

## Reflections on the Rule of Law and Clear Reflection of Income: What Constrains Discretion

Edward A. Morse

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# REFLECTIONS ON THE RULE OF LAW AND “CLEAR REFLECTION OF INCOME”: WHAT CONSTRAINS DISCRETION?

*Edward A. Morse*†

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† Associate Professor of Law, Creighton University School of Law. J.D., University of Michigan Law School, 1988; B.S.B.A., Drake University, 1985. The author gratefully acknowledges the helpful comments of John Coverdale, Collin Mangrum, Eric Pearson, and Ralph Whitten, and the research assistance of Jennifer Root (Creighton Law School Class of 1998) and Sara Peckham (Creighton Law School Class of 2000).

## INTRODUCTION

The Rule of Law is a fundamental ideal in American political and constitutional thought.<sup>1</sup> Often contrasted with “the rule of men,”<sup>2</sup> the Rule of Law represents an ideal of constrained governmental power, as opposed to unfettered discretion.<sup>3</sup> Though the parameters for constraint under the Rule of Law are contested, the Rule of Law is traditionally understood to encompass the following goals: (1) protecting people from one another, in the sense of upholding civil order; (2) protecting people from arbitrary governmental action; and (3) providing people with a basis for planning their affairs in light of pre-existing legal consequences.<sup>4</sup>

The Rule of Law is malleable, in that it can accommodate different theories of justice. For example, rule utilitarians might describe the goals of the Rule of Law in relation to economic efficiency or similar policies oriented toward maximizing wealth or satisfaction.<sup>5</sup> Those who are deontologically oriented view the Rule of Law as a means of protect-

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<sup>1</sup> See generally, Richard H. Fallon, Jr., *The ‘Rule of Law’ as a Concept in Constitutional Discourse*, 97 COLUM. L. REV. 1, 3 (1996) (“Respect for the Rule of Law is central to our political and rhetorical traditions, possibly even to our sense of national identity.”); Richard A. Epstein, *Beyond the Rule of Law: Civic Virtue and Constitutional Structure*, 56 GEO. WASH. L. REV. 149, 149 (1987) (Rule of Law is “an ancient and honorable theme in both political theory and American constitutional law.”); RICHARD A. BRISBIN, JR., JUSTICE ANTONIN SCALIA AND THE CONSERVATIVE REVIVAL 292 (1997) (“All Americans . . . ‘believe that politics *is and should be* conducted in accordance with patterns of rights and obligations established under law.’”) (citation omitted); Randy E. Barnett, *Foreword: Unenumerated Constitutional Rights and the Rule of Law*, 14 HARV. J.L. & PUB. POL’Y 615, 615 (1991) (“The rule of law has long been one of the mainstays of liberal thought.”); *Morrison v. Olson*, 487 U.S. 654, 697 (1988) (“It is the proud boast of our democracy that we have a government of laws and not of men.”) (Scalia, J., dissenting) (quotations omitted).

<sup>2</sup> In more modern terms, this might be referred to as the rule of people or individuals. See Margaret Jane Radin, *Reconsidering the Rule of Law*, 69 B. U. L. REV. 781, 781 n.1 (1989).

<sup>3</sup> This aspect of the Rule of Law is often attributed to A.V. Dicey and his work, THE LAW OF THE CONSTITUTION. See Epstein, *supra* note 1, at 151 (“Speaking of the rule of law, [Dicey] says: ‘It means, in the first place, the absolute supremacy or predominancy of regular law as opposed to the influence of arbitrary power, and excludes the existence of arbitrariness, of prerogative [sic], or even wide discretionary authority on the part of the government.’”) (citation omitted); Fallon, *supra* note 1, at 1 (“Within the Anglo-American tradition, perhaps the most famous exposition came from a turn-of-the-century British lawyer, A.V. Dicey, who associated the Rule of Law with rights-based liberalism and judicial review of governmental action.”). See also *In re Winship*, 397 U.S. 358, 384 (1970) (Black, J., dissenting) (referring to the Founders’ struggle to “make certain that men would be governed by law, not the arbitrary fiat of the man or men in power”).

<sup>4</sup> See Fallon, *supra* note 1, at 7-8.

<sup>5</sup> See, e.g., RICHARD A. POSNER, THE ECONOMICS OF JUSTICE 48-87 (1981) (discussing the theory of wealth maximization as founded on law in the context of other utilitarian views); JOHN RAWLS, A THEORY OF JUSTICE 22 (1971) (“The main idea [of classical utilitarianism] is that society is rightly ordered, and therefore just, when its major institutions are arranged so as to achieve the greatest net balance of satisfaction summed overall for the individuals belonging to it.”).

ing individual rights.<sup>6</sup> Legal formalists emphasize still another orientation to the Rule of Law, which emphasizes the internal morality of law as a value independent of other substantive rights.<sup>7</sup> These different approaches to justice share a common interest in constraining government discretion, at least in part, through rules.<sup>8</sup>

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<sup>6</sup> See, e.g., RAWLS, *supra* note 5, at 235-43 (considering that the "rights of persons . . . are protected by the principle of the rule of law"); FRIEDRICH A. HAYEK, *THE ROAD TO SERFDOM* 73 (1944):

While every law restricts individual freedom to some extent by altering the means which people may use in the pursuit of their aims, under the Rule of Law the government is prevented from stultifying individual efforts by *ad hoc* action. Within the known rules of the game the individual is free to pursue his personal ends and desires, certain that the powers of government will not be used deliberately to frustrate his efforts.

*Id.*

<sup>7</sup> See LON L. FULLER, *THE MORALITY OF LAW* 33-94 (2d ed. 1969). Fuller identifies eight aspirational principles for a system of law, which are exemplified in his identification of "eight distinct routes to disaster" which fail to achieve a legal system:

The first and most obvious lies in a failure to achieve rules at all, so that every issue must be decided on an *ad hoc* basis. The other routes are: (2) a failure to publicize, or at least to make available to the affected party, the rules he is expected to observe; (3) the abuse of retroactive legislation, which not only cannot itself guide action, but undercuts the integrity of rules prospective in effect, since it puts them under the threat of retrospective change; (4) a failure to make rules understandable; (5) the enactment of contradictory rules or (6) rules that require conduct beyond the powers of the affected party; (7) introducing such frequent changes in the rules that the subject cannot orient his action by them; and, finally, (8) a failure of congruence between the rules as announced and their actual administration.

