiency has been asserted and who elects to have section 6015(b) or (c) apply may petition this Court “to determine the appropriate relief available to the individual” under section 6015, I.R.C. § 6015(e)(1)(A) (2000), including relief under section 6015(f). *See also* Ewing v. Comm’r, [2004] Stand. Fed. Tax Rep. (CCH) 4289, 4291 (Jan. 28, 2004) (to be published at 122 T.C. 32 No. 2 (2004)).

²⁶¹ D’Aunay v. Comm’r, 87 T.C.M. (CCH) 1134, 1139 (2004). In D’Aunay the court simply stated,

(continued)

proven to be the exception rather than the rule.²⁶² In the vast majority of cases, the court carefully weighs the facts to determine whether the Service abused its discretion in denying relief.²⁶³ What may account for this distinction is the existence of a set of discrete factors that the Service uses in making its determinations in the equitable relief cases.²⁶⁴ This list of

[C]onsidering the facts and circumstances in this case, we cannot conclude that it would be inequitable to hold petitioner liable for the deficiencies resulting from her filing joint returns with [her husband] for the years in issue. A fortiori, we cannot conclude that denial of relief was an abuse of discretion, i.e., arbitrary, capricious, or without sound basis in fact.

Id. However, the court's opinion is essentially devoid of an in-depth analysis of the facts and circumstances, other than to generally comment on the taxpayer's level of knowledge and lifestyle. See *id.* at 1134; see also *Pless v. Comm'r*, 87 T.C.M. (CCH) 845 (2004), *aff'd*, 111 Fed. Appx. 178 (2004); *Demirjian v. Comm'r*, 87 T.C.M. (CCH) 841 (2004); *Wallace v. Comm'r*, 86 T.C.M. (CCH) 667 (2003); *Ohrman v. Comm'r*, 86 T.C.M. (CCH) 499 (2003); *Ziegler v. Comm'r*, 86 T.C.M. (CCH) 423 (2003); *Malone v. Comm'r*, T.C. Summary Opinion 2004-9, 2004 Tax Ct. Summary LEXIS 9 (Feb. 3, 2004). The court on at least one occasion has stated that if it determines that relief is not available under Code section 6015(b), then it will not independently consider the Service's denial of equitable relief, see *Alt v. Commissioner*, 119 T.C. 306, 316 (2002), *aff'd*, 101 Fed. Appx. 34 (2004), despite the fact that one of the prerequisites to equitable relief is the unavailability of relief under Code section 6015(b), I.R.C. § 6015(f)(2) (2000). The court in *Alt* stated,

Considering the facts and circumstances of this case, we held under section 6015(b)(1)(D) that it is not inequitable to hold petitioner liable for the deficiencies. The language of section 6015(f)(1), "taking into account all the facts and circumstances, it is inequitable to hold the individual liable for any unpaid tax or any deficiency (or any portion of either)" does not differ significantly from the language of section 6015(b)(1)(D), "taking into account all the facts and circumstances, it is inequitable to hold the other individual liable for the deficiency in tax for such taxable year attributable to such understatement." Further, the equitable factors we considered under section 6015(b)(1)(D) are the same equitable factors we consider under section 6015(f). As a result, we hold that respondent did not abuse his discretion in denying petitioner relief under section 6015(f) for taxable years 1982 to 1988.

Alt, 119 T.C. at 316 (citations omitted).

²⁶² See *infra* note 268.

²⁶³ See *infra* note 268.

²⁶⁴ See Rev. Proc. 2003-61, 2003-32 I.R.B. 296 (establishing a list of factors and providing that "[n]o single factor will be determinative of whether to grant equitable relief
(continued)

factors has given the court a basis for a more detailed, albeit still deferential, review of the Service's evaluation of the facts.²⁶⁵

The factors used to guide the Service in equitable relief cases cannot alone account for the disparity in approach to deference as compared to the collection cases. Indeed, the Service has written guidance with respect to review of offers in compromise which is, in many respects, similar to the equitable relief standards.²⁶⁶ Even when an equitable relief case is founded on economic hardship and thus the analysis required is similar to that in the collection cases, the Tax Court seems more inclined to independently review the facts rather than simply defer to the Service.²⁶⁷

in any particular case. Rather, the Service will consider and weigh all relevant factors, regardless of whether the factor is listed"). Prior to the issuance of Rev. Proc. 2003-61, a similar set of factors was contained in Rev. Proc. 2000-15, 2000-1 C.B. 447. In *Durham v. Commissioner*, T.C.M. (CCH) 2004-184, available at <http://tax.cchgroup.com/primesrc/bin/highwire.dll>, the court refused to find an abuse of discretion where the taxpayer presented no evidence relating to the application of the factors. *Id.*

²⁶⁵ See *Jonson v. Comm'r*, 118 T.C. 106 (2002). In *Jonson* the court analyzed the facts and held that the petitioner was aware of the investment that created the liability, as well as of the resulting reported losses, and of the risk of a Service challenge to the tax reductions claimed to result from those reported losses. *Id.* at 118. The court went on to state,

Clearly, then, she had reason to know of the items giving rise to the deficiencies. She benefited from the items in that the losses, among other things, reduced the Jonsons' taxes and contributed to their ability to pay for their children's college educations, which Barbara admitted was important to her. Because Barbara is deceased, there can be no economic hardship to her personally if equitable relief is denied. We cannot conclude that respondent acted arbitrarily, capriciously, or without sound basis in fact in denying Barbara equitable relief.

Id. at 126. In each of the following cases, the court carefully analyzed each factor in some detail: *Monsour v. Comm'r*, T.C.M. (CCH) 2004-190, available at <http://tax.cchgroup.com/primesrc/bin/highwire.dll>; *O'Neill v. Comm'r*, T.C.M. (CCH) 2004-183, available at <http://tax.cchgroup.com/primesrc/bin/highwire.dll>; *Morello v. Comm'r*, T.C.M. (CCH) 2004-181; *Barriga v. Comm'r*, 87 T.C.M. (CCH) 1236, 1238 (2004); *Doyel v. Comm'r*, 87 T.C.M. (CCH) 960, 969 (2004); *Gilliam v. Comm'r*, T.C. Summary Opinion 2004-37, available at <http://tax.cchgroup.com/primesrc/bin/highwire.dll>; *Hollis v. Comm'r*, T.C. Summary Opinion 2004-30, available at <http://tax.cchgroup.com/primesrc/bin/highwire.dll>.

²⁶⁶ Internal Revenue Manual § 5.8.4.

²⁶⁷ See *Cullen v. Comm'r*, T.C.M. (CCH) 2004-176, available at <http://tax.cchgroup.com/primesrc/bin/highwire.dll>; *Bartak v. Comm'r*, 87 T.C.M. (CCH) (continued)

V. SOCIAL SCIENCE EXPLANATIONS FOR THE DEFERENTIAL DIFFERENCE

As the foregoing discussion illustrates, there appears to exist a discernable difference in the approach taken by the Tax Court in abuse of discretion cases.²⁶⁸ In cases involving corporate taxpayers, the court

1152, 1158-60 (2004); *Ellison v. Comm’r*, 87 T.C.M. (CCH) 1062, 1067-68 (2004). In *Cullen*, the court reviewed the taxpayer’s assertion that he would suffer economic hardship, as his income was only \$800 a month, noting that the taxpayer’s bank statements indicated deposits well exceeding that amount. *Cullen*, T.C.M. (CCH) 2004-176. In *Bartak*, the court analyzed the taxpayer’s financial disclosures on Form 433-A (the form used in connection with offers in compromise) in great detail, even noting its calculations of asset fair market values. *Bartak*, 87 T.C.M. at 1159. Compare the above cases to *Hopkins v. Commissioner*, 121 T.C. 73 (2003), and *Ogonoski v. Commissioner*, 87 T.C.M. (CCH) 1038 (2004). In *Hopkins*, the court declined to find that the Service abused its discretion absent a showing of “unique circumstances which might lead [the court] to conclude that [the taxpayer] will suffer economic hardship.” *Hopkins*, 121 T.C. at 88. The court also noted that the income enjoyed as a result of the underpayment of tax was primarily used to rebuild the house in which the taxpayer continued to reside. *Id.* In *Ogonoski*, the taxpayer seeking relief did not introduce into evidence her financial records, such as her current salary, basic living expenses, and amounts of other debts that were necessary to support her claim that she would not be able to pay reasonable basic living expenses if relief was not granted. *Ogonoski*, 87 T.C.M. (CCH) at 1041.

²⁶⁸ What has been demonstrated are tendencies based on close scrutiny of the reasoning contained in the various types of cases addressed. As noted in the preceding discussion, no single approach is consistently observable in any of these types of cases. What is presented here is a qualitative, not quantitative analysis of the intellectual rationalizing that takes place in the Tax Court under certain conditions. As a result, one should not expect statistical data or empirical evidence to illustrate the differences in approach outlined above. Quite to the contrary, it has been asserted that statistical data would not reveal a systematic bias. See James Edward Maule, *Instant Replay, Weak Teams, and Disputed Calls: An Empirical Study of Alleged Tax Court Judge Bias*, 66 TENN. L. REV. 351 (1999). Scholars, most notably Daniel M. Schneider, have attempted to discern consistency and predictability in judicial attitudes using empirical data with only modest success. See generally Daniel M. Schneider, *Assessing and Predicting Who Wins Federal Tax Trial Decisions*, 37 WAKE FOREST L. REV. 473, 475 (2002) [hereinafter Schneider, *Assessing and Predicting*]; Daniel M. Schneider, *Empirical Research on Judicial Reasoning: Statutory Interpretation in Federal Tax Cases*, 31 N.M.L. REV. 325, 326 (2001) [hereinafter Schneider, *Empirical Research*]; Daniel M. Schneider, *Statutory Construction in Federal Appellate Tax Cases: The Effect of Judges’ Social Backgrounds and of Other Aspects of Litigation*, 13 WASH. U. J.L. & POL’Y 257, 258 (2003) [hereinafter Schneider, *Statutory Construction*]; see also George, *supra* note 5, at 1669-96.

appears reluctant to defer to the judgment of the Service.²⁶⁹ At the opposite end of the spectrum are individual taxpayers challenging collection action pursuant to Code section 6330 collections due process hearings, with regard to which the court generally embraces the Service's determination without much analysis.²⁷⁰ With regard to equitable relief cases under Code section 6015(f), the court defers to the Service, but only after a careful, independent review of the facts.²⁷¹ This deferential difference has important implications in regards to the ability to achieve tax justice in the principle federal tax tribunal. The objective of horizontal equity in the administration of tax justice is frustrated when taxpayers in the same position relative to one another—taxpayers seeking to overturn a Service decision on the basis of abuse of discretion—encounter what are in fact different degrees of discretion depending on the social status of the taxpayer.²⁷² Likewise, the concept of vertical equity is stood on its head when taxpayers with more resources to establish the asserted unreasonableness of Service determinations actually enjoy a lesser degree of deference to the Service, and those with few or no resources are faced with an almost insurmountable deference.²⁷³

The existence of this deferential difference cannot be wholly ascribed to accidental inequity or the systematic denial of justice.²⁷⁴ Implicit in the latter proposition is the premise that Tax Court judges intentionally act to unfairly deprive litigants of justice based on social status, a premise that

²⁶⁹ See *supra* notes 53-156 and accompanying text.

²⁷⁰ See *supra* notes 157-249 and accompanying text.

²⁷¹ See *supra* notes 250-267 and accompanying text.

²⁷² The term “social status” has a rich and diverse meaning in the social science literature. Weber defines status position as the “effective claim to social esteem.” MAX WEBER, *ECONOMY AND SOCIETY* (1922); see also BRYAN S. TURNER, *STATUS* (1988). The conditions of the taxpayer in the cases described *supra* (i.e., corporate status, individual obligor seeking financial relief, and joint obligor) can be characterized as each defining a separate social status in this context.

²⁷³ Compare *supra* notes 53-156 and accompanying text, with *supra* notes 140-221 and accompanying text.

²⁷⁴ Although the discussion herein relies on a qualitative analysis of the rationale exhibited in specific case types, there is some empirical evidence supporting this charge. Schneider, *Statutory Construction*, *supra* note 268, at 287, 288 (stating that “there were few statistically significant regressions, or even regressions approaching statistical significance, from which to infer that characteristics of judges’ social backgrounds or aspects of the cases generally predict outcome,” but that “[o]ne independent variable seems to appear more often: the legal status or type of taxpayer. This variable—namely, whether the taxpayer was an individual, business, etc.—appeared more frequently than others among the regressions that were statistically significant or approached statistical significance.”).

does not withstand empirical scrutiny.²⁷⁵ The first assertion, that the deferential difference is merely a reflection of accidental inequity, enjoys more widespread adherence and deserves closer investigation.²⁷⁶

Taxpayers bringing cases under the collections due process statute²⁷⁷ primarily proceed *pro se*.²⁷⁸ Cases under Code sections 446 and section 482, in contrast, typically involve large corporations with access to a battery of sophisticated counsel and expert witnesses.²⁷⁹ Perhaps the

²⁷⁵ See Maule, *supra* note 268. Professor Maule provides a thorough discussion of bias accusations against the court and refutes that assertion with detailed empirical evidence. See *generally id.*

²⁷⁶ It has long been asserted that Tax Court judges (and judges in general) bring specific personal biases to the bench, such biases result in a predictable pattern of decisions that might be characterized as inequitable. See Orley Ashenfelter et al., *Politics and the Judiciary: The Influence of Judicial Background on Case Outcomes*, 24 J. LEGAL STUD. 257, 257 (1995); James J. Brudney et al., *Judicial Hostility Toward Labor Unions? Applying the Social Background Model to a Celebrated Concern*, 60 OHIO ST. L.J. 1675, 1681 (1999); Theodore Eisenberg & Sheri Lynn Johnson, *The Effects of Intent: Do We Know How Legal Standards Work?*, 76 CORNELL L. REV. 1151, 1189-90 (1991) (asserting that, among other factors, the age of a judge has an impact on decisions about intent in racial discrimination cases); Tracey E. George, *Court Fixing*, 43 ARIZ. L. REV. 9, 16 (2001); Maule, *supra* note 268, at 420-21; Schneider, *Assessing and Predicting*, *supra* note 268, at 475; Schneider, *Statutory Construction*, *supra* note 268, at 259; Gregory C. Sisk et al., *Charting the Influences on the Judicial Mind: An Empirical Study of Judicial Reasoning*, 73 N.Y.U. L. REV. 1377, 1383-85 (1998).

²⁷⁷ I.R.C. § 6330 (2000).

²⁷⁸ See David Laro, *The Evolution of the Tax Court as an Independent Tribunal*, 1995 U. ILL. L. REV. 17, 26 (estimating that approximately 43% of Tax Court petitions are brought by *pro se* litigants); Theodore Tannenwald, Jr. & Mary Ann Cohen, *A Dialogue Between Tax Court Judges*, 46 TAX LAW. 672, 676 (1993) (stating that taxpayers represent themselves in more than half of the cases before the Tax Court); Theodore Tannenwald, Jr., *The Tax Litigation Process: Where It Is and Where It Is Going*, 44 REC. ASS'N B. CITY OF N.Y. 825, 827 (1989) (explaining that approximately 60% of Tax Court petitions are filed by *pro se* taxpayers); Vicky Tsilas, *Tax Court Chief Judge Discusses T2 Provisions*, TAX NOTES, Nov. 11, 1996, at 645 (stating that more than half of the Tax Court's cases involving more than \$10,000 in disputed taxes are filed by *pro se* taxpayers). Many *pro se* litigants are undoubtedly also low income taxpayers. Since 1999, the federal government has funded low income taxpayer clinics to represent these individuals. Although at least one such clinic now exists in every state, the number of low income taxpayers represented in Tax Court is still undoubtedly but a small fraction of the litigants bringing cases.

²⁷⁹ Typical among these cases is *Bank One Corp. v. Comm'r*, 120 T.C. 174 (2003), involving a major financial enterprise represented by eleven lawyers. *Id.* at 175. *Exxon Mobil Corp. v. Comm'r*, 114 T.C. 293 (2000), involved twelve attorneys for the petitioner. *Id.* at 294. *PNC Bancorp, Inc. v. Comm'r*, 110 T.C. 349 (1998), *rev'd*, 212 F.3d 822 (3d

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difference in observed results can be attributed primarily to the quality of the presentation of the taxpayer,²⁸⁰ thus compelling the conclusion that the deferential difference is random and inadvertent. The potential legitimacy of this practical explanation, however, does not overcome its inadequacy in justifying the results in terms of the taxpayer rather than the case. Retreating to the intellectual groundcover of accident to explain deferential difference is therefore wholly unsatisfactory.

This is not to say that there can be no explanation. This Part argues that the deferential difference can be explained using a variety of social science approaches,²⁸¹ most notably sociological theory with emphasis on exchange theory as developed by George C. Homans.²⁸² Because the subjects of the social sciences are thinking (some would even say rational) beings, capable of manipulating outcomes and influenced by innumerable external factors, it is folly to impose the requirement of strict consistency on the observed phenomenon.²⁸³ The argument, therefore, is not that social

Cir. 2000), involved only three attorneys for the petitioner, but included an amicus curiae brief filed on behalf of the American Bankers Association. *Id.* at 350 & n.2.

²⁸⁰ This assertion assumes that a *pro se* taxpayer is generally not as effective as a represented litigant. See Jonathan D. Rosenbloom, *Exploring Methods to Improve Management and Fairness in Pro Se Cases: A Study of the Pro Se Docket in the Southern District of New York*, 30 *FORDHAM URB. L.J.* 305 (2002) (positing that representation results in more effective presentation of cases); Kevin H. Smith, *Justice For All?: The Supreme Court's Denial of Pro Se Petitions for Certiorari*, 63 *ALB. L. REV.* 381, 387 (1999) (arguing that the Supreme "Court's denial of paid *pro se* civil petitions constitutes rational judicial action in light of both the Court's functions and the characteristics displayed by cases in which *pro se* petitions are filed"); Brian L. Holtzclaw, Comment, *Pro Se Litigants: Application of a Single Objective Standard Under FRCP 11 to Reduce Frivolous Litigation*, 16 *U. PUGET SOUND L. REV.* 1371 (1993); Spencer G. Park, Note, *Providing Equal Access to Equal Justice: A Statistical Study of Non-Prisoner Pro Se Litigation in the United States District Court for the Northern District of California in San Francisco*, 48 *HASTINGS L.J.* 821, 821-22 (1997).

²⁸¹ Turning to social science for help in understanding legal phenomena is not an original proposition by any means. See Richard E. Redding, *Why It Is Essential to Teach About Mental Health Issues in Criminal Law (And a Primer on How to Do It)*, 14 *WASH. U. J.L. & POL'Y* 407, 428 (2004) ("[L]aw itself is an empty vessel, relying on other disciplines to fill it with the social facts upon which law operates."). *But see* Michael Steven Green, *Hans Kelsen and the Logic of Legal Systems*, 54 *ALA. L. REV.* 365, 389 (2003) (describing the view that legal meaning transcends social acts).

²⁸² See GEORGE CASPAR HOMANS, *SOCIAL BEHAVIOR: ITS ELEMENTARY FORMS* (Robert K. Merton ed., rev. ed. 1974).

²⁸³ Weber advocated what he termed "adequate causality," meaning that the best we can do is make probabilistic statements regarding the relationships between observed social phenomena. MAX WEBER, *THE METHODOLOGY OF THE SOCIAL SCIENCES* 183-84 (Edward
(continued)

science provides unassailable predictors of behavior, but rather that what is provided is a rational framework within which the purported explanations illuminate the underlying social dynamics at work in these cases. The implication of this argument is that the deferential difference is not surprising at all; that there are not only reasons it exists, but perhaps that those reasons even legitimize unjust outcomes. Legitimate outcomes, however, do not necessarily produce justice, a topic that I will take up in due course.