*Id.* at 39. Commentators debate whether Fuller's theory is "substantive and natural-law like" or "a formal, content-neutral analysis of the necessary conditions for rules to be effective in guiding human conduct." See Fallon, *supra* note 1, at 38 n. 191. However, for the purpose of this article, it is treated as a foundational view of formal justice, which is oriented toward regular and impartial administration of rules. See RAWLS, *supra* note 5, at 235 (referring to the "regular and impartial, and in this sense fair, administration of law we may call 'justice as regularity'", which he deems "a more suggestive phrase than 'formal justice'").

<sup>8</sup> See RAWLS, *supra* note 5, at 241:

It is clear that, other things equal, the dangers to liberty are less when the law is impartially and regularly administered in accordance with the principle of legality. While a coercive mechanism is necessary, it is obviously essential to define precisely the tendency of its operations. Knowing what things it penalizes and knowing that these are within their power to do or not to do, citizens can draw up their plans accordingly. One who complies with the announced rules need never fear an infringement of his liberty.

*Id.*; FULLER, *supra* note 7, at 209-10:

Surely the very essence of the Rule of Law is that in acting upon the citizen (by putting him in jail, for example, or declaring invalid a deed under which he claims title to property) a government will faithfully apply rules previously declared as to those to be followed by the citizen and as being determinative of his rights and duties. If the Rule of Law does not mean this, it means nothing. Applying rules faithfully implies, in turn, that rules will take the form of general declarations; it would make little sense, for example, if the government were today to enact a special law whereby Jones should be put in jail and then tomorrow were 'faithfully' to follow this 'rule' by actually putting him in jail. Furthermore, if the law is intended

Discretion to make *ad hoc* determinations threatens both efficiency-based and rights-based theories of justice, because no one completely trusts an unconstrained decisionmaker to implement such theories in a consistent, principled manner.<sup>9</sup> Discretion also threatens the internal morality of law by undermining the notice and publicity requirement of rules, which are fundamental elements of a legal system in the formalist tradition.<sup>10</sup>

Constraining discretion is essential to the Rule of Law, but some discretion is unavoidable.<sup>11</sup> Some forms of discretion are products of linguistic indeterminacy and will remain a problem as long as human beings interpret language differently.<sup>12</sup> The post-modern challenge to the enterprise of law, as reflected in deconstructionist activity associated with the Critical Legal Studies movement, expresses an extreme form of discontent with the constraining power of rules.<sup>13</sup> As a practical matter,

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to permit a man to conduct his own affairs subject to an obligation to observe certain restraints imposed by superior authority, this implies that he will not be told at each turn what to do; law furnishes a baseline for self-directed action, not a detailed set of instructions for accomplishing specific objectives.

*Id.* See also POSNER, *supra* note 5, at 74-76 (arguing that wealth maximization provides a foundation for law similar to that of Rawls, which requires an order from the sovereign that has these additional elements):

(1) to count as law, a command must be one that can be complied with by those to whom it is addressed; (2) it must treat equally those who are similarly situated in all respects relevant to the command; (3) it must be public; (4) there must be a procedure for ascertaining the truth of any facts necessary to the application of the command according to its terms.

*Id.* In a later book, Posner criticizes these elements of law, which he associates with formal justice, as "thin gruel." See RICHARD A. POSNER, *THE PROBLEMS OF JURISPRUDENCE* 332 (1990). He argues for a more pragmatic view, which includes "balancing rule-of-law virtues against equitable and discretionary case-specific considerations." *Id.*

<sup>9</sup> See POSNER, *supra* note 8, at 21 ("The idea of judicial discretion—a blank space or black box, not the solution to the problem of deciding cases when the rules run out but merely the name of the problem—is, no matter how fancied up, a source of unease to the legal profession.").

<sup>10</sup> See FULLER, *supra* note 7, at 35 (stating that it is "very unpleasant to have one's case decided by rules when there was no way of knowing what those rules were.").

<sup>11</sup> See JOSEPH RAZ, *The Rule of Law and Its Virtue*, in *THE AUTHORITY OF LAW* 210, 211 (1979) ("The rule of law is a political ideal which a legal system may lack or may possess to a greater or lesser degree. That much is common ground."); Fallon, *supra* note 1, at 9 ("[T]he extent to which a legal system approaches the Rule-of-Law ideal is itself a matter of degree"). Professor Fuller is also quite clear that the "inner morality of law is condemned to remain largely a morality of aspiration and not of duty. Its primary appeal must be to a sense of trusteeship and to the pride of the craftsman." FULLER, *supra* note 7, at 43.

<sup>12</sup> See J. Harvie Wilkinson III, *The Role of Reason in the Rule of Law*, 56 U. CHI. L. REV. 779, 779 (1989) ("In a perfect world, elected representatives would draft laws of supreme clarity and judges would not disturb the indisputable meaning of legal texts. In our fallen world, however, law requires interpretation.")

<sup>13</sup> See WILLIAM ESKRIDGE, JR., *DYNAMIC STATUTORY INTERPRETATION* 196 (1996):

Deconstruction corrodes our belief in the rule of law, as traditionally defined as a law of rules which are independently binding, universally knowable, and objectively predictable. If the 'rules' in the rule of law are subject to the sorts of manipulation

however, rules are capable of communication and constraint.<sup>14</sup> Controversy about the degree of constraint achievable through rules, while not uninteresting, is not the primary focus of this article.

Discretion also arises from the practical impossibility of drafting rules to speak directly to every situation governed by law. A positivist, believing that decisionmakers have discretion to fill in "gaps" between the rules, would argue that discretion is unavoidable in this context.<sup>15</sup> Alternatively, even if one recognizes constraint from legal authority other than positive law enacted by appropriate social institutions, the process of identifying and applying such authority injects considerable uncertainty into the legal system, which is akin to the uncertainty produced by discretion.<sup>16</sup>

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or contextualization suggested by deconstruction, then the formalist sounding rule seems implausible.