A. *Sociological Theory and Social Psychology*

Social psychology is the method of discerning and describing human experience in the context of interaction between the world and the self.²⁸⁴ Traditional social psychology begins with the study of individual thought processes and behavior that serves as a foundation from which to construct a theory of social experience.²⁸⁵ While pure psychologists are generally inclined to give greater attention to the bearing of thought processes, personality characteristics, and their changes across the life-cycle, pure sociologists are more interested in understanding the relationships between group structures and processes and are, therefore, inclined to give greater attention to social settings and individuals' roles within them. Social psychology bridges this gap. As such, social psychology has had many implications in the analysis of law and its broader social implications.²⁸⁶

A. Shils & Henry A. Finch trans. & eds., 1949). The goal of the social sciences is not to establish static scientific laws, but rather to estimate the degree to which a certain observed effect is favored by certain observed conditions. *Id.* at 183; *see also* GEORGE RITZER, *SOCIOLOGICAL THEORY* 118 (Phillip A. Butcher & Ira C. Roberts eds., McGraw-Hill, Inc. 3d ed. 1992) (1983).

²⁸⁴ While the origins of social psychology cannot be ascertained with certainty, the earliest works to use the term appeared in the early twentieth century. *See, e.g.*, WILLIAM MCDUGALL, *INTRODUCTION TO SOCIAL PSYCHOLOGY* (1908).

²⁸⁵ The most prominent modern social psychology scholar was George H. Mead, who turned this paradigm on its head, viewing individual psychology as a product of social interaction. It has been noted that, for Mead, the proper analysis was “not mind and then society; but society first and then minds arising with that society.” GEORGE RITZER, *CONTEMPORARY SOCIOLOGICAL THEORY* 192 (Phillip A. Butcher & Ira C. Roberts eds., McGraw-Hill, Inc. 3d ed. 1992) (1983). George C. Homans followed in this line of theory. *See infra* notes 309-413 and accompanying text. Some have claimed that the discipline of social psychology was founded as a result of racists searching for explanations of “national character” and superiority in Europe before the Second World War.

²⁸⁶ *See* *Brown v. Bd. of Educ.*, 347 U.S. 483, 494-95 & 494 n.11 (1954). This footnote cited psychologists to the effect that state imposed segregation led to a feeling of inferiority of African Americans, which retards their ability to learn. *See id.* at 494 n.11. Footnote 11 has been referred to as the “famous social psychology footnote.” Kelly A.

(continued)

Explanations of social order, or how and why societies cohere, are the central concern of sociology.²⁸⁷ Such explanations are of necessity grounded in assumptions about things that are not directly observable, and this is the function of theory.²⁸⁸ In its relatively brief history,²⁸⁹ the discipline of sociology has generated a plethora of theories to assist in the task of explaining society and social order. One such approach is a form of methodological individualism²⁹⁰ that has been labeled “exchange

MacGrady & John W. Van Doren, *AALS Constitutional Law Panel on Brown, Another Council of Nicaea?*, 35 AKRON L. REV. 371, 375 (2002); see also E. ALLAN LIND & TOM R. TYLER, *THE SOCIAL PSYCHOLOGY OF PROCEDURAL JUSTICE* (Plenum Press 1988); Dan Coates & Steven Penrod, *Social Psychology and the Emergence of Disputes*, 15 LAW & SOC'Y REV. 655 (1981); Eleanor D. Kinney, *Tapping and Resolving Consumer Concerns About Health Care*, 26 AM. J.L. & MED. 335, 390-91 (2000) (noting that “[e]mpirical theorists in law and social psychology have endeavored to identify characteristics of fair process through empirical experiments with simulated or actual adjudicative models in which research subjects offer perceptions of the fairness of adjudicative models with different process elements”).

²⁸⁷ A DICTIONARY OF SOCIOLOGY 617 (Gordon Marshal ed., 2d ed. 1998).

²⁸⁸ Alfred North Whitehead equated sociological theory with “the understanding of human life.” ALFRED NORTH WHITEHEAD, *ADVENTURES OF IDEAS* 353 (1933). Another commentator has described sociological theory as “a set of mandatory frames for squinting at the world.” David Martin, *Evangelicals and Economic Culture in Latin America: An Interim Comment on Research in Progress*, 39 SOC. COMPASS 9, 10 (1992). Sociological theory has long been a basis for legal scholarship. See, e.g., LUHMANN, *supra* note 5; Robert C. Ellickson, *A Critique of Economic and Sociological Theories of Social Control*, 16 J. LEGAL STUD. 67 (1987). Some jurists have expressed a disdain for sociological theory, as did Chief Justice Burger of the United States Supreme Court in his dissent in a school desegregation case. *Wright v. Council of Emporia*, 407 U.S. 451, 477 (1972) (Burger, C.J., dissenting) (commenting that the approach approved by the majority “gives controlling weight to sociological theories, not constitutional doctrine”). On the other hand, the judicial branch has also recognized the use of sociological theory in the development of law. *Palmigiano v. Garrahy*, 443 F. Supp. 956, 981 n.32 (D.R.I. 1977) (stating, “This Court knows that a sociological theory or idea may ripen into constitutional law; many such theories and ideas have done so.” (quoting *Holt v. Sarver*, 309 F. Supp. 362, 379 (E.D. Ark. 1970))).

²⁸⁹ August Comte coined the term “sociology” in 1822. RITZER, *supra* note 285, at 13, 15. Some, however, posit that the terms of the social science were established during the Enlightenment. See GEOFFREY HAWTHORN, *ENLIGHTENMENT AND DESPAIR: A HISTORY OF SOCIOLOGY* (1976); ROBERT A. NISBET, *THE SOCIOLOGICAL TRADITION* (1966); STEVEN SEIDMAN, *LIBERALISM AND THE ORIGINS OF EUROPEAN SOCIAL THEORY* (1983); IRVING M. ZEITLIN, *IDEOLOGY AND THE DEVELOPMENT OF SOCIOLOGICAL THEORY* (4th ed. 1990).

²⁹⁰ Methodological individualism refers to “the doctrine that social structures are the unintended consequences of individual actions.” ALEX CALLINICOS, *SOCIAL THEORY: A* (continued)

theory.²⁹¹ In general, exchange theory asserts that social order represents the unplanned outcome of the aggregate exchanges that take place between members of society.²⁹² As such, exchange theory occupies that amorphous

HISTORICAL INTRODUCTION 130-31 (1999). It is said to have developed out of the marginalist economics movement of the late nineteenth century. *Id.* at 130.

²⁹¹ Interestingly, although George C. Homans is generally credited with the creation of modern exchange theory, he did not originate the term and, in fact, rejected its application to his work. HOMANS, *supra* note 282, at 56. In describing his theory, Homans observed,

[S]ome social scientists have tended to call the type of explanation we put forward “exchange theory.” We believe that this practice should be given up. It implies that exchange theory is somehow a distinct and independent theory, whereas in our view it consists simply of behavioral psychology applied to the interaction of men.

Id.

²⁹² A DICTIONARY OF SOCIOLOGY, *supra* note 287, at 209. Legal scholars have employed exchange theory in a number of contexts. See Flavio Rose, *Related Contacts and Personal Jurisdiction: The “But For” Test*, 82 CAL. L. REV. 1545 (1994) (discussing exchange theory in the context of personal jurisdiction); Elizabeth S. Scott, *Pluralism, Parental Preference, and Child Custody*, 80 CAL. L. REV. 615, 660 n.144 (1992) (discussing exchange theory in determining gender roles in family participation); Richard E. Speidel, *Warranty Theory, Economic Loss, and the Privity Requirement: Once More into the Void*, 67 B.U. L. REV. 9 (1987) (using exchange theory to argue for the abolition of the privity defense in economic loss cases). Exchange theory has been extensively discussed in regard to the relational theory of contracts, espoused most notably by Ian Macneil. See Ian R. Macneil, *Political Exchange as Relational Contract*, in GENERALIZED POLITICAL EXCHANGE: ANTAGONISTIC COOPERATION AND INTEGRATED POLICY CIRCUITS 151 (Bernd Marin ed., 1990); Ian R. Macneil, *Reflections on Relational Contract Theory After a Neo-Classical Seminar*, in IMPLICIT DIMENSIONS OF CONTRACT: DISCRETE, RELATIONAL AND NETWORK CONTRACTS 207 (David Campbell et al. eds., 2003); Ian R. Macneil, *Bureaucracy and Contracts of Adhesion*, 22 OSGOODE HALL L.J. 5 (1984); Ian R. Macneil, *Contracting Worlds and Essential Contract Theory*, 9 SOC. & LEGAL STUD. 431 (2000); Ian R. Macneil, *Contracts: Adjustment of Long-Term Economic Relations Under Classical, Neoclassical, and Relational Contract Law*, 72 NW. U. L. REV. 854 (1978); Ian R. Macneil, *Economic Analysis of Contractual Relations: Its Shortfalls and the Need for a “Rich Classification Apparatus,”* 75 NW. U. L. REV. 1018 (1981); Ian R. Macneil, *Exchange Revisited: Individual Utility and Social Solidarity*, 96 ETHICS 567 (1986); Ian R. Macneil, *Relational Contract Theory as Sociology: A Reply to Professors Lendenberg and DeVos*, 143 J. INSTITUTIONAL & THEORETICAL ECON. 272 (1987); Ian R. Macneil, *Relational Contract Theory: Challenges and Queries*, 94 NW. U. L. REV. 877 (2000); Ian R. Macneil, *Relational Contract: What We Do and Do Not Know*, 1985 WIS. L. REV. 483; Ian R. Macneil, *The Many Futures of Contracts*, 47 S. CAL. L. REV. 691 (1974); Ian R. Macneil, (continued)

plane existing somewhere between pure sociological theory and social psychology.

Exchange theory is founded upon rational choice concepts borrowed from economics,²⁹³ and sociologists have developed rational choice theory as a discernable variant of exchange theory.²⁹⁴ Like exchange theory,

Values in Contract: Internal and External, 78 NW. U. L. REV. 340 (1983); Ian Ayers & Robert Gertner, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 YALE L.J. 87 (1989); Randy E. Barnett, *Conflicting Visions: A Critique of Ian Macneil's Relational Theory of Contract*, 78 VA. L. REV. 1175, 1179-80 (1992); Jean Braucher, *Contract Versus Contractarianism: The Regulatory Role of Contract Law*, 47 WASH. & LEE L. REV. 697 (1990); Jay M. Feinman, *Relational Contract and Default Rules*, 3 S. CAL. INTERDISC. L.J. 43 (1993); Jay M. Feinman, *Relational Contract Theory in Context*, 94 NW. U. L. REV. 737 (2000); Paul J. Gudel, *Relational Contract Theory and the Concept of Exchange*, 46 BUFF. L. REV. 763 (1998); Matthew Lees, *Contract, Conscience, Communitarian Conspiracies and Confucius: Normativism Through the Looking Glass of Relational Contract Theory*, 25 MELB. U. L. REV. 82 (2001); Stewart Macaulay, *An Empirical View of Contract*, 1985 WIS. L. REV. 465; Stewart Macaulay, *Elegant Models, Empirical Pictures, and the Complexities of Contract*, 11 LAW & SOC. REV. 507 (1977); Stewart Macaulay, *Non-Contractual Relations in Business: A Preliminary Study*, 28 AM. SOC. REV. 55 (1963); Stewart Macaulay, *Relational Contracts Floating on a Sea of Custom? Thoughts About the Ideas of Ian Macneil and Lisa Bernstein*, 94 NW. U. L. REV. 775 (2000); Elizabeth Mertz, *An Afterword: Tapping the Promise of Relational Contract Theory—"Real" Legal Language and a New Legal Realism*, 94 NW. U. L. REV. 909 (2000); Alan Schwartz, *Relational Contracts in the Courts: An Analysis of Incomplete Agreements and Judicial Strategies*, 21 J. LEGAL STUD. 271 (1992); Robert E. Scott, *A Relational Theory of Default Rules for Commercial Contracts*, 19 J. LEGAL STUD. 597 (1990); Elizabeth S. Scott & Robert E. Scott, *Marriage as Relational Contract*, 84 VA. L. REV. 1225 (1998); Richard E. Speidel, *Afterword: The Shifting Domain of Contract*, 90 NW. U. L. REV. 254 (1995); Richard E. Speidel, *Article 2 and Relational Sales Contracts*, 26 LOY. L.A. L. REV. 789 (1993); Richard E. Speidel, *Court-Imposed Price Adjustments Under Long-Term Supply Contracts*, 76 NW. U. L. REV. 369 (1981); Richard E. Speidel, *The Characteristics and Challenges of Relational Contracts*, 94 NW. U. L. REV. 823 (2000).

²⁹³ Homans borrows heavily from economic theory, using concepts such as cost, profit, and the law of diminishing returns to formulate his sociological theory. Law and economics scholars have also equated exchange theory and rational choice. See Thomas S. Ulen, *Rational Choice Theory in Law and Economics*, in *ENCYCLOPEDIA OF LAW AND ECONOMICS* 790 (Boudewijn Bouckaert & Gerrit De Geest eds., 2000); Charles R. P. Pouncy, *The Rational Rogue: Neoclassical Economic Ideology in the Regulation of the Financial Professional*, 26 VT. L. REV. 263 (2002).

²⁹⁴ The two major variants of sociological exchange theory are rational choice theory and anthropological-exchange theory, which "claims that both order and the pursuit of
(continued)

rational choice theory locates the source of social order in the personal advantage individuals gain through cooperative exchange. However, rational choice theory also posits that people always make outcome-maximizing decisions. By assuming a maximization objective, rational choice theory moves beyond exchange theory as originally conceived.²⁹⁵ Not all would agree with this characterization; at least one theorist characterizes rational choice and social exchange theory as being, in fact, the same approach.²⁹⁶

The rational actor assumption dominates economics, but the notion of individuals constantly calculating utility maximization strains credulity in a micro behavioral context, as several critics have noted.²⁹⁷ In reaction to this weakness in rational choice theory, an empirical reformulation known as “prospect theory” has emerged.²⁹⁸ Like rational choice theory, prospect theory assumes that people try to maximize outcomes.²⁹⁹ The latter approach, however, posits that individuals actually fail to maximize outcomes in systematic and predictable ways.³⁰⁰ Although prospect theory was developed by two psychologists noted for their work in the psychology of economics, it is the logical progeny of the work in sociological exchange theory begun by Homans and progressing through

individual advantage are effects of the underlying ritual and symbolic nature of the thing exchanged.” A DICTIONARY OF SOCIOLOGY, *supra* note 287, at 209.

²⁹⁵ Homans, who is generally accepted as the father of modern exchange theory, accepted a “short run rationality,” but rejected the idea that humans consciously calculate maximizing behaviors under all circumstances. *See* HOMANS, *supra* note 282, at 49. For Homans, rationality as applicable to human behavior meant little more than that people “know enough to come in out of the rain unless they enjoy getting soaked.” *Id.* Calculation for long run effects, he posits, is the exception, not the rule. *Id.* Thus, rather than assuming a purely rational actor, Homans’ view represents more a blending of rationality and hedonism.

²⁹⁶ Ronald L. Akers, *Rational Choice, Deterrence, and Social Learning Theory in Criminology: The Path Not Taken*, 81 J. CRIM. L. & CRIMINOLOGY 653, 656 n.14 (1990) (citing ANTHONY HEATH, *RATIONAL CHOICE AND SOCIAL EXCHANGE: A CRITIQUE OF EXCHANGE THEORY* (1976) (criticizing both Homans and Blau and preferring rational choice terminology)).

²⁹⁷ *See, e.g.*, Russell B. Korobkin & Thomas S. Ulen, *Law and Behavioral Science: Removing the Rationality Assumption from Law and Economics*, 88 CAL. L. REV. 1051, 1055 (2000) (observing that there is “too much credible experimental evidence that individuals frequently act in ways that are incompatible with the assumptions of rational choice theory” in its pure form).

²⁹⁸ *See infra* notes 438-459 and accompanying text.

²⁹⁹ *See infra* notes 438-459 and accompanying text.

³⁰⁰ Daniel Kahneman & Amos Tversky, *Prospect Theory: An Analysis of Decision Under Risk*, 47 ECONOMETRICA 263 (1979).

the refinement efforts of Blau, Molm, Cook, Emerson, and others.³⁰¹ Exchange theory can be described as an attempt to explain social interaction by rational choice methods,³⁰² and prospect theory is part of that same intellectual continuum. It is my intent here to assess the soundness of exchange theory and to analyze whether prospect theory can be merged with exchange theory to remedy any perceived weaknesses of the latter in explaining the deferential difference. To do so we must first begin with an understanding of exchange theory, as originally conceived and as modified by subsequent scholars.

1. *Homans' Theory*

Although the roots of exchange theory may be traced at least as far back as the utilitarian views of Adam Smith,³⁰³ the modern incarnation of this approach is generally considered to have emerged in the middle of the twentieth century with the work of George C. Homans.³⁰⁴ Homans' work

³⁰¹ See *infra* notes 409-437 and accompanying text.

³⁰² A DICTIONARY OF SOCIOLOGY, *supra* note 287, at 209.

³⁰³ While Smith's context was political economy, we can hear in his words the intellectual genealogy of later work undertaken by Homans and others:

Whoever offers to another a bargain of any kind, proposes to do this: Give me that which I want, and you shall have this which you want, is the meaning of every such offer; and it is in this manner that we obtain from one another the far greater part of those good offices which we stand in need of.

ADAM SMITH, WEALTH OF NATIONS 20 (Prometheus Books 1991) (1776). Any effort to pinpoint the birth of the exchange idea, however, is invariably arbitrary. See LIONEL ROBBINS, A HISTORY OF ECONOMIC THOUGHT: THE LSE LECTURES 19-21, 23 (Steven G. Medema & Warren J. Samuels eds., 1998) (citing the use of exchange terminology in the moral philosophy of Aristotle).

³⁰⁴ See, e.g., RITZER, *supra* note 285, at 284. Harvard social psychologist George Casper Homans' 1958 article *Social Behavior as Exchange*, 63 AM. J. OF SOC. 597 (1958), and his 1961 book, HOMANS, *supra* note 282, arguably mark the beginning of modern exchange theory in sociology. A colleague of Talcott Parsons, Homans rooted his logic in the behavioral psychology developed by B.F. Skinner. See RITZER, *supra* note 285, at 292-93. Although most properly understood as a dissenting reaction to structural functionalism, see *id.* at 289, Homans' theory acknowledged the importance of social structures and focused on reconciling them to individual action. *Id.* at 291-92. In particular, his work attempted to explain how enduring social structures could arise from and be maintained by individuals, and in this way his approach stands in stark contrast to the Durkheimian emphasis on social structure arising separately and apart from individual influence. *Id.*; see also EMILE DURKHEIM, THE DIVISION OF LABOR IN SOCIETY (W.D. Halls trans., The Free Press 1984) (1893).

stands in contrast to what had been the predominant line of thought in sociological theory espoused by Emile Durkheim.³⁰⁵ Like Homans, Durkheim observed that individual interaction may give rise to the emergence of new social phenomena.³⁰⁶ Durkheim, however, believed that social structures are something more than the results of interactions among individuals, that society constitutes a reality in its own right.³⁰⁷ Thus, the

³⁰⁵ Durkheim is considered to be the founder of the so-called functionalist theories in sociology. See CALLINICOS, *supra* note 290, at 123 n.1. His most influential work was *The Division of Labor in Society*, DURKHEIM, *supra* note 304, published in 1893. In that book, Durkheim argued that society evolved from a state in which mechanical solidarity progressed into organic solidarity as the society matured and adopted more specialized functions. During periods of mechanical solidarity, society was characterized by its use of repressive, or criminal, law based on swift, severe punishment for transgressions against the commonly shared moral values. *Id.* at 31. In a society characterized by organic solidarity, on the other hand, restitutive (i.e., civil) law dominates. *Id.* at 68. As society emerges from mechanical solidarity, the common bonds of shared values are loosened, and an accepted notion of right and wrong becomes difficult to discern, a state that Durkheim refers to as “anomie.” Durkheim’s other books include the following: EMILE DURKHEIM, *THE ELEMENTARY FORMS OF THE RELIGIOUS LIFE* (Joseph Ward Swain trans., The Free Press 1965) (1912); *THE RULES OF SOCIOLOGICAL METHOD* (W.D. Halls trans., The Free Press 1982) (1895) [hereinafter DURKHEIM, *THE RULES*]; *SUICIDE: A STUDY IN SOCIOLOGY* (George Simpson ed., George Simpson & John A. Spaulding trans., Free Press 1951) (1897). For an Internet collection of information on Durkheim, see Robert Alun Jones, *The Durkheim Pages*, at <http://www.relst.uiuc.edu/durkheim/> (last visited Nov. 4, 2004).

³⁰⁶ DURKHEIM, *THE RULES*, *supra* note 305, at 54. Durkheim also considered the possibility that social phenomena are merely the development and realization of certain ideas. *Id.* Even if this were the case, Durkheim posited, we do not know *a priori* what these ideas are, for social phenomena are presented to us only “from the outside,” and therefore must be considered in themselves, detached from the conscious beings who form their own mental representations of them. *Id.* at 70. In other words, even if social facts do not really have the essential features of things, in order to understand social interaction, we must proceed as if they did. For Durkheim, a “thing” is recognizable as such because it is intractable to all modification by mere acts of will, and it is precisely this property of resistance to the action of the individual will that characterizes social facts. *Id.*; see also ROBERT ALUN JONES, *EMILE DURKHEIM: AN INTRODUCTION TO FOUR MAJOR WORKS* 63, 60-81 (1986).

³⁰⁷ Modern sociologists commenting on law have also made use of the concept of social structures. See KAI T. ERIKSON, *WAYWARD PURITANS: A STUDY IN THE SOCIOLOGY OF DEVIANCE* (1966) (describing how the social definitions of crime and deviance in Puritan society reflected the values and social structure of that society). Likewise, legal scholars have made use of the concept. See Andrew E. Taslitz, *Patriarchal Stories I: Cultural Rape Narratives in the Courtroom*, 5 S. CAL. REV. L. & WOMEN’S STUD. 387, 402-03 (1996) (describing Giddens’ theory of structuration).

social facts that constitute reality exist independently of individuals and exert a coercive power over them.³⁰⁸ Homans rejected this view, instead insisting that emergent social structures could be explained by *psychological* principles, taking what he termed “the opposite position” from Durkheim and labeling himself a psychological reductionist.³⁰⁹ Durkheim’s formulation that social facts are caused by social facts misses the point, in Homans’ view.³¹⁰ The latter felt that what needs explanation is the *relationship* between cause and effect; in other words, *why* one social fact causes another. For Homans, that explanation was inevitably rooted in individual human behavior.³¹¹

Thus, while Durkheim would have identified the deferential difference as a social fact emanating from other social facts (such as the social status of the taxpayer), we must turn to Homans for help in understanding the *connection* between the social characteristics of the taxpayer and the disparate outcomes in abuse of discretion cases. Homans injected an individual mediator into Durkheim’s formulation. A social fact (like the non-payment of tax liabilities) results in individual responses, and those individual responses lead to new social facts (the deferential difference).³¹² The essential ingredient, therefore, is the individual behavior, not the social fact itself.³¹³

Homans asserted that social structures, or institutions, can be defined as “relatively persistent patterns of social behavior to whose maintenance

³⁰⁸ JONES, *supra* note 306, at 60-61. Durkheim defined a “social fact” as a category of facts consisting of manners of acting, thinking, and feeling external to the individual. DURKHEIM, *THE RULES*, *supra* note 305, at 52. Social facts, according to Durkheim, are invested with a coercive power by virtue of which they exercise control over the individual. *Id.* at 51. Since these facts consisted of actions, thoughts, and feelings, they should not be confused with biological phenomena, but they can also not be explained by psychology, for they existed outside of, and separate from, the individual conscience. *Id.* at 52; *see also* JONES, *supra* note 306, at 60. The deferential difference, in Durkheimian terms, would be a social fact. As Durkheim insisted that social facts are caused themselves by social facts, he would assert that the deferential difference exists separate and apart from the individual actors (i.e., judges and litigants) to whom we would normally ascribe their creation.

³⁰⁹ HOMANS, *supra* note 282, at 12. Homans is most often considered to be a social psychologist. *See supra* note 285 and accompanying text.

³¹⁰ RITZER, *supra* note 285, at 285.

³¹¹ *Id.* Hence, Homans has more likelihood of offering an explanation for the deferential difference. Whereas Durkheim might give us the foundation for explaining the phenomenon from a macro-societal perspective, only with Homans do we encounter the possibility of dissecting the dynamics that go into the creation of the deferential difference.

³¹² *Id.*

³¹³ *Id.*

the actions of many men contribute.”³¹⁴ The deferential difference may thus be described as a Homanian social structure, just as it could be described as a Durkheimian social fact. Once social structures have been created, Homans maintained that they have continuing effects on the behavior of individuals who take part in them.³¹⁵ This leads to a sort of social inertia that might help to explain the remarkably consistent pattern of judicial thinking with regard to abuse of discretion cases.³¹⁶

The structural element here is the Tax Court adjudicative process itself. If Homans were to take up the issue, he might posit that the deferential difference is merely a further effect of the social structure inherent in the Tax Court litigation process vis-à-vis taxpayers with various characteristics of social standing. More importantly, what has been described as “the hallmark” of this approach was Homans’ assertion that further effects such as these can be explained by the same propositions as those used to explain the creation of the structures in the first place.³¹⁷ To fully understand the deferential difference in Homanian terms, therefore, we must delve into his theory regarding social structures, which is cast in the form of six general propositions.³¹⁸

The six primary propositions of Homans’ theory are as follows: (1) the success proposition; (2) the stimulus proposition; (3) the value proposition; (4) the deprivation-satiation proposition; (5) the aggression-approval proposition; and (6) the rationality proposition.³¹⁹ Homans asserts that these axioms form a unified system of propositions that must be considered as a whole.³²⁰ In other words, the effects produced by one proposition cannot be divorced from the effects produced by the others.³²¹ Furthermore, while Homans places the individual human actor at center stage (in contrast to Durkheim, as noted above), he acknowledges that there is a certain inevitableness, or mechanical nature, regarding what often seems to be spontaneity in social behavior.³²² He also acknowledges that historical experience of both individuals and society influences

³¹⁴ *Id.* at 289. This is the manner in which Homans defined social institutions. Alternatively, social institutions may be described as “all [of] the structural components of a society through which the main concerns and activities [of the society] are organized, and social needs are . . . met.” A DICTIONARY OF SOCIOLOGY, *supra* note 287, at 317-18.

³¹⁵ RITZER, *supra* note 285, at 287.

³¹⁶ See *supra* notes 50-267 and accompanying text.

³¹⁷ George Caspar Homans, *George Caspar Homans: An Autobiographical Sketch*, in RITZER, *supra* note 285, at 286-87.

³¹⁸ HOMANS, *supra* note 282, at 15-47.

³¹⁹ *Id.*

³²⁰ *Id.* at 40.

³²¹ *Id.*

³²² See *id.* at 41.

behavior, maintaining that “there is always some tendency for past behavior to maintain itself.”³²³ These observations seem somewhat out of place in the context of Homans’ anti-Durkheimian views regarding the existence of real social entity separate and apart from its individual components. Homans’ concepts of historicity and the “mechanical nature” of behavior seem to admit of some invisible, exogenous force compelling man to behave in certain ways.³²⁴ In this sense, at least, there appears to be room in Homans’ framework for the evolutionary conception of social change adopted by Durkheim.³²⁵

To evaluate the usefulness of Homans’ theory in explaining the deferential difference, we need to examine each of the six propositions. The success proposition maintains that the frequency of reward is directly proportional to the likelihood that some action will be performed.³²⁶ Behavior in accordance with this proposition involves the following three stages: action, reward, and repetition.³²⁷ The third stage (repetition) will result even if the reward was not caused by the action, but was rather a matter of chance.³²⁸ Homans offers two important qualifications regarding the success proposition. First, he notes that a shorter interval between rewards increases the likelihood of repetition of the action because it enables the actor to “see” the connection between the act and the reward more easily.³²⁹ Second, irregular patterns of reward encourage repetition.³³⁰ Homans hypothesizes that the reason for this phenomena is rooted in its survival value; just as hunters must relentlessly pursue their quarry to survive, so too our instincts compel us to continually repeat behavior that we know will be rewarded eventually.³³¹

At first glance there would seem to be little room for the application of the success proposition in the context of case-level judicial decision

³²³ *Id.*

³²⁴ *See id.* at 40-43.

³²⁵ Acceptance of evolutionary change in the law rationalizes changing judicial attitudes over time. *See infra* note 340.

³²⁶ HOMANS, *supra* note 282, at 16.

³²⁷ *Id.* at 16-18. This proposition is most obviously influenced by Homans’ work with Skinner. To support this proposition of his thesis, Homans explicitly relies on the work of Herrnstein in which the latter developed a formulation to predict the behavior of pigeons. *Id.* at 21-22; *see also* R. J. Herrnstein, *Quantitative Hedonism*, 8 J. PSYCHIATRIC RES. 399 (1971).

³²⁸ *See* HOMANS, *supra* note 282, at 16.

³²⁹ *Id.* at 17.

³³⁰ *See id.* at 17-18. This proposition is derived directly from Skinner’s work. *Id.* at 17; *see also* C.B. FERSTER & B. F. SKINNER, SCHEDULES OF REINFORCEMENT (Copley 1997) (1957).

³³¹ HOMANS, *supra* note 282, at 18.

making, although scholars have analyzed the viability of this portion of Homans' model with respect to the selection of judicial nominees.³³² Specific taxpayers, of course, do not generally appear before the same judge in multiple cases, and thus the idea of action, reward, and repetition seems out of place in this context. On the macro level, however, the success proposition has some vitality. Judges do not like to be overturned,³³³ and the chance that a Tax Court decision will be overturned on appeal is much greater in the case of a high degree of deference afforded to the Service with regard to a corporate taxpayer.³³⁴ The success proposition may, therefore, have a hand in explaining why the Tax Court appears to be more reluctant to grant deference to the Service when a corporate taxpayer is involved.³³⁵

The stimulus proposition asserts that the more similar a stimulus is to a previously rewarded stimulus, the more likely a person is to perform the action that resulted in the initial stimulus.³³⁶ Homans tells us that the

³³² See, e.g., Little, *supra* note 5, at 725 (“[T]he type of nonjudicial expression adequate to reciprocate for a federal judgeship is apt to be so significant as to draw the judge into a close web of exchange or intimacy with her benefactor.”). Professor Little cites Homans' views as expressed in the context of the success proposition as support for her assertion. *Id.* at 725 n.137.

³³³ This proposition seems intuitive. See Karin Wolfe, *A Tale of Two States: Successes and Failures of the 1980 Hague Convention on the Civil Aspects of International Child Abduction in the United States and Germany*, 33 N.Y.U. J. INT'L L. & POL. 285, 324 (2000) (citing RUDOLF B. SCHLESINGER ET AL., *COMPARATIVE LAW: CASES-TEXT-MATERIALS* 714 (6th ed. 1998)). Wolfe notes, in the context of describing the attitudes of German judges, “Not only do judges not like to be overturned, ‘but the fear of reversal is, of course, particularly strong in countries in which the judge is a civil servant whose promotion may be adversely affected if too many of his decisions are reversed.’” *Id.*

³³⁴ As of this writing, the Tax Court has yet to be overturned on appeal with regard to a collection due process case involving an individual taxpayer. On the other hand, multiple abuse of discretion cases involving corporate taxpayers have been overturned by a court of appeals. See, e.g., *USFreightways Corp. v. Comm’r*, 113 T.C. 329 (1999), *rev’d*, 270 F.3d 1137 (7th Cir. 2001); *Consol. Mfg., Inc. v. Comm’r*, 111 T.C. 1 (1998), *aff’d in part, rev’d in part*, 249 F.3d 1231 (10th Cir. 2001); *Tate & Lyle, Inc. v. Comm’r*, 103 T.C. 656 (1994), *rev’d*, 87 F.3d 99 (3d Cir. 1996); *Foglesong v. Comm’r*, 35 T.C.M. (CCH) 1309 (1976), *rev’d*, 621 F.2d 865 (7th Cir. 1980).

³³⁵ It should be noted that Code section 6330 cases and Code section 6015(f) cases are of recent vintage, having only become statutorily authorized in 1998. I.R.C. §§ 6015, 6330 (2000). It may be somewhat misleading to characterize the likelihood of success on appeal for these cases in comparison with the corporate taxpayer abuse of discretion cases, which have been litigated for many more years. Further reflection on the assertions made herein will be warranted as more empirical evidence is produced.

³³⁶ HOMANS, *supra* note 282, at 22-23.

connection between the stimuli and the action may result in either generalization or discrimination;³³⁷ which result obtains in a given circumstance is the subject of the psychological field of study known as perception or cognition, which Homans equates with behavior.³³⁸ As with the success proposition, a lengthy interval between the stimuli and the corresponding behavior may result in a failure of the former to cause the latter. Also like the success proposition, the stimulus proposition may help to explain judicial reluctance to defer to the Service in those instances where they are more likely to be overturned.³³⁹ Taken together, the success and stimulus propositions provide a conceptual foundation for the fact that judicial attitudes can, and do, change over time.³⁴⁰ Such a change will only take place, however, if the constituent rewards are modified.³⁴¹

³³⁷ *Id.* at 23.

³³⁸ *Id.* at 24. According to Homans,

The real intellectual danger is . . . that some social scientists should believe perception and cognition to be essentially different from other behavior and thus require a different type of explanation. They are not essentially different. The ways in which men perceive and think are just as much determined by the results they achieve as are other kinds of behavior.

Id.

³³⁹ See *supra* note 333 and accompanying text.

³⁴⁰ This sort of macro level change has been observed, for example, in the area of securities litigation. See, e.g., *SEC v. Blatt*, 583 F.2d 1325, 1334 (5th Cir. 1978) (commenting on the recent change in the judicial attitude toward SEC injunctions); *SEC v. Commonwealth Chem. Sec., Inc.*, 574 F.2d 90, 99 (2d Cir. 1978) (“[T]he current judicial attitude toward the issuance of injunctions on the basis of past violations . . . has become more circumspect than in earlier days.”); Jonathan Eisenberg, *SEC Injunctive Actions*, 14 REV. SEC. REG. 901, 904-06 (1981) (examining the trend during 1970s in which federal courts expressly constrained SEC’s ability to obtain injunctive relief); David Franklin Levy, *The Impact of the Remedies Act on the SEC’s Ability to Obtain Injunctive Relief*, 44 AM. U. L. REV. 645 (1994) (describing the evolution of judicial change). Scholars have also described changes in judicial attitudes related to social or cultural dynamics. See Susan Brodie Haire et al., *Attorney Expertise, Litigant Success, and Judicial Decisionmaking in the U.S. Courts of Appeals*, 33 LAW & SOC’Y REV. 667 *passim* (1999); Vicki Schultz & Stephen Petterson, *Race, Gender, Work, and Choice: An Empirical Study of the Lack of Interest Defense in Title VII Cases Challenging Job Segregation*, 59 U. CHI. L. REV. 1073 *passim* (1992); Chauncey L. Walker & Scott D. Avitabile, *Regulatory Takings, Historic Preservation and Property Rights Since Penn Central: The Move Toward Greater Protection*, 6 FORDHAM ENVTL. L.J. 819, 819, 835-36, 840-42 (1995) (describing a change in judicial attitudes toward regulatory takings); Marion Wanless, *Mandatory Arrest: A Step Toward Eradicating Domestic Violence, but Is It Enough?*, 1996 U. ILL. L. REV. 533, 542 n.95, 568.

(continued)

Homans' value proposition has perhaps drawn the most criticism from sociological theory scholars.³⁴² It states that value is directly proportional to the likelihood of performing an action.³⁴³ The crux of the criticism is that Homans never defines value, other than by its results (i.e., something is valuable because it results in action and it results in action because it is valuable).³⁴⁴ For Homans, "value" is a rather nebulous concept that is "infinitely varied."³⁴⁵ Some values are learned, and some are genetic.³⁴⁶ Homans does allow that some values are generalized, meaning that the nature of a particular society renders it difficult for the individual members of that society to *not* acquire them.³⁴⁷ In particular, he notes that money and social approval may be generalized values.³⁴⁸ Homans also makes

Likewise, courts themselves often comment on changing judicial attitudes. *Lewis v. Cohen*, 417 F. Supp. 1047, 1054 (E.D. Pa. 1976) (stating when describing the change in judicial attitudes toward women that "societal perceptions are altered and reformulated over a span of years. Views of societal structure are reflected in our judicial decisions . . ."), *vacated by*, 547 F.2d 1162 (3d Cir. 1977); *John Wanamaker Philadelphia, Inc. v. United States*, 359 F.2d 437, 447 n.13 (Ct. Cl. 1966) (commenting on the changing judicial attitudes towards Commissioner-initiated as contrasted with taxpayer-initiated

changes).

³⁴¹ See *supra* note 336 and accompanying text.

³⁴² See, e.g., Karen S. Cook et al., *Exchange Theory: A Blueprint for Structure and Process*, in *FRONTIERS OF SOCIAL THEORY: THE NEW SYNTHESSES* 158, 169 (George Ritzer ed., 1990) ("The exchange model cannot tell us what people value; to say that they value what they exchange and exchange what they value is a tautology, hence independent knowledge of value is required."); Peter Singelmann, *Exchange as Symbolic Interaction: Convergences Between Two Theoretical Perspectives*, 37 *AM. SOC. REV.* 414, 414 (1972) (critiquing Homans generally).

³⁴³ HOMANS, *supra* note 282, at 25.

³⁴⁴ E.g., Cook et al., *supra* note 342, at 169. In the 1974 edition of his book, Homans addresses the criticism that his value proposition constitutes a tautology. HOMANS, *supra* note 282, at 33. Essentially, his response to this criticism is, "So what?" *Id.* at 34. He points out that Newton's law of mechanics has the same characteristic, and is valid nonetheless. *Id.* at 34-36. A tautology, Homans observes, can play a role in a deductive system whose conclusion is not a tautology. *Id.* at 35. The value proposition cannot be viewed in isolation; as pointed out above, Homans presents his propositions as a unified system. Thus, he asserts the validity of the value proposition is apparent only in its relation to the proposition system as a whole. *Id.* at 34.

³⁴⁵ *Id.* at 27.

³⁴⁶ *Id.*

³⁴⁷ *Id.*

³⁴⁸ *Id.*

room for the possibility of altruistic values.³⁴⁹ If an individual obtains reward altruistically, that in itself is of value for that individual.³⁵⁰

Courts have sometimes expressed disdain for injecting value judgments into the tax adjudication process.³⁵¹ However, Homans' theory does not rest on the traditional notion of moral values. Rather, Homans constructs a concept of value based on observed behavior. In accordance with this view, one might conclude that Tax Court judges, or more accurately, the Tax Court as an institution, values deference more in some cases than in others. Contrary to the manner in which we more often speak of values, this value judgment is not a priori in nature, but rather merely describes observable phenomenon and attaches meaning to it; hence, the criticism that this view is tautological.³⁵² Standing by itself, therefore, the value principle may not appear to add much to our understanding of the deferential difference. However, Homans' approach must be considered in its entirety before we draw conclusions as to its relevance to our present endeavor, for none of the propositions asserted by Homans are independent of the others.³⁵³

Perhaps the interdependence of Homans' six propositions may best be illustrated by the deprivation-satiation proposition, which states that the more often in the recent past that a reward has been received, the less valuable a further unit of such reward becomes.³⁵⁴ This proposition corresponds to the economic law of diminishing returns.³⁵⁵ Time is the

³⁴⁹ *Id.* at 28.