*Id.* Even adherents to the Critical Legal Studies movement agree that the American legal system provides some level of determinacy and constraint. See Mark V. Tushnet, *Critical Legal Studies: A Political History*, 100 YALE L.J. 1515, 1538 (1991):

A completely determinate legal system would measure 100 determiniles, while a completely indeterminate one would measure zero. CLS adherents at present defend the position that the proper measure of legal systems is probably between five and fifteen; that is no system is completely indeterminate, but the level of determinacy is relatively low. Mainstream legal theorists at present defend the position that the proper measure of well-functioning legal systems like that of the United States is somewhere between forty and sixty; that is, such systems have a substantial amount of indeterminacy, but not nearly as much as the CLS position claims.

*Id.*

<sup>14</sup> See John F. Coverdale, *Text as Limit: A Plea for Decent Respect of the Tax Code*, 71 TUL. L. REV. 1501, 1511 (1997):

Although the precise limits of language are difficult to establish, our daily experience of communication demonstrates that they lie well outside the range of the trivial. Were this not so, every effort at communication would be pointless. Experience attests to the fact that language works. Whatever theoretical difficulties we may have in explaining how language functions, discussing the subject would be pointless unless we were convinced that words are valid instruments of communication, and for that to be true we must at minimum be able to say with confidence that certain meanings lie outside the plausible range of significance of a particular set of words understood in their context.

*Id.* (footnotes omitted).

<sup>15</sup> See POSNER, *supra* note 8, at 20:

In the influential positivist view expounded by H.L.A. Hart in his book, *THE CONCEPT OF LAW* (1961), the law is the set of rules laid down by legislators, judges, and other authorized lawgivers. When the rules run out or fail to fit (as they often do), the judges have discretion to modify, trim, or extend them as may be necessary to make them cover the case at hand. Alternatively—but it comes to the same thing—one of the rules that compose the law is a jurisdictional rule authorizing judges to exercise discretion whenever there is a gap or ambiguity in the substantive rules. In this view the judge is, as Holmes put it, an interstitial legislator.

*Id.* (citation in original).

<sup>16</sup> See generally RONALD DWORKIN, *TAKING RIGHTS SERIOUSLY* 81 (1978). Professor Dworkin challenges the proposition that judges have discretion to decide cases not governed by a clear rule of law. Instead, Dworkin suggests that the judge has a duty to discover what

Some discretion, though clearly avoidable, is nevertheless permitted in our legal system. Rulemakers may consciously choose to omit detailed criteria for decisionmaking from a rule, relying instead on a decisionmaker's judgment on a case-by-case basis.<sup>17</sup> Normative considerations affect the extent to which rule-based decisionmaking is adopted in the legal system and emphasized in the legal culture. Several different considerations affect the extent to which discretion is tolerated, or even embraced in a legal system. These considerations include: (1) beliefs about the trustworthiness and capacity of government decisionmakers to make appropriate decisions apart from formal rules, (2) the importance of protecting individual rights from discretionary choices, and (3) the economic costs and benefits of rulemaking efforts.<sup>18</sup>

Federal tax law is heavily oriented toward rule-based decisionmaking. Tax determinations are rooted in a highly complex system of rules,<sup>19</sup> and the extensive policy goals and transactional demands on the current tax system are not conducive to brevity or simplicity.<sup>20</sup> The sheer volume and complexity of tax rules has caused some commentators to complain of "hyperlexis,"<sup>21</sup> and more recently it has led to outcries for

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the parties' rights are, and that those rights may compel a particular result. However, he denies that those rights can be identified through a "mechanical procedure," and he also admits that disagreement may result over the identification and weight given to these rights. *See id.* As a practical matter, the resulting uncertainty will often be indistinguishable from that produced by discretion. *See also* POSNER, *supra* note 8, at 22:

The irony of Dworkin's project is that the more broadly law is defined, the less rather than more secure the 'rule of law' becomes. Law loses distinctness—merging first with morals, and then, when it is recognized that society is morally diverse, with politics and hence no-law. If law includes a broad swath of political principles, then judges can do politics and say with a good conscience that they are doing law. 'Right' and 'wrong' become epithets bestowed on the legal analyst's political friends and enemies.

*Id.* at 22-23.

<sup>17</sup> *See infra* notes 161-63 and accompanying text.

<sup>18</sup> *See infra* notes 237-39 and accompanying text.

<sup>19</sup> *See* James W. Colliton, *Standards, Rules and the Decline of Courts in the Law of Taxation*, 99 DICK. L. REV. 265 (1995) (referring to "progression of the tax law from one governed by broad standards to a law dominated by specific rules").

<sup>20</sup> *See* Sheldon S. Cohen, *Taming the Tax Code*, 68 TAX NOTES 1495 (1995) (arguing that a simple tax system is unattainable given the complexity of the current world, and thus Congress should focus on improving the current income tax system); Deborah L. Paul, *The Sources of Tax Complexity: How Much Simplicity Can Fundamental Tax Reform Achieve?*, 76 N.C. L. REV. 151 (1997) (reaching similar conclusions about the prospects of simplicity).

<sup>21</sup> *See* Bayless Manning, *Hyperlexis: Our National Disease*, 71 NW. U. L. REV. 767 (1977). Professor Manning apparently invented this term, which he defined as a "pathological condition caused by an overactive law-making gland." *Id.* Several commentators have adopted this terminology in evaluating our federal tax system. *See, e.g.,* Walter D. Schwidetsky, *Hyperlexis and the Loophole*, 49 OKLA. L. REV. 403 (1996); Colliton, *supra* note 19, at 265 ("The tax law is the most complex body of statutory law that exists in our legal system."); Gordon D Henderson, *Controlling Hyperlexis — the Most Important "Law And . . ."*, 43 TAX LAW. 177 (1989); Richard M. Lipton, *We Have Met the Enemy and He is Us: More Thoughts on Hyperlexis*, 47 TAX LAW. 1 (1993).

reform and simplification.<sup>22</sup> The Internal Revenue Code occupies hundreds of pages of text and is supplemented by thousands of pages of regulations and other pronouncements designed to provide guidance for taxpayers, as well as the government actors charged with administering the tax law.<sup>23</sup> Moreover, a substantial body of case law has emerged, reflecting the further development and refinement of tax rules through the process of judicial review.