³⁵⁰ *Id.*

³⁵¹ In considering whether the rationale of *Commissioner v. Duberstein*, 363 U.S. 278 (1960), should apply to determinations of deductibility of charitable contributions, the Court of Appeals for the First Circuit observed,

Were the deductibility of a contribution under section 170(c) of the Internal Revenue Code of 1954 to depend on "detached and disinterested generosity," an important area of tax law would become a mare's nest of uncertainty woven of judicial value judgments irrelevant to eleemosynary reality. . . . If the policy . . . favoring charitable contributions is to be effectively carried out, there is good reason to avoid unnecessary intrusions of subjective judgments as to what prompts the financial support of the organized but non-governmental good works of society.

Crosby Valve & Gage Co. v. Comm'r, 380 F.2d 146, 146-47 (1st Cir. 1967).

³⁵² See *infra* notes 423-429 and accompanying text.

³⁵³ See *supra* note 321 and accompanying text.

³⁵⁴ HOMANS, *supra* note 282, at 29.

³⁵⁵ The law of diminishing returns predicts that where increasing amounts of a variable input are added, the total and marginal outputs will eventually decline, while total
(continued)

crucial element in the deprivation-satiation proposition; satiation is less likely to take place where rewards are stretched out over a long period of time.³⁵⁶ This idea underlies the concepts represented by the success, stimulus, and value propositions in that the relative interval is asserted to impact the behavioral connection involved. The dichotomous fact that the Service is inundated with collections cases³⁵⁷ and the fact that few of these cases are appealed³⁵⁸ illustrates the working of the deprivation-satiation principle.

The aggression-approval proposition is presented in two parts.³⁵⁹ The first asserts that when an expected reward is not received, or when an unexpected punishment is received, the result will be anger and aggressive behavior, and the results of such behavior will become more valuable to the actor.³⁶⁰ The last portion of this statement follows directly from the tautological nature of the value proposition (i.e., an action must be valuable because it is undertaken). Note also that the first part of the aggression-approval proposition refers only to negative behavior; the second part represents the reverse side of the coin—when an expected or greater than expected reward is received, or when an expected punishment is escaped or diminished, the actor is pleased and becomes more likely to perform approving behavior, which in turn becomes more valuable to him.³⁶¹

Finally, Homans' rationality proposition states that in choosing between alternatives, individuals will choose the one that they perceive, at the time, to result in greater value.³⁶² "Greater value" is determined by multiplying the absolute value of the alternative by the probability of

and marginal costs will increase at an increasing rate. See KARL E. CASE & RAY C. FAIR, *PRINCIPLES OF MICROECONOMICS* 275-83 (2d ed. 1992). Similarly, Homans asserts that a point will be reached where increasing amounts of a reward will produce a decreasing rate of the effected behavior. HOMANS, *supra* note 282, at 29.

³⁵⁶ See HOMANS, *supra* note 282, at 29.

³⁵⁷ The IRS Office of Appeals hears 50,000 collection cases a year, 35,000 of which are collection due process cases brought under I.R.C. section 6330. Sheryl Stratton, *IRS Appeals Getting Better, Faster, Officials Say*, 2004 TAX NOTES TODAY 179-4, Sept. 15, 2004, LEXIS, News, Commentary, and Analysis; News Stories.

³⁵⁸ Although there are 35,000 collections due process cases brought before the IRS Office of Appeals each year, *see id.*, from 2000 through September of 2004 there have been less than 200 CDP cases brought before the Tax Court.

³⁵⁹ HOMANS, *supra* note 282, at 37.

³⁶⁰ *Id.*

³⁶¹ *Id.* at 39.

³⁶² *Id.* at 43.

getting the result.³⁶³ Homans circumscribes this proposition by acknowledging that it says nothing about why the individual values a particular result or how he arrives at his perception of the probability of success.³⁶⁴ Rather, the key to the rationality proposition is that it crystallizes the notion that action is determined by both value *and* the probability of success.³⁶⁵ As an example, certain groups, such as low income taxpayers, may fail to appeal adverse Service determinations not because their values differ from corporate taxpayers, but because their past experience makes them perceive the chances of success as being quite low.

Having set forth these basic propositions, Homans proceeds to apply them to sets of given conditions, beginning with a single type of social exchange between two individuals and working through multiple exchanges between multiple individuals.³⁶⁶ Using the “payoff matrix” developed by Thibaut and Kelley,³⁶⁷ Homans asserts that social exchange governed by these propositions results in new phenomena emerging from the interaction.³⁶⁸ This idea is certainly not new or different from the concepts identified earlier by Durkheim and others.³⁶⁹ What Homans offers is the notion that no new propositions are necessary to explain newly emergent social phenomena,³⁷⁰ any more than a new theory of gravity is needed each time a new physical phenomena is observed. Thus, for Homans, social order is the result of individual action governed by timeless and unchanging principles of behavior embodied in the six propositions.³⁷¹

Although the concept of “power” was referred to in the first edition of *Social Behavior*,³⁷² it did not play a major role in Homans’ argument, nor was it even explicitly mentioned. In the revised 1974 edition, however,

³⁶³ *Id.* In accordance with the rationality proposition, if the rate at which someone performs an action is designated by A , then the equation describing this action is $A = pV$, where V is the perceived value to the actor and p is the probability of getting the desired result. *Id.* at 43-44.

³⁶⁴ *Id.* at 45.

³⁶⁵ *See id.* at 47.

³⁶⁶ *Id.* at 51-57.

³⁶⁷ JOHN W. THIBAUT & HAROLD H. KELLEY, *THE SOCIAL PSYCHOLOGY OF GROUPS* 100-125 (1959).

³⁶⁸ HOMANS, *supra* note 282, at 51-63.

³⁶⁹ *See supra* notes 305-308.

³⁷⁰ HOMANS, *supra* note 282, at 51.

³⁷¹ *See id.*

³⁷² GEORGE CASPAR HOMANS, *SOCIAL BEHAVIOR: ITS ELEMENTARY FORMS* (Robert K. Merton ed. 1961).

Homans devotes an entire chapter to power and authority,³⁷³ no doubt in reaction to the subsequent work published by Peter Blau.³⁷⁴

Homans links the concept of *power* with that of *status*.³⁷⁵ Power results in asymmetrical social exchanges.³⁷⁶ Status, Homans tells us, begins with comparisons individuals make with regard to one another.³⁷⁷ When persons, such as a Tax Court judge and a litigant before the court, interact, they present visible and other stimuli to each other.³⁷⁸ This exhibition of stimuli is being presented, at the same time, to others who are able to observe the interaction.³⁷⁹ Although Homans wrote in terms of those who “watch” or “hear” the interchange,³⁸⁰ in the context of Tax Court litigation, the audience is much wider through reporting and dissemination of the decisions of the court. Thus, what the court does in any individual case, and what the court tends to do in different categories of cases, sends important messages not just to the litigants before it, but to a much wider audience. This creates the opportunity for comparison.

Status implies a ranking based on these comparisons.³⁸¹ A crucial determinant of these rankings is “the relative value of the goods men exchange with others, value being determined by scarcity in relation to demand.”³⁸² A person is considered to be of a higher status in relationship to another if, in exchange, that person gives more of a scarce good but receives more of a good that is relatively plentiful.³⁸³ Of course, this is all

³⁷³ HOMANS, *supra* note 282, at 70-93.

³⁷⁴ See PETER M. BLAU, EXCHANGE AND POWER IN SOCIAL LIFE (1964). Blau’s volume was published in 1964, three years after the first edition of Homans’ book.

³⁷⁵ HOMANS, *supra* note 282, at 193-96.

³⁷⁶ See *id.* at 70. Homans also draws a distinction between power and authority, both of which he posits are founded upon one individual’s ability to control the behavior of another. *Id.* When the basis of that ability to exert control comes from the exchange itself, Homans terms it “power,” whereas if it comes from some factor outside of the exchange, Homans designates it as “authority.” *Id.* Tax Court judges would therefore seem to have both power and authority in the context of the exchange relationship that takes place before the court.

³⁷⁷ *Id.* at 194.

³⁷⁸ *Id.*

³⁷⁹ *Id.*

³⁸⁰ *Id.*

³⁸¹ *Id.* As Homans puts it, “Status always begins with . . . comparisons, but status also implies a ranking—from top to bottom, from good to bad.” *Id.* Status, therefore, is more than just distinction, there is a qualitative dimension to status, as those doing the comparison invariably establish “the direction in which each scale [of comparison] runs.” *Id.*

³⁸² *Id.* at 195.

³⁸³ *Id.*

very subjective, as Homans himself rests the notion of status on individual perception and not ingrained socialization, as does Marx.³⁸⁴ Furthermore, the concept is situational, for what is scarce or plentiful in one circumstance may be the opposite in another.³⁸⁵

Homans asserts that status has a variety of implications for exchange and gives rise to discernable effects that can be demonstrated in exchange relationships. One of these effects is termed *noblesse oblige*.³⁸⁶ This phenomenon is characterized by the act of maintaining the perception of one's overall higher status by tangibly demonstrating one's superiority.³⁸⁷ Here, Homans attributes this phenomena to a tendency toward stabilization of social processes, which Homans asserts is often achieved by such specific mechanisms.³⁸⁸ Again, although Homans purports to be anti-Durkheimian in outlook,³⁸⁹ he seems to be suggesting that there is some tendency toward an equilibrium of sorts, at least in the context of exchange relationships involving differentials of status. The same assertion is made with regard to perceived equals.³⁹⁰

Greater judicial deference with respect to one category of taxpayer as opposed to others may simply be a method of maintaining both established superiority and social equilibrium. A constant level of deference would indicate an equality of social status, which may in fact be contrary to reality. As Judge Nims pointed out, there are significant economic considerations at play when a corporate taxpayer is before the court in an abuse of discretion case.³⁹¹ At the same time, the concept of *noblesse oblige* may account for the fact that greater deference is given to the Service in individual collections than in innocent spouse cases arising under Code section 6015(f).

Other aspects of status explored by Homans may help to explain the relatively lesser deference given to the Service by the Tax Court in Code

³⁸⁴ See KARL MARX, *The Communist Manifesto*, in SELECTED WRITINGS 221, 221-37 (David McLellan ed., 1977).

³⁸⁵ HOMANS, *supra* note 282, at 195.

³⁸⁶ *Id.* at 215-17. This phrase translates literally to "nobility obligates" from the French. E. D. HIRSCH, JR. ET AL., *THE NEW DICTIONARY OF CULTURAL LITERACY* 73 (3d ed. 2002). The general definition of the phrase is as follows: "The belief that the wealthy and privileged are obliged to help those less fortunate." *Id.*

³⁸⁷ *Id.* at 215-16. Homans uses the example of full-time grocery store clerks in relation to part-timers. *Id.* In a study conducted by Clark, Homans points out, the full-timers reported that it was important to them that they work faster than the part-timers in order to maintain the perception of their superior status. *Id.* at 215.

³⁸⁸ *Id.* at 216.

³⁸⁹ *Id.* at 12.

³⁹⁰ *Id.* at 217-221.

³⁹¹ See *supra* note 45 and accompanying text.

section 6015(f) cases.³⁹² Not all power resides in the hands of those with a perceived higher status. Persons perceived as inferior in one dimension may be able to exploit that situation to their advantage in an exchange by displaying deference to the other.³⁹³ When one acts deferentially, the other party to the exchange receives a reward.³⁹⁴ The inferior party is thus able to provide the superior party with an additional reward, possibly procuring additional rewards for himself.³⁹⁵ Of course, deference also has the effect of more firmly establishing the inferior status perceived as the baseline, so the deferential party may also forego whatever chance there was of reversing the perception.³⁹⁶

At first blush, this discussion of deference may seem antithetical to the dynamics of the courtroom. The player who gives deference in this context is the Tax Court judge; the recipient of such deference is the Service. To say that the “inferior” party may procure additional rewards by showing deference seems to stand common sense on its head: how can the court achieve reward by being deferential to the Service, itself a litigant that is in no way “superior” to the tribunal? The answer may lie not in the

³⁹² See *supra* notes 250-267 and accompanying text.

³⁹³ HOMANS, *supra* note 282, at 222. Deference in this context is described by Homans as “symbolic inferiority.” *Id.*

³⁹⁴ *Id.* Thus, when the Tax Court accords greater deference to the Service, the Service is thereby rewarded. This inadvertent system of rewards may help explain differences in the perception of taxpayer status. See Karyl A. Kinsey & Loretta J. Stalans, *Which “Haves” Come Out Ahead and Why? Cultural Capital and Legal Mobilization in Frontline Law Enforcement*, 33 LAW & SOC’Y REV. 993, 998 (1999). According to Kinsey and Stalans,

In the burden of proof hypothesis, status effects arise not so much from the initiative and actions of high-status taxpayers, but more from a tendency by people to assume from the onset that high-status taxpayers are more credible and trustworthy people than taxpayers with a lower social status. We have in our data set one variable that directly measures the burden of proof: whether the auditor accepted oral testimony instead of insisting on seeing documentation related to an audit issue. Based on status expectancy theory, we hypothesized that auditors will more often accept the oral testimony of higher-status taxpayers than of lower-status taxpayers.

Id.; see e.g., Nancy C. Staudt, *Taxation Without Representation*, 55 TAX L. REV. 555 (2002) (arguing that taxpayer status is a means by which individuals gain a voice in political debates); Richard Delgado, *Reply Essay: Pep Talks for the Poor: A Reply and Remonstrance on the Evils of Scapegoating*, 71 B.U. L. REV. 525 (1991).

³⁹⁵ HOMANS, *supra* note 282, at 222.

³⁹⁶ *Id.*; see also *supra* note 381.

notion of absolute deference for absolute reward, but rather in the notion of relative deference. When the Tax Court convenes, it is faced with two litigants who do not always display equal status vis-à-vis one another. The Service is a sophisticated organization with a great deal of technical expertise at its disposal. The corporate taxpayer likewise exhibits similar characteristics. The individual taxpayer, however, is not generally sophisticated in legal and tax matters and, in the vast majority of collections cases, is unrepresented.³⁹⁷ When viewed as a three-way exchange, we see that the Tax Court is confronted with relative equals in status when a corporate taxpayer is before it, but it is confronted with a relative unequal when an individual is the petitioner. Perhaps the greater deference given to the Service in the latter cases is a means of “rewarding” the Service for the relative lack of deference shown in the former.

This discussion of status and power ultimately ties in with Homans’ notion of justice or, as he phrases it, “distributive justice.”³⁹⁸ The Homanian concept of distributive justice involves the relationship between at least four terms: two persons involved in an exchange and two rewards.³⁹⁹ “The condition of distributive justice is satisfied, [Homans tells us,] when the ratio of the measures of the persons [by status or otherwise] is equal to the ratio of the . . . rewards.”⁴⁰⁰ Thus, when individuals stand in relative equality to one another, the rewards received should be equal.⁴⁰¹ It follows that when an individual is superior to another individual in some way (for example, through a greater effort expended or a higher status), the reward received by the superior individual ought to be greater than that received by the other.⁴⁰²

³⁹⁷ In 191 collections due process cases reviewed since 2000, the taxpayer was represented in only 46. More astonishingly, the taxpayer prevailed in only seven of those cases. In each of those cases, the taxpayer was represented by counsel. *Robinette v. Comm’r*, [2004] Stand. Fed. Tax Rep. (CCH) 4489 (July 20, 2004) (to be published at 123 T.C. 85 (2004)); *Ratke v. Comm’r*, 87 T.C.M. (CCH) 1169 (2004); *Ewing v. Comm’r*, [2004] Stand. Fed. Tax Rep. (CCH) 4289 (Jan. 28, 2004) (to be published at 122 T.C. 32 (2004)); *Montgomery v. Comm’r*, [2004] Stand. Fed. Tax Rep. (CCH) 4277 (Jan. 22, 2004) (to be published at 122 T.C. 1 (2004)); *Tatum v. Comm’r*, 85 T.C.M. (CCH) 1200 (2003); *Hoffman v. Comm’r*, 119 T.C. 140 (2002); *Ewing v. Comm’r*, 118 T.C. 494 (2002).

³⁹⁸ Homans characterizes the problem of “distributive justice” as injustice in the distribution of rewards between individuals and groups, but he attributes the terminology to Aristotle. HOMANS, *supra* note 282, at 242; *see also supra* notes 8-12 and accompanying text.

³⁹⁹ HOMANS, *supra* note 282, at 249. For a detailed analysis of this relationship, see *id.* at 245-252.

⁴⁰⁰ *Id.* at 249.

⁴⁰¹ *Id.*

⁴⁰² *Id.*

This too, is tied to power in that the problem of injustice is a problem for the weak rather than for the strong.⁴⁰³ According to the frustration-aggression hypothesis, however, an unjust distribution of rewards that is repeated so often that it becomes expected will cease to arouse resentment and will, in fact, become perceived as just.⁴⁰⁴ Hence, the Tax Court's tradition of lessening deference in cases involving corporate taxpayers and increasing it in collections cases⁴⁰⁵ may have become so ingrained in the institution that its fundamental injustice has become masked.

Furthermore, an interesting phenomenon occurs if a person gets more reward than expected under the distributive justice ratio.⁴⁰⁶ When one is the beneficiary of injustice rather than its victim, he tends to increase what he gives in social exchange beyond that which is otherwise called for, an act not unlike that earlier concept described as *noblesse oblige*.⁴⁰⁷ But why would this be so? The concept of *noblesse oblige* is tied to reward; it occurs because some reward is received in the maintenance or enhancement of the perception of superiority.⁴⁰⁸ Absent such reward, why would a rational being, within the framework of Homans' theory, voluntarily increase their exchange output?

For Homans, parties to the exchange are not necessarily utility maximizers. While individuals may be maximizers for the moment, they do not generally take the long term view. However, only by taking the long term view does the idea of giving up more now than is necessary make any sense, as the achievement of distributive justice in this way only makes sense in the long term. Homans fails to adequately reconcile his general framework to this observed phenomena. Thus, if we are to use Homans' basic premise to explain the deferential difference, we need to explore the refinements made by subsequent scholars.

2. *The Progeny of Homans*

Peter M. Blau built on Homans' work by attempting to derive better understanding of the complex structures found in society.⁴⁰⁹ Blau

⁴⁰³ *Id.* at 262.

⁴⁰⁴ *Id.* at 263.

⁴⁰⁵ See *supra* notes 54-249 and accompanying text.

⁴⁰⁶ HOMANS, *supra* note 282, at 268.

⁴⁰⁷ *Id.*

⁴⁰⁸ *Id.* at 216.