Discretion also plays an important role in tax administration, and sometimes that discretion is extensive. Section 446(b) of the Code, which allows the Commissioner to determine whether methods of accounting "clearly reflect income" and impose alternative methods on the basis of that determination, represents an area where Congress has conferred extensive discretionary authority. As discussed below, the Commissioner's "clear reflection" authority originated when few substantive rules governed methods of accounting. However, this authority has persisted in the midst of detailed substantive rules, sometimes modifying rules that would otherwise produce what is perceived to be an undesirable result.<sup>24</sup>

Clear reflection authority is kept in check by the process of judicial review. Hence, the Commissioner is arguably constrained by principles of tax law that have not been reduced to the status of formal rules. This approach to constraining discretion injects considerable uncertainty into the process, raising concerns about efficiency and the protection of taxpayer rights.<sup>25</sup> This approach also tends to overly complicate tax law, resulting in a situation where specific outcomes are determined by an elite cadre of lawyers and judges (and perhaps even academics), rather than by a democratically responsive mechanism that is accessible to the public.<sup>26</sup>

Discretion may be an expedient remedy to correct a perceived "abuse" or "distortion" in measuring taxable income, but it compromises Rule of Law values. Rule-based constraint in this context is both possible and desirable for those who believe in the Rule of Law. Rule-based constraint is likely to enhance efficiency in tax administration and protect taxpayer rights to a greater degree than a discretionary approach to jus-

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<sup>22</sup> See ROBERT E. HALL & ALVIN RABUSHKA, *THE FLAT TAX* 1-11 (2d ed. 1995) (discussing the volume and complexity of the current tax law as reasons for a "flat tax" proposal). Although others challenge whether Hall and Rabushka's approach achieves the goal of reducing complexity, simplification is undoubtedly among the animating forces behind their proposal.

<sup>23</sup> See Wilkinson, *supra* note 12, at 779 ("Even laws of legendary specificity, such as the Internal Revenue Code, have left interstitial questions unaddressed."); Lipton, *supra* note 21, at 3-9 (suggesting that clamoring for more guidance is part of the problem).

<sup>24</sup> See *infra* notes 233-42 and accompanying text.

<sup>25</sup> See *infra* notes 54-55 and accompanying text.

<sup>26</sup> See *infra* notes 54-55 and accompanying text.



tice. Accordingly, normative judgments involved in choosing to embrace discretion—and to compromise Rule of Law values—deserve careful scrutiny.

Part I examines the role of rules in the concept of the Rule of Law and looks at the normative trade-offs that accompany rule-based decisionmaking. Part II provides a brief look at Rule of Law values within the general context of federal tax law, discussing several areas where current tax law compromises Rule of Law values in order to achieve other policy goals. Part III examines the clear reflection of income principle and analyzes several clear reflection cases in relation to concepts of rule-based constraint. Part IV provides concluding observations about effective rule-based constraint on the Commissioner's clear reflection authority.

## I. RULE-BASED CONSTRAINT AND THE RULE OF LAW

The traditional understanding of the Rule of Law involves a fundamental tension between providing civil order through government power while also constraining the scope of that power. Civil order requires "ruling" through government-imposed constraints, whether to protect citizens from each other in the Hobbesian sense,<sup>27</sup> or to enable citizens to cooperate and advance common interests.<sup>28</sup> As for the citizens being "ruled," the Rule of Law seeks to constrain that ruling power, protecting them from arbitrary actions with potentially detrimental effects on human rights or other social and economic values.<sup>29</sup>

Rules have traditionally played an important role in achieving these protective functions of the Rule of Law,<sup>30</sup> as well as the related function

<sup>27</sup> See Eric J. Segall, *Justice Scalia, Critical Legal Studies, and the Rule of Law*, 62 GEO. WASH. L. REV. 991, 996 (1994) ("[T]o escape from Hobbes' state of nature in which freedom is greatly impaired, a coercive sovereign is necessary to ensure that individuals will not 'break the rules that all should see are in their interest as long as all obey.'" (citations omitted); Fallon, *supra* note 1, at 7 (listing "protect[ion] against anarchy and the Hobbesian war of all against all" as one of three central purposes of Rule of Law).

<sup>28</sup> See ESKRIDGE, *supra* note 13, at 141. Professor Eskridge distinguishes legal process theory associated with Henry Hart and Albert Sacks with the Hobbesian aspects of nineteenth century liberalism: "Whereas liberal theory posits mutually suspicious humans who form a social contract to escape the state of nature, legal process theory posits humans who recognize their interdependence and cooperate for the advancement of common interests." *Id.*

<sup>29</sup> See Segall, *supra* note 27, at 997; Fallon, *supra* note 1, at 7 (protection against "some kinds of arbitrariness" is one of three central purposes of Rule of Law); cf. BRISBIN, *supra* note 1, at 299 (discussing concept of "ordered liberty" underlying Rule of Law tradition in American Constitutionalism).

<sup>30</sup> See Radin, *supra* note 2, at 706 ("The Rule of Law as it comes down to us in the liberal tradition is committed to the model of rules, and this means, under the traditional conception of rules, that it is committed to traditional formalism."); Daniel A. Farber, *The Inevitability of Practical Reason: Statutes, Formalism, and the Rule of Law*, 45 VAND. L. REV. 533, 534 (1992) (associating formalism with "'rule of law' virtues" of legal certainty, predictability, and objectivity) (citation omitted); ESKRIDGE, *supra* note 13, at 111:

of facilitating planning by providing reasonably certain and predictable legal consequences.<sup>31</sup> The function of constraint in rule-based decision-making and the normative trade-offs that accompany that constraint are discussed below.

A. RULE-BASED CONSTRAINT: "THE RULE OF LAW AS A LAW OF RULES"<sup>32</sup>

Under the formalist conception of law, "the ideal if not necessary form of 'law' is that of a 'rule,' conceived as a clear prescription that exists prior to its application and that determines appropriate conduct or legal outcomes."<sup>33</sup> Friedrich Hayek concisely describes the Rule of Law in terms of the essential role of rules:

Stripped of all its technicalities, [the Rule of Law] means that government in all its actions is bound by rules fixed and announced beforehand—rules which make it possible to foresee with fair certainty how the authority will use its coercive powers in given circumstances and to plan one's individual affairs on the basis of this knowledge.<sup>34</sup>

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[S]ome liberals (the 'formalists') view the interpreter's role as relatively mechanical, reasoning from authoritative sources to reach determinate answers. This determinacy, or at least the pretense, is essential to the rule of law, which enables citizens to know what statutes govern their conduct and how the statutes will be applied to their activities.

*Id.*

<sup>31</sup> See Fallon, *supra* note 1, at 7-8.