⁴⁰⁹ BLAU, *supra* note 374, at 2. Although *Exchange and Power in Social Life* is Blau's principle response to and refinement of Homans' work, other works that contain insight into Blau's theory are as follows: PETER M. BLAU, *INEQUALITY AND HETEROGENEITY: A PRIMITIVE THEORY OF SOCIAL STRUCTURE* (1977), and Peter M. Blau, *Microprocesses and Macrostructure*, in *SOCIAL EXCHANGE THEORY* (Karen S. Cook ed., 1987).

attempted to expand exchange theory so that it combined social behaviorism and social “factism.”⁴¹⁰ In doing so, Blau was cautious to avoid the reductionist fallacy of ignoring emergent properties. Homans’ failure, implicitly addressed in Blau’s work, was to stop at the behavioral level.⁴¹¹ For Blau, an analysis of behavior is merely a means to the more important task of explaining evolving social structures and emergent social forces that characterize the development of such structures.⁴¹²

Whereas Homans offered a three stage model of behavior as it relates to the success proposition,⁴¹³ Blau proposed four stage model, leading from interpersonal interaction to social structure and, ultimately, to social change.⁴¹⁴ The process begins with personal exchange transactions, similar to Homan’s model. Such exchanges, in Blau’s view, give rise to differentiation of status and power.⁴¹⁵ This differentiation leads to legitimization and organization, which ultimately results in opposition and social change.⁴¹⁶ Blau sees people as forming social associations in which rewards are exchanged. The strength of this exchange of rewards is directly proportional to the strength of the association. When the exchange is unequal, differentiation in status and power result.⁴¹⁷

Blau uses this framework as a foundation for his assertion that justice is inextricably linked to social norms, which, in turn, function to promote socially significant investments, which results in justice. The social norms at work in Tax Court abuse of discretion cases are ones in which corporate taxpayers are perceived as having much more at stake than individuals.⁴¹⁸ The appropriate socially significant investment, therefore, is to restrict the amount of deference given to the government in those cases because this creates a social equilibrium within the context of exchange dynamics. Therefore, justice is achieved in exchange theory terms.

What dynamics are involved when one party has nothing of equivalence to offer in exchange for something he needs, as when a litigant taxpayer arrives in Tax Court? Blau identifies the following four

⁴¹⁰ RITZER, *supra* note 285, at 300.

⁴¹¹ *Id.* It should be noted that Blau is much more Durkheimian than Homans. For example, Blau maintains that once social structures emerge from social interaction, they have a separate existence unto themselves. See BLAU, *supra* note 374, at 271-73 (discussing the four facets of social structures).

⁴¹² BLAU, *supra* note 374, at 13.

⁴¹³ See *supra* note 327 and accompanying text.

⁴¹⁴ RITZER, *supra* note 285, at 300.

⁴¹⁵ See BLAU, *supra* note 374, at 21-22.

⁴¹⁶ *Id.* at 301-05.

⁴¹⁷ See *id.* at 320-24.

⁴¹⁸ See *supra* note 46 and accompanying text.

possibilities⁴¹⁹ whereby the individual with the need can satisfy that need: use of force; finding another source of satisfaction; making due without the thing needed; or subordinating themselves to the other.⁴²⁰ When the last alternative is pursued, power results by creating in the other a “generalized credit” in the relationship that can be drawn upon at a future time.⁴²¹

In the context of Tax Court adjudication, the first two alternatives are not available. Thus, taxpayers are forced to either acclimate themselves to an unsatisfactory result or hope to create Blau’s “generalized credit.” Individual taxpayers, however, have no real prospect of a continuing relationship with the court. Large corporate taxpayers, on the other hand, are subject to a high rate of audit⁴²² and do, in fact, have the potential for an on-going relationship with the court. Therefore, the creation of a future credit on the part of either the court or the taxpayer is therefore possible when a taxpayer is a large corporation.

Blau attempts to counter the tautological weakness of Homans’ consideration of the role of value in these exchanges by dissecting the concept and laying bare its constituent parts. Specifically, Blau identified four distinct types of values.⁴²³ “Particularistic” values unite members of a group.⁴²⁴ Patriotism, company loyalty, and school pride would be examples of particularistic values.⁴²⁵ “Universalistic” values are standards by which the relative worth of the various things that can be exchanged are valued.⁴²⁶ Blau’s last two categories of value have the greatest implications for our analysis of the deferential difference. The third category comprises values that legitimate authority—in other words, the values that distribute power among certain members of the group.⁴²⁷ The authority of both the Service and the Tax Court depend on these sorts of values. The reverse of authority values are opposition values, which legitimate opposition to those whose power is legitimated by authority

⁴¹⁹ See RITZER, *supra* note 285, at 300.

⁴²⁰ *Id.*

⁴²¹ *Id.*

⁴²² For fiscal year 2003, the overall audit rate was approximately one-half of one percent. 2003 IRS Data Book, *Examination Coverage: Recommended and Average Recommended Additional Tax After Examination, by Type and Size of Return, Fiscal Year 2003* (March 4, 2004), available at <http://www.irs.gov/taxstats/article/0,,id=97177,00.html>. For corporations with assets of over \$250 million, however, the audit rate was nearly 30%, or almost 60 times the average exam rate. *Id.*

⁴²³ BLAU, *supra* note 374, at 265.

⁴²⁴ *Id.* at 267.

⁴²⁵ RITZER, *supra* note 285, at 303.

⁴²⁶ BLAU, *supra* note 374, at 268. Blau relies heavily on Parsons for this concept. *Id.* at 58 & n.20.

⁴²⁷ *Id.* at 231-33.

values.⁴²⁸ The power of the Tax Court, manifest in its ability to defer to or reverse the discretionary decisions of the Service, arises from this last category of values. This value paradigm marks Blau's greatest distinction from Homans. Where Homans grants a central role (perhaps the *only* role) in social order to the individual, Blau inserts social facts as his main character. As such, some have argued that, in fact, Blau has transformed exchange theory beyond recognition.⁴²⁹

However, instead of dismantling exchange theory, Blau has accomplished a refinement of the theory that makes it better able to assist in understanding the deferential difference. Blau, like Homans, concerns himself with the functions of status and power in exchange relationships. Individuals who are in need of services from another, Blau tells us, have the following five basic alternatives: they can supply a reciprocal service; obtain the needed service elsewhere; obtain the service by coercion or force; simply learn to do without the service; or comply with the wishes of the service provider.⁴³⁰ The supply of services, therefore, begets power, and the absence of the first four alternatives defines the conditions of power in general.⁴³¹ The availability of the first four alternatives, in contrast, represents a condition of social independence.⁴³²

This notion of power, as used by Blau, may also shed some light on the dynamics of the personal relationships in the courtroom giving rise to the deferential difference. While the corporate taxpayer may have a higher social status than the individual, the court itself, in the form of the judge, has the highest status of all since the court holds the power to determine the fate of the litigants. The litigants, of course, will evaluate the court's performance on the basis of that decision, praising it when a favorable decision is rendered and condemning it when the opposite is the outcome. Blau points out that the validity of others' evaluations are appraised by the one being evaluated in accordance with relative social position.⁴³³ The appraisals of relative superiors are more likely to be accepted at face value than those of inferiors.⁴³⁴ It makes sense, therefore, that approval from those in a higher relative social status (corporate taxpayers) is more sought after by the court than those in a relatively inferior social status (individual taxpayers in collections cases).

⁴²⁸ *Id.*; see also RITZER, *supra* note 291, at 304.

⁴²⁹ RITZER, *supra* note 285, at 304.

⁴³⁰ BLAU, *supra* note 374, at 118-19 (citing Richard M. Emerson, *Power-Dependence Relations*, 27 AM. SOC. REV. 31, 31-41 (1962)). Drawing upon the work of Richard Emerson, Blau engages in a detailed discussion. See *id.* at 118-25.

⁴³¹ *Id.* at 119.

⁴³² *Id.*

⁴³³ See *id.* at 67.

⁴³⁴ *Id.* at 67 & n.14 (citing several studies supporting this proposition).

This may also provide an explanation of the outcomes in innocent spouse cases. Although cases under Code section 6015(f) involve individual taxpayers, they come before the court in a more sympathetic posture, as the label “innocent spouse” itself indicates. Taxpayers bringing collections cases before the court are, by definition, individuals who have failed to meet their legal obligations. Thus, their social status may be perceived as quite different from the individuals involved in the former cases.

While acknowledging the importance of power as a social dynamic, however, both Homans and Blau failed to adequately incorporate the concept of coercion into exchange theory. British theorist Anthony Heath pointed out that a gap exists in exchange theory without the inclusion of both rewards *and* punishments.⁴³⁵ This gap was later filled by Linda Molm.⁴³⁶ Molm argues that by providing or withdrawing rewards and punishments, individuals have the power to elicit very different behaviors and consequent effects on social relationships. Thus, Molm demonstrates the effectiveness of coercive power in social settings to increase rewards. This is illustrated especially well when an actor who is power-disadvantaged in a social relationship uses coercion to punish the lack of exchange received from the other participant. This may occur, for example, when an individual taxpayer loses a Tax Court case, becomes disgruntled, and attempts to “punish” the Service by being non-compliant in the future.⁴³⁷ However, the use of coercion by weaker parties is often ineffective because it is utilized too infrequently and in a non-contingent fashion. Restating this assertion in Homansian terms, coercion is not utilized to overcome superior social power because the probability of success is low.

3. *Prospect Theory*

Common to all of the approaches to exchange or rational choice theory is the notion that, in either the short run or long run, people make outcome-maximizing decisions.⁴³⁸ Experience, however, seems to indicate that people often actually act in ways that are contrary to the assumption of utility maximization.

⁴³⁵ HEATH, *supra* note 296.

⁴³⁶ LINDA D. MOLM, COERCIVE POWER IN SOCIAL EXCHANGE (1997).

⁴³⁷ The Service itself recognizes this as a possible response to collection activity. For example, taxpayers now may seek an offer-in-compromise on the basis of “effective tax administration.” Treas. Reg. § 301.7122-1(b)(3)(ii) (as amended in 2002) (providing that an offer may be accepted if “collection of the full liability would undermine public confidence that the tax laws are being administered in a fair and equitable manner”).

⁴³⁸ Even for Homans, who did not think people were capable of maximizing in the long term, individuals attempt to achieve short term gains in social exchange.

Take, for example, taxpayer compliance with federal income tax law. Rational choice theory predicts that decisions regarding compliance with tax law should be based on an assessment of the cost of the tax, on the one hand, vis-à-vis the cost (by way of legal sanction) of noncompliance, on the other.⁴³⁹ Tax return audit rates are exceptionally low.⁴⁴⁰ Since the chance of incurring a cost for noncompliance is so low, rational choice theory tells us that utility maximizers will choose the rewards of paying less tax than is imposed by law in most cases. Observable experience, however, is quite the opposite; most taxpayers at least attempt to pay the correct amount of tax imposed by law.⁴⁴¹ Rational choice and exchange theory seems to fail to explain this phenomena, which I shall refer to as the “taxpayers’ dilemma.”

What is needed is a further refinement of rational choice and exchange theory approaches to adequately explain such observed behaviors. Just such a refinement has been offered by Daniel Kahneman and Amos Tversky.⁴⁴² Kahneman and Tversky accept the notion that people *try* to maximize outcomes, but they also acknowledge that outcome maximization frequently fails to be achieved.⁴⁴³ What is most significant about their work, however, is that they argue that this failure occurs in systematic and predictable ways, thereby remedying the lack of predictability inherent in exchange and rational choice theory.

⁴³⁹ Eric A. Posner, *Law and Social Norms: The Case of Tax Compliance*, 86 VA. L. REV. 1781, 1783 (2000); see also James Andreoni et al., *Tax Compliance*, 36 J. ECON. LITERATURE 818, 820-21 (1998); WHY PEOPLE PAY TAXES: TAX COMPLIANCE AND ENFORCEMENT (Joel Slemrod ed., 1992).

⁴⁴⁰ For fiscal year 2003, the Service audited only about one-half of one percent of all returns filed. 2003 IRS Data Book, *supra* note 422. For individuals with incomes between \$25,000 and \$50,000, the audit rate was less than one-third of one percent. *Id.*

⁴⁴¹ This conclusion is supported by Service data generated through the Taxpayer Compliance Measurement Program initiated during the 1980s to generate proper algorithms for selecting return for audit. Andreoni et al., *supra* note 439, at 819-20. Using this data, it has been estimated that the vast majority of taxpayers voluntarily comply with federal income tax law. *Id.* at 820. Furthermore, the rate of tax compliance remained steady during the period from 1973 through 1992, see *id.* at 819, despite the fact that audit activity varied greatly during this period, see *id.* at 820. Even though the Service specifically targets returns that are likely to yield audit adjustments, the most recent data shows that fully twenty percent of audited returns result in no change, 2003 IRS Data Book, *supra* note 422, and many of those audits result in refunds.

⁴⁴² Kahneman & Tversky, *supra* note 300.

⁴⁴³ *Id.* at 263.

Kahneman and Tversky's approach, which they refer to as "prospect theory,"⁴⁴⁴ maintains that people value a certain gain more than a probable gain with an equal or greater expected value and feel the opposite with respect to losses. Thus people will generally make risk-averse decisions when choosing between gain outcomes and risk-seeking decisions when choosing between loss outcomes.⁴⁴⁵

Kahneman and Tversky's theory is founded on the notion that people evaluate decision options relative to some reference point.⁴⁴⁶ When choosing options that appear to be gains relative to that reference point, people will act in risk-averse ways, and they will do the opposite in choosing options that appear to be relative losses.⁴⁴⁷ However, risk preferences tend to reverse themselves in situations in which the probability of gain or loss is low.⁴⁴⁸ In other words, people will become risk-seeking when there is a low probability of gain and risk-averse when there is a low probability of loss. These assertions are contrary to rational choice theory, which generally assumes either risk neutrality or risk aversion in the face of both gains and losses, regardless of their probability.⁴⁴⁹

The efficacy of prospect theory can be demonstrated by its response to the taxpayers' dilemma described above. In regard to decisions about whether or not to comply with federal income tax laws, prospect theory provides a satisfactory explanation of behavior where exchange and rational choice theory fail. In prospect theory terms, taxpayers who

⁴⁴⁴ *Id.* at 274. This approach actually traces its roots to experiments in decision theory conducted by Kahneman and Tversky in the early 1970s. Daniel Kahneman, *Preface to CHOICES, VALUES, AND FRAMES*, at ix-x (Daniel Kahneman & Amos Tversky eds., 2000). They originally labeled their approach "value theory," *id.* at x, but opted for the label "prospect theory" in their seminal 1979 article, Kahneman & Tversky *supra* note 450; see also Chris Guthrie, *Prospect Theory, Risk Preference, and the Law*, 97 NW. U. L. REV., 1115, 1117 (2003).

⁴⁴⁵ Kahneman & Tversky, *supra* note 450, at 279 ("A salient characteristic of attitudes to changes in welfare is that losses loom larger than gains."). In prospect theory, the value of each outcome is multiplied by a decision weight. *Id.* at 280. Decision weights are not probabilities, but rather are inferred from the subjective choices between prospects. *Id.*

⁴⁴⁶ *Id.* at 274, 286. Before taking up shifts in the reference point, Kahneman and Tversky's paper takes the status quo as the reference point for decisions. *Id.* at 286.

⁴⁴⁷ *Id.* at 284-86.

⁴⁴⁸ *Id.*

⁴⁴⁹ Jeffrey J. Rachlinski, *Gains, Losses, and the Psychology of Litigation*, 70 S. CAL. L. REV. 113, 121 (1996).

anticipate receiving a refund from the Service are in a “gains frame.”⁴⁵⁰ Taxpayers expecting to owe money are in a “loss frame.”⁴⁵¹ Since taxpayers in the former category are assured of a perceived gain without risk, they will tend to be risk-adverse, whereas those in the latter category will tend to be risk-seeking, as they are likely to see the amount owed as a loss situation.⁴⁵² Thus, those taxpayers who owe money are more likely to risk sanctions for noncompliance than those who are due a refund in the first place.⁴⁵³ The validity of this assumption is born out by empirical evidence, which demonstrates that income tax compliance varies as a function of the size of the taxpayers’ refund or balance due.⁴⁵⁴

Prospect theory posits that there are two distinct phases in every choice.⁴⁵⁵ The first is an “editing” or “coding” phase where options are organized and reformulated in order to simplify subsequent evaluation.⁴⁵⁶ In the second phase, the prospects are evaluated in light of the decisionmaker’s values.⁴⁵⁷ For Kahneman and Tversky, the value function is defined by deviations from the status quo, which, when plotted on a graph, form an “S” shaped curve that is concave for gains and convex (and steeper) for losses.⁴⁵⁸ Thus, expected outcomes will be coded as gains or losses relative to a neutral reference point (i.e., the status quo), and losses will loom larger to the decision-maker than gains.⁴⁵⁹

⁴⁵⁰ See Amos Tversky & Daniel Kahneman, *Rational Choice and the Framing of Decisions*, 59 J. BUS. S251, S258 (1986).

⁴⁵¹ See *id.* These “gains frames” and “loss frames” represent different perceptions, or frames of reference. For example, the difference in value between a gain of \$100 and a gain of \$200 is perceived as greater than the difference between a gain of \$1100 and a gain of \$1200. *Id.* The absolute value of the gain is not the determining factor in perception. The same is true for losses, so that the difference between a \$100 loss and a \$200 loss is perceived as greater than the difference between an \$1100 loss and a \$1200 loss. *Id.* Although couched in monetary terms, Kahneman and Tversky insist that their theory is readily applicable to choices involving other attributes. Kahneman & Tversky, *supra* note 450, at 288.

⁴⁵² Guthrie, *supra* note 444, at 1143.

⁴⁵³ See *id.*

⁴⁵⁴ Henry S.J. Robben et al., *Decision Frame and Opportunity as Determinants of Tax Cheating: An International Experimental Study*, 11 J. ECON. PSYCHOL. 341, 345 (1990). Robben found that the voluntary compliance rate was 96% among those expecting refunds, as compared to only 89% for those with a balance due. *Id.* at 346.

⁴⁵⁵ Kahneman and Tversky, *supra* note 450, at 274.

⁴⁵⁶ *Id.*

⁴⁵⁷ *Id.*

⁴⁵⁸ *Id.* at 279.

⁴⁵⁹ *Id.* at 288.

4. *Application of Sociological Theory to Judicial Decisions*

The commonality among exchange, rational choice, and prospect theorists is located in their attempts to apply the calculated choice concept to theaters of social life as to which the approach may appear, at first blush, incongruous, such as family life and loving relationships.⁴⁶⁰ Judicial behavior, on the other hand, would seem to provide the perfect laboratory for testing the completeness, if not the validity, of exchange theory, for nowhere do we find more relevant social implications than in the exchange that takes place between judge and litigant in the process of judicial decision-making.⁴⁶¹

Exchange theory, however, is not so esoteric as to preclude the role of status in the analysis of behavior, as noted above.⁴⁶² Homans' articulation of exchange theory, for example, emphasizes that status factors are integral to expectations about rewards.⁴⁶³ Blau acknowledges that differences in received rewards that are based on background characteristics do not necessarily reflect justice and that power may have the effect of suppressing opposition to unquestionably unequal exchanges.⁴⁶⁴ The

⁴⁶⁰ See Cook et al., *supra* note 342, at 158. ("A central feature of exchange theory is the observation that exchange processes are ubiquitous.")

⁴⁶¹ This assertion rests on the presumption that judicial decisions do, in fact, represent an exchange. While some may view such decisions as mere dictates from the source of authority to those subject to it, the reality is that judges do not decide cases in a vacuum or abstractly. Rather, judicial decisions are founded on the arguments and facts presented to them by the litigants. A judicial decision, therefore, reflects a sort of "cutting and pasting" of the propositions and arguments presented, and can therefore validly be characterized as an exchange. See Brian K. Pinaire, *A Funny Thing Happened on the Way to the Market: The Supreme Court and Political Speech in the Electoral Process*, 17 J. L. & POL. 489, 546-47 & n.204 (2001) ("The distinctions between decisions are not the products of policy disputes, but rather reflect alternative visions of the marketplace of ideas and the very nature and operation of the market 'exchange.'"); Nancy A. Welsh, *Making Deals in Court-Connected Mediation: What's Justice Got to Do with It?*, 79 WASH. U. L.Q. 787, 826-27 (2001) (characterizing the judicial process as one of exchange dynamics in which litigants value the opportunity to have their say because this provides them with the opportunity to influence the decision-maker and indirectly influence the final outcome). Furthermore, it has been noted that litigants "evaluate procedures in terms of the immediate financial and social benefits they receive from the procedure." *Id.* at 827. (quoting E. Allan Lind, *Procedural Justice, Disputing, and Reactions to Legal Authorities*, in *EVERYDAY PRACTICES AND TROUBLE CASES* 177, 179 (Austin Sarat et al. eds., 1998))

⁴⁶² See *supra* note 375 and accompanying text.

⁴⁶³ HOMANS, *supra* note 282, at 193-224.

⁴⁶⁴ See BLAU, *supra* note 374, at 158. Blau states that

(continued)

primary issue, then, is whether exchange theory is capable of providing a good model of judicial behavior in Tax Court abuse of discretion cases.

Blau asserts that the existence of a baseline for expectations gives rise to a “feedback effect” on behavior.⁴⁶⁵ This same line of reasoning is reflected in legal scholarship dealing with judicial behavior. Professor Stake, for example, concludes that there are two discernable and fundamentally different social effects associated with judicial decisions.⁴⁶⁶ According to Professor Stake, court decisions not only provide incentives for behavior, but also affect status.⁴⁶⁷ The “status effects” of judicial action are characterized by changes in the states of being of the parties and result from the dynamics inherent in the transformation from pre-litigation uncertainty to post-litigation certainty.⁴⁶⁸ According to Professor Stake, an economic model can offer a comprehensive normative or positive theory of judicial behavior only when it takes status effects into account.⁴⁶⁹ By definition, the taxpayer is always the petitioner in Tax Court, seeking a mandate from the judge compelling the Service to act in the desired way.⁴⁷⁰ Thus viewed, these cases involve a three-way social exchange involving the taxpayer, the Service, and the court itself. It is an exchange, however, in which power and authority play a central role and in which the inter-relational dynamics change at various points in time. Although the judge has the power to grant the taxpayer’s wish, the taxpayer ostensibly has no tangible reward to offer in return. Therefore, the exchange relationship must be analyzed under the rubric of power and authority.

In order to apply Homans’ analysis to the exchange that takes place in Tax Court abuse of discretion cases, it is first necessary to identify the nature of the exchange or what, exactly, is capable of being exchanged in this context. The specific inter-relational dynamic within the exchange that we are interested in is that which occurs between the court and the taxpayer. A related exchange takes place between the taxpayer and the

great power may enable men to prevent those subject to it from expressing their negative feelings, and it may immunize men against disapproval and dislike if they do find overt expression. Moreover, the exploited and oppressed continue to receive inequitable treatment in terms of prevailing standards of fairness . . . as long as they remain subjugated to the dominant power.

Id.

⁴⁶⁵ *Id.* at 58.

⁴⁶⁶ Stake, *supra* note 5, at 1450

⁴⁶⁷ *Id.*

⁴⁶⁸ *Id.* at 1450-51.

⁴⁶⁹ *Id.* at 1450, 1494.

⁴⁷⁰ TAX CT. RULE 13(c).

Service, but that exchange precedes litigation and is conducted in a different context. In the Tax Court setting, the taxpayer is proposing a specific application of discretion to the facts at hand and is seeking the court's agreement that the Service acted without a reasonable basis (i.e., abused its discretion) in rejecting that specific application of discretion to the facts. The issue in these cases, therefore, is not a determination of the correct or best result, but rather merely an assessment of whether any basis in reason exists for the Service's rejection of the taxpayer's proposed treatment. If any such basis exists, the Service has not abused its discretion, and the decision of that agency will stand.⁴⁷¹

What is it that the taxpayer offers the court in exchange for its ruling? Admittedly, very little, but in any social interaction there is always something to exchange. At the very least, the taxpayer offers respect for the authority of the court and the rule of law. All courts depend on such respect for their continued viability. While the Tax Court, like other tribunals, has contempt powers, these powers are solely punitive in that they may be effective for punishing instances of disrespect that have occurred, but it is unlikely that they act as effective deterrents in all cases. As noted above, most taxpayers in collections cases act *pro se*⁴⁷² and may not even be familiar with the judge's contempt power.⁴⁷³ Thus, some degree of legitimization may be offered in exchange for the Tax Court's adjudication of these matters. Furthermore, since there seems to be a systematic difference in the "rewards," to use Homans' terminology, meted out by the court in these cases, Homans' theory would seem to compel the conclusion that there must be some disparity in the things that are exchanged.

Such a disparity would seem to stem from the relative social standing of the taxpayer. Large corporations, for example, are undoubtedly in a much different position than individual taxpayers with respect to their ability to enhance judicial legitimacy. Large corporations employ legions of lawyers and lobbyists who advocate on their behalf before the other branches of government.⁴⁷⁴ These entities also contribute heavily to the

⁴⁷¹ See cases cited *supra* note 51.

⁴⁷² See *supra* note 278 and accompanying text.

⁴⁷³ "[T]he Tax Court is given the same powers regarding contempt, and the carrying out of its writs, orders, etc., that Congress has previously given to the District Courts." S. REP. NO. 91-552, at 304 (1969), *reprinted in* 1969 U.S.C.C.A.N. 2340, 2343. Some sociological theorists would argue that legitimization could not be compelled by force in any event; rather, some would maintain that the acceptance of the Tax Court's legitimacy and authority is due to acceptance of the same through the socialization process. See, e.g., TALCOTT PARSONS, *THE SOCIAL SYSTEM* (1951).

⁴⁷⁴ See *supra* note 279 and accompanying text.

political parties and candidates for public office.⁴⁷⁵ Those office holders may directly affect the court, as well as individual judges. For example, Tax Court judges must be appointed by the President of the United States and confirmed by the U.S. Senate.⁴⁷⁶ Furthermore, they do not enjoy lifetime appointment; rather, they must be re-appointed after fifteen years if they are to remain on the bench.⁴⁷⁷ This suggests that the rewards of legitimacy received by Tax Court judges from large corporations greatly exceeds that from individual taxpayers, especially poor individuals with little political clout. Thus, Homans' success, stimulus, and value propositions may, in fact, be consistent with the power/status dynamics leading to the deferential difference described above.⁴⁷⁸ Certainly an individual taxpayer, and particularly a taxpayer acting *pro se*, has far less power and status vis-à-vis the judge than a large corporation. Thus, the concept of *noblesse oblige* may have a role to play in explaining the disparity in these decisions.⁴⁷⁹ Because the authority of the court is more firmly established with regard to the corporations, perhaps judges do not feel quite so compelled to validate their authority by deciding against the taxpayer in these cases.

At this point, the application of Homans' theory begins to show weaknesses for at least two reasons. First, the cases under discussion represent but a small proportion of all Tax Court cases. There is no data to suggest, and no reason to believe, that Tax Court judges favor corporate taxpayers in all cases. If it is true that they do not, then the application of Homans' propositions and his ideas about power and status quickly lose their appeal. Second, the application of Homans' notion of distributive justice gives rise to some difficulty in this context. If it is assumed that the

⁴⁷⁵ Based on data released by the Federal Elections Commission on Monday, October 4, 2004, among the top political campaign contributors are the nations largest corporations, including: AFLAC, Inc. (\$10,090,320); Anheuser-Busch (\$8,112,019); Archer Daniels Midland (\$7,698,839); AT&T (\$19,639,808); Bank of America (\$10,910,561); Boeing Co. (\$8,999,578); Citigroup, Inc. (\$17,527,957); CSX Corp. (\$6,847,980); Exxon Mobil (\$7,817,383); General Electric (\$10,916,280); General Motors (\$8,216,084); Lockheed Martin (\$11,890,175); Microsoft Corp. (\$13,221,113); Pfizer Inc. (\$8,856,433); RJR Nabisco/RJ Reynolds Tobacco (\$11,317,372); Time Warner (\$14,068,942); Verizon Communications (\$12,966,511); and Walt Disney Co. (\$8,374,195). The Center for Responsive Politics, <http://www.opensecrets.org/orgs/list.asp> (last visited Oct. 29, 2004). As noted above, these corporations are nearly sixty times more likely to be audited (and thus appear before the Tax Court) than individual taxpayers. See *supra* note 422.

⁴⁷⁶ I.R.C. § 7443(b) (2000).

⁴⁷⁷ *Id.* § 7443(e).

⁴⁷⁸ See *supra* text accompanying notes 336-353.

⁴⁷⁹ See *supra* note 386 and accompanying text.

corporate taxpayers are superior in status to the individuals, then it would follow from Homans' work that the corporations will see a bigger reward. As noted above, this is exactly what happens in that the corporations are much more likely to be successful in abuse of discretion cases.⁴⁸⁰ The notion of the superiority of corporate taxpayers vis-à-vis individual taxpayers is, to say the least, troubling from a tax justice perspective. It is hard to imagine that Tax Court judges actually perceive corporations as being superior and, therefore, more *deserving* of rewards. While the perception of the rewards received in exchange may reveal a disparity, a belief that corporations are *ab initio* superior before the court flies in the face of any semblance of attempted justice. If one accepts the fact that Tax Court judges are genuine in their pursuit of some notion of justice, Homans' distributive justice theory would suggest an opposite result from that which has been observed. Furthermore, neither Homans nor Blau offers much help in explaining why the deferential difference is so much less pronounced in innocent spouse cases.⁴⁸¹ Thus, while exchange theory and its progeny offer valuable explanations of many of the social dynamics underlying the deferential difference, close examination reveals their incompleteness.

Perhaps prospect theory offers a more complete explanation of judicial behavior in this regard. To apply prospect theory we must first locate the reference point⁴⁸² for Tax Court judges in abuse of discretion cases. This is rather easy to do because by definition in an abuse of discretion case, the reference point is the status quo; that is, the judge is required to allow the decision of the Service to stand, absent some compelling demonstration that the decision is without any basis in reason.⁴⁸³ Prospect theory also assumes a decision that involves risk or uncertainty.⁴⁸⁴ For the Tax Court

⁴⁸⁰ See *supra* notes 250-267 and accompanying text.

⁴⁸¹ See *supra* notes 256-273 and accompanying text.

⁴⁸² See *supra* text accompanying note 466.

⁴⁸³ See *supra* note 51.

⁴⁸⁴ Kahneman & Tversky, *supra* note 300, at 263 ("Decision making under risk can be viewed as a choice between prospects or gambles."). Kahneman and Tversky restricted their discussion to situations in which the prospects had objective or standard probabilities, *id.*, but that was merely to illustrate their point through mathematical proof. The authors themselves acknowledged that their theory could also be extended to more common situations of choice, without standard probabilities. *Id.* at 288. In these real-life situations, "decision weights must be attached to particular events rather than to stated probabilities," *id.*, an undertaking that will be addressed *infra*. Risk can also be thought of as a fundamental consequence of any exchange relationship. As Blau states, "By taking these risks, an individual brings to an end the complete indifference between himself and another and forces on the other a choice of two alternatives, as Lévi-Strauss has noted: 'From now
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in abuse of discretion cases, risk means deviating from the high degree of deference normally expected to be accorded to the Service. Since the taxing agency is specially equipped to handle tax issues and Congress has vested it with discretionary authority in these cases, the riskless thing to do would be to leave the agency's decision undisturbed. By overturning the agency's decision, the judge may be said to be taking a risk in at least two ways. First, there is the risk of being overturned by an appellate court.⁴⁸⁵ Second, there is the risk of an adverse social outcome—that is, there is a risk that a socially unacceptable decision will be subject to criticism and will undermine the authority and credibility of the court.⁴⁸⁶

on it must become a relationship either of cordiality or hostility.” BLAU, *supra* note 374, at 98.

⁴⁸⁵ Tax Court decisions are appealable unless a specific restriction applies. For example, decisions entered under the court's so-called “small case procedures” may not be appealed. I.R.C. § 7463(b) (2000); *Cole v. Comm’r*, 958 F.2d 288, 289-90 (9th Cir. 1992) (finding that the court lacked jurisdiction to review a case heard by the Tax Court using the latter's small case procedures). Appealable cases are reviewed by the United States Court of Appeals for the circuit in which is located the taxpayer's legal residence, I.R.C. § 7482(a)(1), (b)(1)(A) (2000), or, in the case of a corporation, its principle place of business, *id.* § 7482(b)(1)(B).

⁴⁸⁶ Several scholars have acknowledged the idea that judicial credibility may be diminished by socially unacceptable decisions. See, e.g., Michael Heise, *Preliminary Thoughts on the Virtues of Passive Dialogue*, 34 AKRON L. REV. 73, 86-87 (2000) (observing that courts have a limited amount of “political capital” that may be exhausted, resulting in a loss of credibility for the court, and by way of illustration stating, “[T]here are only so many times that the [New Jersey Supreme Court] can be portrayed as the dictatorial villain forcing the State to do, in the name of a constitutional mandate, what a majority of its citizens disfavor before judicial credibility is undermined.” (quoting Paul L. Tractenberg, *A Clear and Powerful Voice for Poor Urban Students: Chief Justice Robert Wilentz's Role in Abbot v. Burke*, 49 RUTGERS L. REV. 719, 743-44 (1997) (altered from original)); Steven M. Simpson, *Judicial Abdication and the Rise of Special Interests*, 6 CHAP. L. REV. 173, 191 (2003) (“A rubber stamp is just as damaging to judicial credibility as a sledgehammer.”); Ross A. Albert, Comment, *Restitutionary Recovery for Rescuers of Human Life*, 74 CAL. L. REV. 85, 94 (1986) (noting that “fanciful assignments of negligence” strain judicial credibility); Michelle Freeman, Note, *First Amendment Protection for the Arts After Nea v. Finley*, 38 BRANDEIS L.J. 405, 421 (2000) (observing that controversial decisions weakens both legislative and judicial credibility); Maria C. Holland, *Judicial Review of Compliance with the National Environmental Policy Act: An Opportunity for the Rule of Reason*, 12 B.C. ENVTL. AFF. L. REV. 743, 766 (1985) (footnote omitted) (stating that “proponents of construing NEPA as a procedural mandate are concerned about the potential loss of judicial neutrality through the active direction of the NEPA mandate—undermining judicial credibility in the eyes of the public”); Eric D. (continued)

Once we have established the reference point, the next thing we must do is identify the “gain frames” and “loss frames” with respect to each reference point.⁴⁸⁷ As noted above, appeals are much more likely in corporate taxpayer cases than in individual cases.⁴⁸⁸ Thus, the status quo (i.e., affirming the Service’s decision and holding that there was no abuse of discretion) is within a loss frame when the court is confronted with a corporate taxpayer because it renders an appeal (and subsequent overturning) more likely. Kahneman and Tversky’s prospect theory predicts that when the status quo constitutes a loss frame, the decision maker is more likely to engage behavior involving risk;⁴⁸⁹ just as a taxpayer who is going to incur a tax liability is more likely to cheat on his or her return. Thus, the court is more likely to depart from the deference principle in corporate taxpayer cases.

The opposite is true with respect to individual collections cases brought under Code section 6330. In these cases there is little likelihood of an appeal.⁴⁹⁰ Furthermore, due to these taxpayers’ lack of resources and inability to draw attention to their plight,⁴⁹¹ there is little chance for public scorn thrust upon the court as a consequence of the decisions in these cases. Thus, the status quo with regard to individual collection cases represents a “gain frame” whereby the court may grant great deference to the Service, not only with little risk of adverse consequence, but arguably safely with the knowledge that the rule of law is being upheld through observance of the mandated deferential posture. Taking a risk by reducing the amount of deference, Kahneman and Tversky would tell us, is unlikely under these circumstances.

This leaves us only with the equitable relief cases under Code section 6015(f) to consider. As has been noted, the deferential difference exhibited by the Tax Court with regard to corporate taxpayer cases as compared to individual collections cases under Code section 6330 does not appear to exist with regard to the so-called “innocent spouse” cases, specifically those cases in which equitable relief is sought under Code section 6015(f). To the contrary, like the corporate cases, the court tends to closely scrutinize the facts presented and is more likely to overrule the

Miller, Comment, *Should Courts Consider 18 USC § 3501 Sua Sponte?*, 65 U. CHI. L. REV. 1029, 1057 (1998) (deciding cases on incorrect principles damages judicial credibility).

⁴⁸⁷ See *supra* notes 450-452 and accompanying text.

⁴⁸⁸ See *supra* note 344 and accompanying text. The greater availability of resources is undoubtedly one of the reasons for this.

⁴⁸⁹ Kahneman & Tversky, *supra* note 300, at 287-88.

⁴⁹⁰ As noted *supra* note 334, no case brought under I.R.C. section 6330 has yet to be successfully appealed.

⁴⁹¹ As noted *supra* note 278, few of the individual taxpayers in collection cases are even represented by counsel.

Service than in the individual collections cases.⁴⁹² If prospect theory is to be accepted as a sufficient model to explain the deferential difference, it must be able to explain why the phenomenon does not seem to occur in equitable relief cases. As with the corporate cases, prospect theory must enable us to reach the conclusion that these cases represent loss frames so that the incentive of the court is to take a risk in the appropriate circumstances by jettisoning the traditional constraints of deference.

How are equitable relief cases like corporate cases in this regard? First, these cases involve taxpayers who are much more likely to be represented than the individual collection cases who are much more likely to be appeal.⁴⁹³ Second, there may be something of a social stigma attached to taxpayer-disfavorable outcomes in these cases. Equitable relief cases are brought under the penumbra of innocent spouse cases, which were originally created to combat perceived unfairness in the joint and several liability rules of the Code.⁴⁹⁴ In this sense, taxpayers bringing an equitable relief case under Code section 6015(f) present themselves to the court in a more sympathetic posture than the individuals who are seeking refuge from legitimate tax debts.⁴⁹⁵

Thus, it appears that sociological theory may provide several palatable explanations for the deferential difference. Homans' exchange theory, especially as refined by Blau and others, seems to offer good insight, but it displays areas of weakness that render it an incomplete explanation. Prospect theory would appear to overcome these weaknesses and offers a satisfactorily complete model with which to explain Tax Court behavior in abuse of discretion cases.

Although this Article has focused on sociological theory, other social sciences may also help to explain the deferential difference. For example, Professor Lott has used economic theory to demonstrate that varying the probability of imprisonment based on the wealth of the defendant could create more efficient outcomes in criminal cases.⁴⁹⁶ By the same token, it

⁴⁹² See *supra* notes 250-267 and accompanying text.

⁴⁹³ In sixty-eight cases brought before the Tax Court seeking equitable relief under I.R.C. section 6015(f) since 2000, counsel appeared on behalf of the taxpayer in 19, nearly one-third of the time.

⁴⁹⁴ See *supra* note 250 and accompanying text.

⁴⁹⁵ Earlier I discussed how this concept may be extrapolated from Blau's approach to risk. See *supra* note 434 and accompanying text.

⁴⁹⁶ John R. Lott, Jr., *Should the Wealthy Be Able to "Buy Justice"?*, 95 J. POL. ECON. 1307, 1307-08 (1987). Professor Lott posits that varying the probability of conviction might more likely result in the optimum level of deterrence and might be preferable to varying the length of imprisonment when it is sufficiently costly for others to determine the subjective opportunity costs of a criminal defendant. *Id.* at 1307. This conclusion begins with the proposition that the penalty levied on a criminal only maximizes social good "if a
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might be argued that the deferential difference is, in fact, more efficient than a consistent level of deference and that the latter would fail to maximize social good, despite its attractiveness on equity grounds.⁴⁹⁷

Scholars, including one of the original proponents of prospect theory, have enhanced the literature in this area by exploring explanations of behavior from a political science perspective.⁴⁹⁸ Perhaps the most valuable

crime is not deterred when the benefit to the criminal of a particular crime is greater than the total social cost of that crime.” *Id.* at 1308. Professor Lott states his controversial conclusion as follows:

Preventing wealthy people from influencing the opinion of the court in their favor will lead to expected punishments that are too large for the wealthy, assuming that they are at the correct level for the poor. Similarly, if the expected level of punishment equaled the total social cost for wealthy criminals and the probability that punishment will be imposed is the same for both the poor and the wealthy, too much crime will be committed by the poor.