<sup>32</sup> Antonin Scalia, *The Rule of Law as a Law of Rules*, 56 U. Chi. L. Rev. 1175, 1175 (1989).

<sup>33</sup> *Id.* at 14. It should be noted that this description of rules focuses on substantive matters, but says little about jurisdictional issues (i.e., who properly decides). Professor Schauer has asserted that "a system employing empowering rules but leaving substantive decisionmaking authority largely unconstrained by external legal rules seems both pragmatically plausible and accepted as 'law' within the world in which we now exist." Frederick Schauer, *Rules and the Rule of Law*, 14 HARV. J.L. & PUB. POL'Y 646, 657 (1991). A "largely unconstrained" system would not completely fail Fuller's eight requirements for a legal system, as rules would indicate whether one's conduct was within the scope of governmental authority. However, such a system falls dramatically short of the aspirational ideal in which the content of rules is clearly known. In other words, there would certainly be room for improvement.

<sup>34</sup> FRIEDRICH A. HAYEK, *THE ROAD TO SERFDOM* 72 (1944). Joseph Raz calls this "one of the clearest and most powerful formulations of the ideal of the rule of law." Raz, *supra* note 11, at 210. *But see* KENNETH CULP DAVIS, *DISCRETIONARY JUSTICE: A PRELIMINARY INQUIRY* 32-33 (1970), which criticizes Hayek's statement as "an absurdity" to the extent that "all its actions" is interpreted to include such items as the Executive's powers in connection with foreign relations or war. However, Hayek's statement is clearly aspirational, and when understood in that sense, its practical failings may be less problematic. Davis would apparently agree as to the aspirational quality of this statement, although he apparently accepts discretion at a far greater extent than Hayek. *See id.* at 33 (Hayek's version of the Rule of Law expresses "an emotion, an aspiration, an ideal" that is not "based on a down-to-earth analysis of the practical problems with which modern governments are confronted.").

Rules may achieve their predictive and constraining power through several important attributes, which merit closer examination.

As Hayek suggests, rules must be "fixed and announced beforehand."<sup>35</sup> This requirement emphasizes that planning in reliance upon a rule is possible only to the extent that its content is published and understood in advance of its application.<sup>36</sup> Thus, retroactive legislation is particularly troubling from a Rule of Law perspective.<sup>37</sup>

Rules facilitate planning by identifying the relevant criteria for decisionmaking in advance of their application to particular cases, thereby preventing the decisionmaker from choosing criteria outside the rule.<sup>38</sup> In this sense, rules seek to provide "closed" systems that supply the basis for resolving a question or case without resort to other principles or background justifications.<sup>39</sup> By closing off the consideration of other criteria, including potentially disputable criteria involving the purposes behind the rule, rules can limit the variation in results that might occur with a discretion-conferring approach.<sup>40</sup>

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<sup>35</sup> This presumes the ability to identify relevant rules, to understand their requirements, and to conform to those requirements, which are commonly recognized as essential elements of law. See Radin, *supra* note 1, at 785-86 (discussing "know-ability" and "perform-ability" as essential characteristics of law); Fallon, *supra* note 1, at 8 ("People must be able to understand the law and comply with it.").

<sup>36</sup> See POSNER, *supra* note 5, at 75 (public nature of laws is essential to their effectiveness in regulating behavior).

<sup>37</sup> See Stephen R. Munzer, *A Theory of Retroactive Legislation*, 61 TEX. L. REV. 425, 427 (1982) ("[R]etroactive lawmaking violates what is often called the rule of law, namely, an entitlement of persons to guide their behavior by impartial rules that are publicly fixed in advance."). Fuller viewed retroactivity as one of the eight features to be avoided in law, but he also indicated a willingness to tolerate retroactivity in some circumstances. See FULLER, *supra* note 7, at 53:

Like every other human undertaking, the effort to meet the often complex demands of internal morality of the law may suffer various kinds of shipwreck. It is when things go wrong that the retroactive statute often becomes indispensable as a curative measure; though the proper movement of law is forward in time, we sometimes have to stop and turn about to pick up the pieces.

*Id.* As discussed *infra*, taxation may be one of these areas where Fuller is comfortable in compromising Rule of Law values.

<sup>38</sup> See Frederick Schauer, *Formalism*, 97 YALE L. J. 509, 540 (1988) ("[T]he key to understanding the relationship of ruleness to predictability is the idea of decisional jurisdiction.").

<sup>39</sup> See *id.* at 535-36 ("Closedness refers to the capacity of a system to decide cases within the confines of that system.").

<sup>40</sup> See *id.* at 540-41. The constraining effect of rules does not require an interpretational theory that focuses only on the dictionary meaning of words. Rule-based constraint can tolerate contextual references, such as legislative purpose, intent, structure, or other features, in matters of interpretation, but the such references should not contradict the limits of the text. See Coverdale, *supra* note 14, at 1504 (arguing against the use of context to produce interpretations that are "anti-textual", which he defines as "a meaning that Congress could not reasonably be expected to express in the text it actually enacted"); Michael Livingston, *Practical Reason, "Purposivism," and the Interpretation of Tax Statutes*, 51 TAX L. REV. 677, 684 (1996) (noting that "an especially radical purposivism, under which courts may ignore or re-

Rule-based decisionmaking contrasts with particularistic decision-making, in which a decisionmaker is free to take into account any criteria that he deems relevant to the case at hand.<sup>41</sup> A positive example of particularistic decisionmaking is the wise monarch who dispenses justice without resort to the constraints of formal rules.<sup>42</sup> Such unconstrained decisionmakers are empowered to determine relevant criteria for themselves on the basis of currently available information.<sup>43</sup>

Rules constrain discretion by channeling the decisionmaking process through the prescribed criteria, but they do not necessarily eliminate discretion. No clear consensus exists on the extent to which discretion must be constrained in order to achieve "ruleness."<sup>44</sup> Frederick Schauer has suggested that "any specification of mandate narrower than a mandate to make the best all-things-considered decision is a form of rule, because it precludes the decisionmaker from considering those factors that would be included in an all-things-considered mandate but are not included in the narrower mandate."<sup>45</sup>

Others have defined the quality of "ruleness" based on the specificity of criteria provided by a rule in advance of its application, and have invoked distinctions between "rules" and "standards."<sup>46</sup> So-called "clear

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wise even explicit statutory language that is inconsistent with the underlying goals of the statute" may violate the rule of law).