Therefore, allowing wealthy people to do what on first glance may seem like “subverting” the legal system can be efficient. It allows society to come closer to obtaining the optimum expected penalty for a larger group of people without having to vary the jail term for any given crime according to the opportunity cost of the criminal.

Id. at 1310 (footnote omitted).

⁴⁹⁷ The same analysis utilized by Professor Lott could be applied to abuse of discretion cases. As was observed by Judge Nims, there is a lot at stake when a corporate taxpayer is before the court. *See* Nims, *supra* note 45 and accompanying text. Thus, perhaps it is more efficient to allow corporations to influence the opinion of the court in their favor, lest the price of deference be too high a cost for them, resulting in a failure to maximize social good. Professor Lott insisted that “[e]quity considerations do not present a plausible justification” for failing to maximize social utility in criminal cases, but acknowledged that taxation might be an appropriate mechanism for leveling the playing field between rich and poor. Lott, *supra* note 496, at 1310 n.5. “Justice,” in Lott’s view, does not necessarily imply equal treatment of the same activity, and he suggests that equalizing probabilities may, in fact, “move us away from the goal of equality under the law.” *Id.* at 1315.

⁴⁹⁸ George, *supra* note 5 (considering the implications of a combined attitudinal and strategic theory of en banc court of appeals decision-making and the effects of judges’ policy preferences on judicial decisions); Schneider, *Statutory Construction*, *supra* note 268 (finding that judges’ social backgrounds were a poor indication of their methods of statutory construction and judicial decisions); George A. Quattrone & Amos Tversky, *Contrasting Rational and Psychological Analyses of Political Choice*, 82 AM. POL. SCI. REV. 719 (1988) (discussing and contrasting expected utility theory and prospect theory in
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political science insights in this respect come through the lens of the so-called “new institutionalism.” New institutionalism, also called neo-institutionalism, is a social theory that explores the role of institutions in society and how these institutions interact.⁴⁹⁹ The interaction of institutions has a distinct impact on both society and the individual, as the institutions create a framework that influences human behavior.⁵⁰⁰ The new institutionalism school of thought posits that institutions are the “critical contextual variable” that affects individual behavior and in turn results in collective outcomes.⁵⁰¹ The term “institution” itself can have a variety of meanings depending on how inclusive or exclusive a new institutionalism theorist chooses to be.⁵⁰² Samuel P. Huntington offers one of the most inclusive definitions of institution by including “stable, valued, recurring patterns of behavior.”⁵⁰³ Likewise, the term has also been identified as a “regularized or crystallized principle of conduct, action or behaviour that governs a crucial area of social life and that endures over time.”⁵⁰⁴ However, the definition of institution also extends to institutions such as government agencies and corporations, which are generally thought of as more concrete as opposed to cognitive, concepts.⁵⁰⁵

The relationship between institutions and individuals is disputed among scholars within new institutionalism.⁵⁰⁶ On the one hand, it is argued that institutions shape individuals’ preferences. On the other hand, it is argued that individuals develop their preferences without the influence of institutions and that institutions actually constrain individuals and prompt them to form new institutions that further their self-determined preferences.⁵⁰⁷ Nonetheless, the essential nature of institutions in society is not lost in either interpretation. The former argument seems to view the

relation to the choice between political candidates and referendum issues and the rationality of voting).

⁴⁹⁹ For a definition of “new institutionalism,” see *New Institutionalism*, at http://en.wikipedia.org/wiki/New_institutionalism (last visited Oct. 27, 2004).

⁵⁰⁰ See *id.*

⁵⁰¹ James M. Ferris & Shui-Yan Tang, *The New Institutionalism and Public Administration: An Overview*, 3 J. PUB. ADMIN. RES. & THEORY 4, 4 (1993).

⁵⁰² Rogers M. Smith, *Political Jurisprudence, The “New Institutionalism,” and the Future of Public Law*, 82 AM. POL. SCI. REV. 89, 91 (1988).

⁵⁰³ *Id.*

⁵⁰⁴ Philip Ethington & Eileen McDonagh, *The Eclectic Center of the New Institutionalism: Axes of Analysis in Comparative Perspective*, 19 SOC. SCI. HIST. 467, 468-69 (1995).

⁵⁰⁵ See Smith, *supra* note 502, at 91.

⁵⁰⁶ Ferris & Tang, *supra* note 501, at 5.

⁵⁰⁷ *Id.* at 5; see also Smith, *supra* note 501 (discussing the two roads leading to new institutionalism).

constructs of institutions as transcending and immutable—individuals conform to institutions regardless, perhaps, of rational or irrational nature. The latter argument intimates that individuals have the power to change institutions when the constructs of the institutions hinder, rather than encourage, individuals. This theory of new institutionalism seems to parallel the rational choice assertion that individuals act to maximize outcomes.

It seems that in the legal and political arena, these two conceptions of new institutionalism converge.⁵⁰⁸ Institutions shape the preferences and decisions of political actors, but at the same time political actors have the power and ability to change institutions.⁵⁰⁹ For instance, judges make decisions based on rules of statutory construction or case precedent, but when it appears justice will no longer be met by adhering to these institutions, judges should set new precedent.

Some theorists would go further to assert that individuals also have the means to affect a change through “social ruptures.”⁵¹⁰ These theorists find that concerns and needs of certain groups in society are excluded; thus, there is a frustrated sector among the institutions that profess to embody societal norms.⁵¹¹ Rogers M. Smith articulates the relationship by stating that it is

[a] kind of drama at sea. It occurs on the surface, where individuals and groups sail along, rationally navigating in pursuit of booty, frequently clashing with each other in the process. Their fates, however, frequently depend on the dynamics of the largely uncontrollable economic, technological, and social forces that surround them.⁵¹²

In Smith’s analogy, people make rational choices but only within the framework of institutional norms.⁵¹³ Yet the question arises as to what degree individuals’ decisions can truly be rational when information asymmetry exists between institutions and individuals.⁵¹⁴ It is costly for individuals to obtain information, while, conversely, institutions have the resources to obtain information and, thus, make more informed decisions.⁵¹⁵ Referring again to the political and legal arena, specifically the Tax Court, judges may give deference to corporations in corporate

⁵⁰⁸ See Smith, *supra* note 501, at 90-91.

⁵⁰⁹ *Id.* at 91.

⁵¹⁰ *Id.* at 92.

⁵¹¹ *Id.*

⁵¹² *Id.*

⁵¹³ See *id.*

⁵¹⁴ See Ferris & Tang, *supra* note 501, at 6.

⁵¹⁵ See *id.*

taxation issues and to the Service in individual taxpayer issues because they recognize that institutions are more informed and, therefore, make decisions that benefit the collective outcome.

Regardless of which of these perspectives or explanations the reader finds most satisfying, the point is that what at first appears to be an unacceptable anomaly in judicial decision-making on the part of the Tax Court can, in fact, be explained in a variety of ways using social science techniques. Far from representing a breakdown of the rule of law, social science indicates that the deferential difference is an expected and justifiable outcome given the social constraints involved. Rather than occurring because of accidental inattentiveness or blatant bias, the deferential difference represents an understandable, ingrained institutional inclination. In other words, it is not the “fault” of any of the participants in the process, but a natural, and possibly even efficient, outcome. Because an outcome may be justified and explained by social science, however, does not mean it must be deemed acceptable. As outlined earlier in this Article, tax justice requires certain frameworks of horizontal and vertical equity that cannot be achieved so long as the deferential difference exists.⁵¹⁶ In order to promote the goal of tax justice, therefore, a solution to the deferential difference must be implemented. Since it is an ingrained institutional inclination, the only realistic hope of change is to modify the institutional rules.

VI. MODIFYING THE STANDARD OF REVIEW

Tax Court jurisdiction is founded upon specific provisions of the Code, and is, therefore, not reliant upon the judicial review provisions of the Administrative Procedures Act (“APA”).⁵¹⁷ Instead, the Tax Court is empowered to prescribe its own rules of practice and procedure and, unless statutorily mandated, may establish its own standards of review.⁵¹⁸ Many different types of standards of review have been employed by the Tax Court for various purposes.⁵¹⁹

⁵¹⁶ See *supra* notes 23-45 and accompanying text.

⁵¹⁷ Administrative Procedure Act, ch. 324, 60 stat. 237 (1946) (codified as amended in scattered sections of 5 U.S.C.); see also *O’Dwyer v. Comm’r*, 266 F.2d 575, 580 (4th Cir. 1959) (holding that the APA does not apply to deficiency determinations in the Tax Court because there is no review of a record made in a formal proceeding).

⁵¹⁸ See *infra* note 519.

⁵¹⁹ For example, the preponderance standard has been used. *Dorsey v. Comm’r*, 49 T.C. 606, 629 (1968); *Abraham & Straus, Inc. v. Comm’r*, 21 B.T.A. 1145, 1149 (1931). The clear and convincing standard has also been applied by the court. *ASAT, Inc. v. Comm’r*, 108 T.C. 147, 167 (1997). *ASAT* distinguishes the clear and convincing standard from the abuse of discretion standard as follows:

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Generally speaking, “where the validity of the underlying tax liability is properly at issue, the Court will review the matter de novo. Where the validity of the underlying tax liability is not properly at issue, however, the Court will review the Commissioner's administrative determination for abuse of discretion.”⁵²⁰ Under an abuse of discretion standard, the court does not interfere with the Service’s determination unless it “is arbitrary, capricious, clearly unlawful, or without sound basis in fact or law.”⁵²¹ As noted above, the abuse of discretion standard is particularly appropriate when the decisions are predominantly factual in nature.⁵²² The abuse of

The standard of proof is not identical to that in a section 482 case—proving that the Commissioner’s allocations are arbitrary, capricious, or unreasonable. Rather, the standard of proof under section 6038A(e)(3) requires petitioner to show by clear and convincing evidence and without reference to information not in respondent’s possession or knowledge when the determination was made that respondent’s determination was made with an improper motive or is clearly erroneous in light of all reasonably credible interpretations or assumptions of facts.

Id. The court has also used hybrid standards. *McWilliams v. Comm’r*, 103 T.C. 416, 422 (1994) (stating, in a review of a jeopardy assessment case, “The standard of proof by which reasonableness must be established is something more than ‘not arbitrary or capricious’ and something less than ‘substantial evidence.’” (citing *Davis v. United States*, 511 F. Supp. 193, 197 (D. Kan. 1981))); *Meredith Corp. v. Comm’r*, 102 T.C. 406, 438 (1994) (“Where a taxpayer asserts that an allocation of consideration is other than that specified in a contract, this Court has generally taken the position that the taxpayer must present ‘strong proof’ that the asserted allocation ‘is correct based on the intent of the parties and the economic realities.’” (quoting *Major v. Comm’r*, 76 T.C. 239, 247 (1981))).

⁵²⁰ *Robinette v. Comm’r*, [2004] Stand. Fed. Tax Rep. (CCH) 4489, 4492 (July 20, 2004) (to be published at 123 T.C. 85 (2004) (citing *Sego v. Comm’r*, 114 T.C. 604, 610 (2000), and *Goza v. Comm’r*, 114 T.C. 176, 181-82 (2000))).

⁵²¹ *Ewing v. Comm’r*, [2004] Stand. Fed. Tax Rep. (CCH) 4289, 4292 (Jan. 28, 2004) (to be published at 122 T.C. 32 (2004)); *see also* *Woodral v. Comm’r*, 112 T.C. 19, 23 (1999).

⁵²² *See supra* note 50. This has been the general trend of thinking in the courts. *See, e.g.*, *Ornelas v. United States*, 517 U.S. 690 (1996). In that case, the defendants were found guilty of possession of cocaine with the intent to distribute. *Id.* at 691. The District Court ruled that the police officer was credible and that there was probable cause. *Id.* at 695. The appellate court affirmed this ruling using a deferential standard of review. *Id.* at 694-95. The court explained that there was no clear error in the district court’s determination. *Id.* at 695. The Supreme Court granted certiorari to determine the proper standard of review. *Id.* In the majority opinion, delivered by Chief Justice Rehnquist, *id.* at 691, the Court asserted that the appellate court should have used de novo review to be consistent with similar past

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cases. *Id.* at 697. The Court reasoned that independent appellate review of probable cause and reasonable suspicion cases is essential to maintaining appellate court control of legal principles. *Id.* Additionally, the Court stated de novo review would help unify precedent to provide law enforcement with a set of generally applicable rules. *Id.* at 697-98. The Court instructed reviewing courts to still give weight to trial court determinations, as trial judges have the advantage of certain historical facts. *Id.* at 699. In his dissent, Justice Scalia stated that it is unwise for the Court to require de novo review of all probable cause and reasonable suspicion cases. *Id.* at 700 (Scalia, J., dissenting). These particular cases typically involve mixed questions of law and fact, but the dissent points out that this does not necessarily warrant de novo review. *Id.* at 701 (Scalia, J., dissenting). The dissent cites the expertise of district court judges and the “lack of law-clarifying value in the appellate decision” as reasons supporting deferential review of probable cause and reasonable suspicion cases. *Id.* The dissent recognizes that the choice between de novo and deferential review is fact driven and deference should be given to fact finders at the trial level. *Id.* at 701-02 (Scalia, J., dissenting). Generally, appellate courts are inclined to use the de novo standard of review when evaluating questions of state law. *E.g., In re McLinn*, 739 F.2d 1395, 1398 (9th Cir. 1984) (en banc). In *McLinn*, the United States Court of Appeals for the Ninth Circuit ruled that appellate courts must review determinations of state law de novo to make fair and responsible decisions. *Id.* The court recognized that the deferential standard had generally been applied to such questions, but that the structure of appellate courts is advantageous for deciding questions of law de novo and questions of fact under the clearly erroneous standard. *Id.* The court explained that appellate courts do not hear evidence and are comprised of three judges, which minimizes judicial error. *Id.* The dissent in *McLinn* is similar to the dissent in *Ornelas*, as it argues that the deferential standard of review should be used based on the assumption of expertise of district court judges. *Id.* at 1406 (Schroeder, J., dissenting). Similarly, in *Salve Regina College v. Russell*, 499 U.S. 225 (1991), the United States Supreme Court concluded that a “court of appeals should review *de novo* a district court’s determination of state law.” *Id.* at 231. The Court reasoned that appellate courts should use the de novo standard of review to avoid differing decisions on state law. *See id.* In both *McLinn* and *Salve Regina College*, the courts determined that de novo review was the proper standard for appellate determinations of questions of state law. *Id.*; *McLinn*, 739 F.2d at 1398. In these cases it seems the selection of the standard was not quite as fact driven as in *Ornelas*, but more centered on the notions of appellate responsibility and judicial soundness. While there was a movement away from using deferential review in state law determination cases, federal courts have continued to apply this standard in other instances. Most recently in *United States v. Wolny*, 133 F.3d 758 (10th Cir. 1998), the United States Court of Appeals for the Tenth Circuit interpreted *Ornelas* as not extending beyond the search and seizure context. *Id.* at 762. Here, the defendant moved for a mistrial, claiming “that the government knowingly used perjured testimony.” *Id.* at 762. The court ruled that “we have explicitly rejected de novo review of mistrial decisions, opting instead for an abuse of discretion standard.” *Id.* at 762 (citing *United States v. Gabaldon*, 91 F.3d 91, 94 (10th Cir. 1996)). The Court in *Pierce v. Underwood*, 487 U.S. 552 (1998), also applied the deferential standard of review
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discretion standard is currently applied by the Tax Court in collections cases under Code section 6330.⁵²³

However, a less deferential standard may be warranted in these cases on several grounds. First, not every resolution of a collections appeal involves purely factual issues; cases resulting from Code section 6330 hearings are often more legal than factual in nature. Several cases, for example, have involved questions regarding whether the tax at issue was discharged in bankruptcy.⁵²⁴ In July of 1999, Lottie Richardson filed a Chapter 7 bankruptcy petition listing her income tax liabilities as unsecured priority claims.⁵²⁵ Approximately three months later, the bankruptcy court granted Ms. Richardson a discharge.⁵²⁶ Subsequently, the Service filed a Notice of Federal Tax Lien, pursuant to which the

when reviewing a district court decision to award attorney fees under the Equal Access to Justice Act. *Id.* at 563. Here, the Court reasoned that “[b]y reason of settlement conferences and other pretrial activities, the district court may have insights not conveyed by the record.” *Id.* at 560. Twelve years later in *Cooter & Gell v. Hartmarx Corp.*, 496 U.S. 384 (1990), the United States Supreme Court used the deferential standard based on its reasoning in *Pierce*. *Id.* at 403-05. Here, the Supreme Court affirmed the court of appeals’ selection of the deferential standard for reviewing Rule 11 violations. *Id.* at 405. The court of appeals ruled on a mixed question of law and fact, as in *Ornelas*, but instead followed the majority of circuit courts and used the deferential standard. *Id.* at 399-401. In contrast with the Court in *Ornelas*, the Court in *Cooter & Gell* stated, “Deference to the determination of courts on the front lines of litigation will enhance these courts’ ability to control the litigants before them [and] will streamline the litigation process” *Id.* at 404. In *Pierce* and *Cooter & Gell* the Court also appeared to base its decisions to use the deferential standard of review on language of the statute or rule, respectively. In *Pierce*, the Court pointed to the language “unless the court finds that the position of the United States was substantially justified,” to infer that the statute itself dictated appellate court discretion. *Pierce*, 487 U.S. at 559. Likewise in *Cooter & Gell*, the Court looks to the Rule 11 language dictating that the court may “impose an ‘appropriate’ sanction.” *Cooter & Gell*, 496 U.S. at 400. This language indicates that the district court can use its discretion in determining sanctions; thus, appellate courts should review these decisions deferentially. This analysis suggests that the Court may be using a plain language approach, on a case-by-case basis, to determine the appropriate standard of review.

⁵²³ See *supra* note 51.

⁵²⁴ *E.g.*, *Young v. United States*, 535 U.S. 43, 46 (2002) (“If the [Service] has a claim for taxes for which the return was due within three years before the bankruptcy petition was filed, the claim . . . is nondischargeable in bankruptcy”). Income tax liabilities may not be discharged in bankruptcy under a variety of circumstances. 11 U.S.C. § 523 (2000). For example, as in *Young*, the bankruptcy code excepts from discharge taxes for the three years prior to the date of the bankruptcy petition. See *id.* § 523(a)(1)(A).

⁵²⁵ *Richardson v. Comm’r*, 85 T.C.M. (CCH) 1417, 1418-19 (2003).

⁵²⁶ *Id.* at 1419.

taxpayer requested a Collections Due Process hearing.⁵²⁷ After reviewing her account transcripts and documentation of her bankruptcy proceedings, the Appeals Officer determined that Ms. Richardson's bankruptcy discharge had no effect on her income tax liabilities and suggested that she file an offer in compromise.⁵²⁸ Resolution of the issue involved a somewhat complicated application of the rule of equitable tolling.⁵²⁹

Likewise, the Tax Court was confronted with the issue of whether taxes had been discharged in *Swanson v. Commissioner*.⁵³⁰ In that case, the bankruptcy court entered an order of discharge in December of 1998.⁵³¹ On January 23, 2000, the Service sent the taxpayer a notice of intent to levy regarding unpaid income tax liabilities for 1993, 1994, and 1995.⁵³² “[O]n February 10, 2000, petitioner requested a [Code] section 6330 hearing[,]” and on May 3, 2001, the Appeals Officer issued a notice of determination stating that, in its opinion, the income tax liability had not been discharged in the bankruptcy proceeding.⁵³³

Although the ultimate outcome in *Richardson* and *Swanson* hinged on the legal question of whether the taxes involved were dischargeable in a bankruptcy proceeding, in both cases the Tax Court applied the abuse of discretion standard to the Appeals Officer's actions.⁵³⁴ In *Swanson* the court acknowledged that the Appeals Officer's “determination regarding whether [the taxpayer's] unpaid liabilities were discharged in bankruptcy required the interpretation and application of bankruptcy law” and asserted

⁵²⁷ *Id.* at 1418.

⁵²⁸ *Id.* at 1419.

⁵²⁹ *Id.* at 1420-21. With respect to one particular year at issue, the Service acknowledges that the income tax return in question was due more than three years before the chapter seven filing, but asserted that the income tax liability was not discharged because of principles of equitable tolling because of a previously filed chapter thirteen bankruptcy petition. *Id.*

⁵³⁰ 121 T.C. 111, 116 (2003).

⁵³¹ *Id.* at 113.

⁵³² *Id.* at 114.

⁵³³ *Id.* at 114-15. It should be noted that the basis for the Appeals Officer's contention was that the taxpayer had not filed returns for the years in question, and that the notice of determination also cited this failure to file as a reason for not considering any collection alternatives. *Id.* at 115.

⁵³⁴ *Id.* at 119 (“Petitioner received a notice of deficiency, and his arguments are challenges to the appropriateness of the collection action. Therefore, we review the determination to proceed with collection for abuse of discretion.”). In *Richardson*, the court did not specifically state that it was applying an abuse of discretion standard, but the Service's arguments were clearly founded on that basis. *Richardson*, 85 T.C.M. at 1419 (stating that the Service's motion for summary judgment maintained “that the Appeals officer's determination was not an abuse of discretion”).

that abuse of discretion would be found only if the Service's determination was based on "erroneous views of the law."⁵³⁵ In support of this approach, the Tax Court cited a United States Supreme Court case and a case decided by the United States Court of Appeals for the Second Circuit.⁵³⁶ In the Supreme Court case, the issue involved the review of a district court's determination regarding the imposition of a Rule 11⁵³⁷ sanction.⁵³⁸ The Second Circuit case involved a district court's denial of class certification in a class action lawsuit.⁵³⁹ Both cases, therefore, involved the application of law by a federal judge. In the case before the Tax Court, however, the determination of law under review was made by an official of an administrative agency who may not have had any formal legal training.⁵⁴⁰

It would appear that de novo review would have been more appropriate in these cases. Furthermore, de novo review of matters committed to the Service's discretion is not without precedent.⁵⁴¹ The Tax Court has recently indicated a willingness to depart from traditional deference in cases where the Service is statutorily authorized to act with discretion.⁵⁴² In pursuing her innocent spouse/equitable relief claim in Tax Court, Gwendolyn Ewing attempted to introduce evidence that had not been previously considered by the Service in making its adverse determination.⁵⁴³ The Service objected, consistent with its long held position that any facts not presented to the Service are irrelevant for the purpose of the court's abuse of discretion review of the Service's determination, reasoning by analogy to cases decided under the

⁵³⁵ *Swanson*, 121 T.C. at 119.

⁵³⁶ *Id.* (citing *Cooter & Gell v. Hartmarx Corp.*, 496 U.S. 384, 405 (1990), and *Abrams v. Interco, Inc.*, 719 F.2d 23, 28 (2d Cir. 1983)).

⁵³⁷ Rule 11 of the Federal Rules of Civil Procedure provide for the imposition of sanctions on attorneys who are found to have made false or unwarranted representations in a pleading or other document submitted to the court. FED. RUL. CIV. P. 11(b)-(c).

⁵³⁸ *Cooter & Gell*, 496 U.S. at 405 ("[A]n appellate court should apply an abuse-of-discretion standard in reviewing all aspects of a district court's Rule 11 determination.").

⁵³⁹ *Abrams*, 719 F.2d at 25, 27-31.

⁵⁴⁰ *Swanson*, 121 T.C. at 114-15. Neither case indicates the level of legal education, if any attained by the official involved. While some Appeals Officers are, in fact, lawyers, neither a law degree nor any specific legal education credentials are required for that position. A job announcement for the position indicates that "ability to make reasoned judgments involving matters of fact and law" and "ability to conduct legal research and apply the law to a variety of factual situations" is required, but lists no specific education prerequisites. Service SPD No. 90756E.

⁵⁴¹ *E.g.*, *Ewing v. Comm'r*, [2004] Stand. Fed. Tax Rep. (CCH) 4289, 4292 (Jan. 28, 2004) (to be published at 122 T.C. 32 (2004)).

⁵⁴² *Id.*

⁵⁴³ *See id.* at 4290.

Administrative Procedure Act.⁵⁴⁴ In response, the court noted that Code section 6015(e)(1)(A), which authorizes the court to determine the appropriate relief available under Code section 6015, is similar to the court's deficiency jurisdiction in section 6213, which provides that taxpayers who receive a notice of deficiency may petition the Tax Court for a redetermination of the deficiency, implying de novo review.⁵⁴⁵ The court went on to observe that "[i]t is well established that the APA does not apply to deficiency cases in this Court."⁵⁴⁶

⁵⁴⁴ *Id.* The Service maintained that, in making its determination under Code section 6015(f), the Tax Court could not consider evidence introduced at trial that was not included in the administrative record. *Id.* More specifically, the Service contended that, "pursuant to the Administrative Procedure Act (APA), 5 U.S.C. [§§] 551-559, 701-706 (2000), and cases decided thereunder, [the Tax Court] may consider only the administrative record (the record rule) in making our determination in this case." *Id.* (citing *Camp v. Pitts*, 411 U.S. 138 (1973) and *United States v. Carlo Bianchi & Co.*, 373 U.S. 709 (1963)). The Tax Court noted, however, that the Service had recently taken a contrary position in three U.S. Court of Appeals cases involving collections disputes under Code section 6330. *Id.* at n.3. In those cases, the Service contended that the Tax Court did not err in allowing the introduction of evidence that was not part of the administrative record. *Id.* (citing the Commissioner's briefs in *Holliday v. Comm'r*, 57 Fed. Appx. 774 (9th Cir. 2003), *aff'g* 83 T.C.M. (CCH) 1360 (2002); *Lindsey v. Comm'r*, 56 Fed. Appx. 802 (9th Cir. 2003), *aff'g* 83 T.C.M. (CCH) 1440 (2002); *Chase v. Comm'r*, 55 Fed. Appx. 717 (5th Cir. 2002), *aff'g* 83 T.C.M. (CCH) 1464 (2002)). The court quoted from the Service's brief in *Holliday*,

[T]he taxpayer labors under the faulty assumption that judicial review of CDP hearings is governed by the "record review" requirements of the Administrative Procedure Act. . . . Although judicial review of the merits of agency actions pursuant to the APA is generally limited to the administrative record upon which the challenged action was based, see, e.g., *Florida Power & Light Co. v. Lorion*, 470 U.S. 729, 743-44 (1985); *Camp v. Pitts*, 411 U.S. 138, 142 (1973), taxpayer's petition in Tax Court was founded upon I.R.C. § 6330(d)(1), not the judicial review provisions of the APA. . . . Section 6330 does not impose any requirement that the Office of Appeals create a record or that judicial review by the Tax Court be limited to the facts or documents presented at the CDP hearing.

Id. In each of the cases where the Service took this contrary position, the appellate court upheld the Service's position. *Id.*

⁵⁴⁵ *Id.* at 4291. (citing I.R.C. § 6213(a) (2000)).

⁵⁴⁶ *Id.* (citing *O'Dwyer v. Comm'r*, 266 F.2d 575, 580 (4th Cir. 1959) (holding that 5 U.S.C. section 554(a)(1) does not apply to deficiency determinations in the Tax Court because in those cases, the court is not reviewing a record of a formal proceeding; there is
(continued)

The court then focused on the word “determine” as it appears in Code section 6015.⁵⁴⁷ The court noted that since 1924, the Tax Court (and the predecessor Board of Tax Appeal(s), has had jurisdiction to “redetermine” deficiencies and additions to tax; since 1926, it been able to “determine” overpayments.⁵⁴⁸ Thus, the court and its predecessors have “redetermined” deficiencies de novo, not limited to the administrative record, for more than 75 years.⁵⁴⁹ The court went on to say,

[W]e can presume that Congress was aware of this long history in 1998 when Congress used the word ‘determine’ in section 6015. If Congress includes language from a prior statute in a new statute, courts can presume that Congress intended the longstanding legal interpretation of that language to be applied to the new statute.⁵⁵⁰

Most significantly, the court articulated its conclusion that the de novo standard of review could be applied in cases where it was to accord the

no hearing transcript, witness testimony, or exhibits introduced by the parties), *aff’g* 28 T.C. 698 (1957), and *Nappi v. Comm’r*, 58 T.C. 282, 284 (1972).

⁵⁴⁷ *Id.* I.R.C. section 6015(e)(1)(A) provides, “In addition to any other remedy provided by law, the individual may petition the Tax Court (and the Tax Court shall have jurisdiction) to *determine* the appropriate relief available to the individual under this section if such petition is filed” I.R.C. § 6015(e)(1)(A) (2000) (emphasis added).

⁵⁴⁸ *Ewing*, [2004] Stand. Fed. Tax Rep. (CCH) at 4291.

⁵⁴⁹ *Id.*

⁵⁵⁰ *Id.* (citing *Comm’r v. Estate of Noel*, 380 U.S. 678, 680-81 (1965), and *United States v. 101.80 Acres*, 716 F.2d 714, 721 (9th Cir. 1983)). The court also noted,

[T]here are other situations in which [it] makes determinations de novo. For example, section 7436(a) provides that the Tax Court may ‘determine’ whether the Commissioner’s determination regarding an individual’s employment status is correct. Congress intended that we conduct a trial de novo with respect to our determinations regarding employment status.

Id. (citing H.R. REP. NO. 105-148, at 639 (1997), *reprinted in* 1997 U.S.C.C.A.N. 678; S. REP. NO. 105-33, at 304 (1997); H.R. CONF. REP. NO. 105-220, at 734 (1997), *reprinted in* 1997 U.S.C.C.A.N. 1129). The court went on to state, “As another example, section 6404 authorizes this Court to ‘determine’ whether the Secretary’s refusal to abate interest was an abuse of discretion. Our practice has been to make our determination after providing an opportunity for a trial de novo.” *Id.* (citing *Goettee v. Comm’r*, 85 T.C.M. (CCH) 867 (2003); *Jean v. Comm’r*, 84 T.C.M. (CCH) 436 (2002); *Jacobs v. Comm’r*, 2000 T.C.M. (RIA) 671 (2000)).

Service deference under an abuse of discretion evaluation.⁵⁵¹ Examples of actions in which the Tax Court has conducted a trial de novo, when the abuse of discretion standard was applicable, include the corporate taxpayer cases under Code sections 446 and 482,⁵⁵² the Service's failure to waive penalties and additions to tax,⁵⁵³ the Service's refusal to grant the taxpayer's request for an extension of time to file,⁵⁵⁴ and the Service's disallowance of a bad debt reserve deduction.⁵⁵⁵

It is clear, therefore, that the Tax Court is perfectly comfortable with reviewing cases de novo and considering facts not previously submitted to the Service when reviewing a case for abuse of discretion. This makes sense in light of the fact that new information could arise, subsequent to the Service's initial review, that might have an important impact on the case. For example, in a collections case brought under Code section 6330, the taxpayers "received additional documents relating to disputed gains on [certain] sales transactions."⁵⁵⁶ Based on this information, the taxpayers discovered that the Service had calculated their income based on statistics, which was unknown to them at the time of the conference with the Appeals Officer.⁵⁵⁷ As in *Ewing*, the Service contended that this information was irrelevant in a case where the court was to apply the abuse of discretion standard.⁵⁵⁸ Unlike *Ewing*, in this collections case, the Tax Court refused to consider any claims based on events occurring after the Appeals Office hearing, stating that "[m]atters raised after a hearing do not reflect on whether the determinations that are the basis of this petition were an abuse of discretion."⁵⁵⁹

⁵⁵¹ *Id.* at 4292. The court stated: "Our longstanding practice has been to hold trials de novo in many situations where an abuse of discretion standard applies. In those cases, our practice has not been to limit taxpayers to evidence contained in the administrative record or arguments made by the taxpayer at the administrative level." *Id.*

⁵⁵² *Id.* at 4292; see also *Thor Power Tool Co. v. Comm'r*, 439 U.S. 522, 533 (1979); *Bausch & Lomb, Inc. v. Comm'r*, 933 F.2d 1084, 1088 (2d Cir. 1991) (approving implicitly the Tax Court's de novo consideration of Code section 482 reallocations), *aff'g* 92 T.C. 525 (1989); *Mulholland v. United States*, 25 Cl. Ct. 748, 753-56 (1992).

⁵⁵³ *Ewing*, [2004] Stand. Fed. Tax Rep. (CCH) at 4292; see also *Krause v. Comm'r*, 99 T.C. 132, 179 (1992), *aff'd sub nom.* *Hildebrand v. Comm'r*, 28 F.3d 1024 (10th Cir. 1994).

⁵⁵⁴ *Ewing*, [2004] Stand. Fed. Tax Rep. (CCH) at 4292; see also *Estate of Proios v. Comm'r*, 68 T.C.M. (CCH) 645, 650 (1994).

⁵⁵⁵ *Ewing*, [2004] Stand. Fed. Tax Rep. (CCH) at 4292; see also *Newlin Mach. Corp. v. Comm'r*, 28 T.C. 837, 845 (1957), *acq.*, 1958-2 C.B. 3 (1958).

⁵⁵⁶ *Sego v. Comm'r*, 114 T.C. 604, 606 (2000).

⁵⁵⁷ *Id.*

⁵⁵⁸ *Id.*

⁵⁵⁹ *Id.* at 612.

It is surprising that the court would take such a severe stand in light of its subsequent embracing of de novo review in *Ewing* and its emphasis therein on the wide range of abuse of discretion cases in which de novo review has been used.⁵⁶⁰ When the Service is confronted with a collections due process case under Code section 6330, invariably its decision rests on the financial circumstances of the taxpayer. In many of these cases, the taxpayer is proposing a collection alternative, most commonly an offer in compromise.⁵⁶¹ The purpose of an offer in compromise is to give taxpayers a “fresh start,” much like the underlying concept of bankruptcy.⁵⁶² Thus, new information regarding the financial circumstances of the taxpayer would be of particular relevance in these matters.

In *Chandler v. Commissioner*,⁵⁶³ a case decided just 22 days before *Ewing*, Deavrah M. Chandler offered to pay the Service \$100 in compromise of her outstanding tax liability as a collection alternative pursuant to a I.R.C. section 6330 hearing.⁵⁶⁴ The Service rejected the offer, concluding that Chandler could pay the full amount of her tax liability based on income information from the previous year.⁵⁶⁵ Before

⁵⁶⁰ See *supra* notes 552-555 and accompanying text.

⁵⁶¹ See *supra* note 180.

⁵⁶² In February of 1992, the IRS issued a policy statement reflecting the then commissioner's directive to bring people back into the tax system by having them compromise their liability on a more realistic basis than was previously employed, stating that an offer should be accepted “when it is unlikely that the tax liability can be collected in full and the amount offered reasonably reflects collection potential,” and specifying that “[t]he ultimate goal is a compromise which is in the best interests of both the taxpayer and the Service.” Internal Revenue Manual § 1.2.1.5.18 (1992), IRS Policy Statement P-5-100.

Also, in February of 1992, the Internal Revenue Manual . . . was revised to provide that, in considering the amount that should be offered in connection with an offer in compromise, the IRS offer specialist . . . should look at: The taxpayer's present ability to pay . . . for the next five years and reduce that amount to a present value; and the full value of all assets owned by the taxpayer at their “quick sale” value.

Aaron H. Sherbin & Stephen M. Feldman, *The Taxpayer's Ability To Pay—Can the IRS Collection Process Be Made Consistent?*, 74 MICH. BAR J. 1054, 1055 (1995). The offer program was again liberalized by Congress with Title III of the Internal Revenue Service Restructuring and Reform Act of 1998, commonly referred to as the Taxpayer Bill of Rights. Internal Revenue Service Restructuring and Reform Act of 1998, Pub. L. No. 105-206, 112 Stat. 685 (1998).

⁵⁶³ 87 T.C.M. (CCH) 804 (2004).

⁵⁶⁴ *Id.*

⁵⁶⁵ *Id.*

the Tax Court, Ms. Chandler asserted that she was faced with insurmountable debt, that she was diligently trying to avoid bankruptcy as a means of avoiding her debts, and that she faced economic hardship in paying her tax liabilities.⁵⁶⁶ Most importantly, however, she indicated “that the information submitted with the offer in compromise was out of date and that she was prepared to update the information to establish her inability to pay.”⁵⁶⁷ The court, however, would have none of it, stating categorically that her “claims of current financial hardship cannot be considered in this proceeding because they were not raised before the Appeals [O]fficer.”⁵⁶⁸

VII. CONCLUSION

Thus, we are confronted with a situation where the Tax Court, ostensibly applying a consistent standard of review, exhibits a discernable deferential difference with respect to a category of cases and, with respect to that same category of cases, refuses to adopt a de novo standard or to consider subsequent facts, despite its willingness to do so in similar circumstances.

The deferential difference violates both the principles of horizontal and vertical equity and, thereby, represents a failure to achieve tax justice. Corporate taxpayers challenging the Service’s determinations under Code sections 446 and 482, joint filers seeking equitable relief under Code section 6015(f), and individual taxpayers seeking collection relief pursuant to their rights under Code section 6330 are each entitled to have their cases judged by the same standard. As such, these taxpayers are similarly situated in relationship to the tax adjudication process. As has been demonstrated above, however, the treatment they receive is remarkably inconsistent, violating the basic tenant of horizontal equity.

At opposite ends of the deferential difference spectrum, we find large corporations with vast resources for challenging the government and individual taxpayers in collection cases, most of whom proceed without the advantage of counsel.⁵⁶⁹ If Tax Court adjudication is to attain the goal of “the constant and perpetual disposition of legal matters or disputes to render every man his due,”⁵⁷⁰ an element of progressivity must be injected into the disposition of abuse of discretion standards. The foregoing discussion has demonstrated that, far from allocating burdens in accordance with taxpayers’ ability to bear them, the result of the

⁵⁶⁶ *Id.* at 805.

⁵⁶⁷ *Id.*

⁵⁶⁸ *Id.* at 806 (citing *Magana v. Comm’r*, 118 T.C. 488, 493-94 (2002)).

⁵⁶⁹ *See supra* note 278-279.

⁵⁷⁰ BLACK’S LAW DICTIONARY 864 (6th ed. 1990).

deferential difference is to place the heaviest burden upon those least able to bear it.

The solution to this problem is remarkably simple. Social science indicates that the dynamics underlying the deferential difference are ingrained into the structure of the Tax Court as an institution, but massive institutional change is not necessary to overcome the problem. By jettisoning the abuse of discretion standard with regard to cases brought under Code section 6330, the court could level the playing field and make significant progress toward achieving the goal of tax justice. I do not suggest that the burden of proof be placed on the Service. I merely suggest that the degree of proof required of the taxpayer in these cases be modified so that the individual taxpayer may find himself or herself in the same relative posture vis-à-vis the government and the tribunal that corporate taxpayers now enjoy in similar cases. The Tax Court is free to establish its own standards of review, and it has not hesitated to craft malleable standards to address specific problems in the past.⁵⁷¹ In *Ewing* the court showed that it would sua sponte adjust the standard when appropriate.⁵⁷² The time has come to do so again with respect to the collection cases brought under Code section 6330 so that tax justice may be achieved.

⁵⁷¹ See *supra* note 519.

⁵⁷² See *supra* text accompanying notes 541-551.