<sup>41</sup> See Scalia, *supra* note 32, at 1175; KENT GREENAWALT, *LAW AND OBJECTIVITY* 142 (1992) ("The opposite of regulation by general rules of law is decision by someone based on circumstances or characteristics that he or she thinks relevant.").

<sup>42</sup> See Scalia, *supra* note 32, at 1175-76 (discussing Louis IX of France and King Solomon as positive examples of discretionary decisionmaking).

<sup>43</sup> This does not necessarily mean that the decisionmaker can do as he or she wishes, without regard to principles of justice recognized in the community. There may be other sources of constraint besides formal rules. For example, see DWORKIN, *supra* note 16, at 33 ("The strong sense of discretion [i.e., that an official "is simply not bound by standards set by the authority in question", *id.* at 32] is not tantamount to license, and does not exclude criticism. Almost any situation in which a person acts . . . makes relevant certain standards of rationality, fairness, and effectiveness."). For example, the monarch may be constrained by principles of equality and consistency from reaching a result that is inconsistent with prior decisions in similar cases. However, even a monarch with Herculean powers in the realm of justice may not reach the same result as any other judge would reach. See *id.* at 128. Identifying and ascribing weight to principles is a contestable process, and in a legal culture that emphasizes democratic values, the assessability of legal outcomes should not be limited to those with an Herculean aptitude for justice, which is likely to be claimed by lawyers, law professors, and judges. See *infra* notes 140-150 and accompanying text (discussing the Rule of Lenity).

<sup>44</sup> See Schauer, *supra* note 33, at 650-51. ("Where the categories of decision are both large and opaque, the dimension of *ruleness* is greatest, and where the categories are narrow and more transparent to background justifications, the constraints of ruleness are minimized."); Pierre Schlag, *Rules and Standards*, 33 UCLA L. REV. 379, 382 n.16 (1985) ("The terms 'rules' and 'standards' do not have clear and fixed meanings in the scholarly literature.").

<sup>45</sup> Schauer, *supra* note 33, at 653 n.11.

<sup>46</sup> See Louis Kaplow, *Rules Versus Standards: An Economic Analysis*, 42 DUKE L.J. 557, 568-69 (1992) (differentiating between rules and standards based on whether content of law is

rules," which identify in advance objectively determinable criteria that essentially dictate a particular result, represent the strongest form of rule-ness.<sup>47</sup> Rules imposing fines for speed limit violations are frequently offered as examples of clear rules, as they proscribe behavior defined in advance, *i.e.*, driving a motor vehicle faster than a stated speed, and they identify a consequence, *e.g.*, a fine of \$50.<sup>48</sup> A decisionmaker applying such a rule must determine whether someone driving a motor vehicle has exceeded the stated speed.<sup>49</sup> Once these facts are determined, the decisionmaker's role becomes largely ministerial. The application of policy judgments to the content of these categories is minimal in the typical case.

"Standards" present a weaker form of "ruleness," as they allow discretionary power to consider other relevant, but unspecified, factors in a particular case.<sup>50</sup> For example, a speed limit could be designed as a "standard" by prohibiting "unreasonable" or "excessive" speed, but leaving the particular speed open to determination based on facts and circumstances.<sup>51</sup> In this situation, a decisionmaker must give content to the standard, presumably by considering such factors as road and traffic conditions, which are not specifically identified in the law. Such a standard might still constrain discretion to impose a consequence based on irrelevant factors, such as the color of the driver's vehicle, skin, or clothing, but it allows the decisionmaker some latitude to consider other factors besides the driver's speed.

Clear rules provide greater certainty of the law's demands, thereby enhancing the predictability of legal outcomes, which is one of the core

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determined before or after individuals act); Radin, *supra* note 2, at 795-96; Segall, *supra* note 27 at 997-99; *see also* Schlag, *supra* note 44, at 382-83 (distinguishing rules from standards based on the determinacy of the "trigger" and the legal consequences of that triggering event):

The paradigm example of a rule has a hard empirical trigger and a hard determinate response. For instance, the directive that "sounds above 70 decibels shall be punished by a ten dollar fine," is an example of a rule. A standard, by contrast, has a soft evaluative trigger and a soft modulated response. The directive that "excessive loudness shall be enjoined upon a showing of irreparable harm," is an example of a standard.

*Id.*

<sup>47</sup> *See* Segall, *supra* note 27, at 997-98.

<sup>48</sup> *See id.*

<sup>49</sup> *See id.* This assumes a consensus on the meaning of many features of the rule, including the meaning of terms such as "person" and "motor vehicle." *Cf.* H.L.A. HART, *ESSAYS IN JURISPRUDENCE AND PHILOSOPHY* 67 (1983) (discussing different definitions of the term "vehicle" in connection with a statute prohibiting the act of taking a stolen vehicle across state lines).

<sup>50</sup> *See* Segall, *supra* note 27, at 997.

<sup>51</sup> *See id.*; *see also* Schlag, *supra* note 44, at 383 (comparing "70 decibels" to "excessive loudness").

values of the Rule of Law.<sup>52</sup> However, predictability is an aspiration that will not be perfectly realized. For example, Hayek's description of the Rule of Law, as quoted above, required only that results be "foreseeable with fair certainty."<sup>53</sup> Hayek recognized that some unpredictability is a necessary consequence of human limitations in drafting, interpreting, and applying the law:

Though this ideal can never be perfectly achieved, since legislators as well as those to whom the administration of the law is entrusted are fallible men, the essential point, that the discretion left to the executive organs wielding coercive power should be reduced as much as possible, is clear enough.<sup>54</sup>

Even if humans had no limitations and language was perfectly determinate, resource constraints continue to affect the rulemaking process, and those constraints ensure that rules will not identify all relevant criteria for decisionmaking in every situation. Departures from rule-based decisionmaking are practically inevitable, and the question of how much departure is acceptable involves normative considerations, which are explored below.

## B. NORMATIVE ASPECTS OF RULE-BASED DECISIONMAKING

The tendency of rules to suppress the consideration of relevant facts, or to emphasize facts that may be insignificant or inappropriate for a decisionmaker in a particular case, suggests the possibility that rules may produce an unjust result in a particular case.<sup>55</sup> The possibility of

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<sup>52</sup> See Segall, *supra* note 27, at 998. Predictability may also increase productivity, to the extent that economic commitments can be made in reliance upon a stable legal structure. See *id.*; see also Raz, *supra* note 11, at 214 ("This is the basic intuition from which the doctrine of the rule of law derives: the law must be capable of guiding the behavior of its subjects."); Fallon, *supra* note 1, at 8 ("People must be able to understand the law and comply with it."); FREDERICK SCHAUER, *PLAYING BY THE RULES* 137-38 (1991):

Arguments for rule-based decision-making have traditionally focused on the ability of rules to foster the interrelated virtues of reliance, predictability, and certainty. According to such arguments, decision-makers who follow rules even when other results appear preferable enable those affected to predict in advance what the decisions are likely to be. Consequently, those affected by the decisions of others can plan their activities more successfully under a regime of rules than under more particularistic decision-making.

*Id.*

<sup>53</sup> See HAYEK, *supra* note 34, at 72.

<sup>54</sup> *Id.*

<sup>55</sup> Cf. SCHAUER, *supra* note 52, at 136 ("Rules have bite when they ignore differences that are then relevant, consequently treating as alike some cases that are not alike at all. Moreover, rules at times draw distinctions that are in the circumstances irrelevant, so that rules also at times treat differently cases that are actually alike.). Although a rule could take into account all of the relevant factors considered by a decisionmaker unconstrained by rules, this is likely

avoiding substantive injustice that would flow from following rules creates a powerful temptation to leave some matters in the realm of discretion, which might include granting decisionmakers the authority to create exceptions to rules.<sup>56</sup>

Preference for rule-based decisionmaking over particularistic decisionmaking (which may be at least partially constrained by general principles of justice or other social norms) thus involves normative choices and assumptions.<sup>57</sup> The importance of flexibility to achieve substantive justice in particular situations, beliefs about the human capacity to exercise discretion and the constraining power of language, and the willingness to commit resources to rule-making, rule-learning, and rule-following, are among the considerations that affect this choice.

Rules are inherently conservative mechanisms, in that they reflect historical determinations of relevant decisionmaking categories that may be resistant to change. As Professor Schauer explains:

By limiting the ability of decisionmakers to consider every factor relevant to an event, rules make it more difficult to adapt to a changing future. Rules force the future into the categories of the past . . . . A decisionmaker can never exceed the optimal result based on all relevant factors. Thus, a rule-bound decisionmaker, precluded from taking into account certain features of the present case, can never do better but can do worse than a decisionmaker seeking the optimal result for a case through a rule-free decision.<sup>58</sup>

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to make the rule quite complex. For a discussion of the comparative complexity in rules and standards, see Kaplow, *supra* note 46, at 586-96.

<sup>56</sup> See Frederick Schauer, *Exceptions*, 58 U. CHI. L. REV. 871, 894-95 (1991). The exception might take the form of looking to the purpose behind the rule, which is common in American courts. See *id.* However, this is really another means of grafting an additional category into the rule, which further detracts from their predictive power. See *id.*; see also Schauer, *supra* note 33, at 687. Schauer suggests that "rule-revision by judges might be a necessary pressure-release valve from rules the under- or over-inclusion of which would otherwise produce results of such unjustness or silliness as to exceed the capacity of a society to tolerate them." *Id.* However, assigning such capacity to judges is a context dependent judgment. See *id.* at 689.

<sup>57</sup> Professor Schlag's list of "virtues" and "vices" for rules and standards, respectively, reflects some of these normative considerations, to the extent that standards are understood as permitting more discretion. See Schlag, *supra* note 44, at 400. The "virtues" of rules—certainty, uniformity, stability, and security—have countervailing "vices"—intransigence, regimentation, rigidity, and closure. See *id.* Similarly the "virtues" of standards—flexibility, individualization, open-endedness, dynamism, have countervailing "vices"—manipulability, disintegration, indeterminacy, and adventurism. See *id.* Professor Schlag challenges whether this list accurately reflects the characteristics of rules and standards based in significant part on his disagreement as to the potential for determinate language apart from context. See *id.* at 406-408.

<sup>58</sup> Schauer, *supra* note 38, at 542.

Thus, although rules may provide certainty and stability, they may also sacrifice some measure of flexibility in adapting to changed circumstances.<sup>59</sup> Substantive justice in a particular case may not be achieved because the decisionmaker constrained by historically determined criteria in rules cannot make an up-to-the-minute assessment of relevant considerations and values.<sup>60</sup> Legislative changes to update those considerations will, if prospectively effective, occur too late to remedy that injustice in a particular case.

Professor Schauer's suggestion that a rule-based decisionmaker can never do better than a decisionmaker unfettered by rules necessarily assumes that both rule-based and particularistic decisionmakers will decide appropriately, either in interpreting and applying the rule, or in identifying and applying principles of justice. Assumptions about the human capacity for rule interpretation or for exercising discretion are therefore important in this calculus of choosing the extent to which a legal system relies upon rule-based decisionmaking.

To the extent that one doubts the constraining power of rules, allowing more discretion may not seem so troublesome. If language is inherently indeterminate, so that decisionmakers are not constrained from imposing their values through the process of interpretation, then rules unnecessarily burden decisionmakers. In fact, reliance on rule-based decisionmaking may even be viewed as means to mask the decisionmaker's ulterior policy goals or personal biases.<sup>61</sup> However, not

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<sup>59</sup> *Id.* Others have attempted to challenge the inherently conservative nature of rules through "dynamic" theories of statutory interpretation, which take into account current understandings of the hypothetical purposes of rules. See, e.g., WILLIAM N. ESKRIDGE, JR., *DYNAMIC STATUTORY INTERPRETATION* (1994); Alexander Alienikoff, *Updating Statutory Interpretation*, 87 MICH. L. REV. 20, 47-61 (1988) (arguing that statutes be read as though they were "enacted yesterday"). For an interesting critique of Eskridge's view, see John C. Nagle, *Newt Gingrich, Dynamic Statutory Interpreter*, 143 U. PA. L. REV. 2209 (1995) (book review).

<sup>60</sup> Schauer, *supra* note 38, at 535:

[I]t is exactly a rule's rigidity, even in the face of applications that would ill serve its purpose, that renders it a rule. This rigidity derives from the language of the rule's formulation, which prevents the contemplation of every fact and principle relevant to a particular application of the rule. To be formalistic in Llewellyn's sense is to be governed by the rigidity of the rules' formulation; yet, this governance by rigidity is central to the constraint of regulative rules. Formalism in this sense is therefore indistinguishable from "rulism," for what makes a regulative rule a rule, and what distinguishes it from a reason, is precisely the unwillingness to pierce the generalization even in cases in which the generalization appears to the decisionmaker to be inapposite. A rule's acontextual rigidity is what makes it a rule.

*Id.* (footnote omitted).

<sup>61</sup> Deconstructionist theories associated with the Critical Legal Studies movement are quick to recognize doubts about the human capacity for interpreting texts without injecting contextual biases. However, once the framework of rules is deconstructed, they typically offer no positive alternative. See Barnett, *supra* note 1, at 617 ("Although the realists succeeded in undermining confidence in the efficacy of rules, they never succeeded in finding an adequate substitute for the formal requirements of the rule of law.").



everyone shares this judgment about the malleability of rules and the trustworthiness of the unconstrained decisionmaker. As Professor Schauer points out:

It may be a liability to get in the way of wise decisionmakers who sensitively consider all of the relevant factors as they accurately pursue the good. However, it may be an asset to restrict misguided, incompetent, wicked, power-hungry, or simply mistaken decisionmakers whose own sense of the good might diverge from that of the system they serve. The problem, of course, is the difficulty in determining which characterization will fit decisionmakers; we must therefore decide the extent to which we are willing to disable good decisionmakers in order simultaneously to disable bad ones.<sup>62</sup>

Our political and constitutional traditions have historically expressed distrust for discretionary power. On a structural level, the separation of executive, legislative, and judicial powers clearly anticipates the potential for the “misguided, incompetent, wicked, power-hungry, and simply mistaken” to exercise power in our legal system.<sup>63</sup> Locating rulemaking powers primarily in politically accountable branches of government provides some measure of protection from harsh rules; allowing judicial review of the application of rules and of their content in light of constitutional constraints provides additional protection for individual rights.<sup>64</sup> Limiting judicial discretion in interpreting and applying rules preserves their constraining power, as well as their predictive utility.<sup>65</sup>

However, our legal system also includes a traditional concern about law viewed from the perspective of the “bad man,” or more accurately the “legal strategist,” who seeks to exploit weaknesses in the system

<sup>62</sup> Schauer, *supra* note 38, at 543.

<sup>63</sup> Separation of powers is frequently invoked in discussing the Rule of Law as applied to the legal system in the United States. Justice Brandeis has credited separation of powers as a principal bulwark against the exercise of arbitrary power:

[T]he doctrine of the separation of powers was adopted by the Convention of 1787, not to promote efficiency but to preclude the exercise of arbitrary power. The purpose was, not to avoid friction, but, by means of the inevitable friction incident to the distribution of the governmental powers among three departments, to save the people from autocracy.

*Meyers v. United States*, 272 U.S. 52, 293 (1926) (Brandeis, J., dissenting).

<sup>64</sup> *Cf.* Schauer, *supra* note 38, at 541 (noting that expanded grants of decisional jurisdiction “involve decisionmakers in determinations that a system may prefer to have made by someone else.”) See *In re Winship*, 397 U.S. 358, 384 (1970) (Black, J., dissenting) (expressing concern that “law of the judges” was displacing democratically enacted laws).

<sup>65</sup> See Scalia, *supra* note 32, at 1177.

without regard for external standards of justice or morality.<sup>66</sup> The predictive value of rules made possible by the textual emphasis of formalism facilitates this behavior, whereas discretionary power to avoid textual constraints may prevent such exploitation.

Thus, desirability of rule-based decisionmaking depends in part on which is trusted (or feared) most: government decisionmakers (with the potential to violate individual rights through discretion) or citizens (with the potential to exploit weakness in rules to the detriment of the common good). Within the liberal tradition, concerns about enforcement error and abuse by Government actors have often trumped concerns about rule exploitation by individuals.<sup>67</sup> The citizen-favoring approach reaches its apex in criminal law, where the Government faces high standards of proof for conviction and the Rule of Lenity traditionally applies for the benefit of citizens when the construction of criminal statutes are in doubt.<sup>68</sup>

However, rule exploitation can also threaten respect for the legal system, to the extent that significant incongruence develops between rules and widely held views of substantive justice.<sup>69</sup> Developing better rules can curtail such exploitation, but that process entails costs and delays. The costs of developing and enforcing specific rules must be compared with the costs of more generalized and open provisions tolerating more discretion. This cost differential must also be taken into account in assessing the value of rule-based decisionmaking in this model.

Rules are generally more expensive to promulgate than more open standards because rules impose costs of prescribing and articulating the specific factors to be considered in advance of their application.<sup>70</sup> De-

<sup>66</sup> See Oliver Wendell Holmes, *The Path of Law*, 10 HARV. L. REV. 457, 459 (1897).

If you want to know the law and nothing else, you must look at it as a bad man, who cares only for the material consequences which such knowledge enables him to predict, not as a good one, who finds his reasons for conduct, whether inside the law or outside of it, in the vaguer sanctions of conscience.

*Id.* See also Lynn Lopucki, *Legal Culture, Legal Strategy, and the Law in Lawyers' Heads*, 90 NW. U. L. REV. 1498, 1547 (1996) ("Like Holmes' bad man, today's legal strategist probes for weaknesses and exploitable inconsistencies.").

<sup>67</sup> See Barnett, *supra* note 1, at 642 ("For we must never forget that the rule of law is meant to protect the people from the government, not to protect the government from the people.").

<sup>68</sup> For a discussion of the origins of the Rule of Lenity and an argument that courts have, and should have, departed from it in favor of a context-specific approach to statutory interpretation, see generally John Calvin Jeffries, Jr., *Legality, Vagueness, and the Construction of Penal Statutes*, 71 VA. L. REV. 189 (1985).

<sup>69</sup> Cf. Ashutosh Bhagwat, *Hard Cases and the (D)Evolution of Constitutional Doctrine*, 30 CONN. L. REV. 961, 969 (1998) ("[W]hy should we adhere to the law if it is an ass? And if the law seems to require an unjust or socially unpalatable result, is it not an ass?").

<sup>70</sup> See Kaplow, *supra* note 46, at 569. This cost comparison assumes that the rule prescribed would reflect the same degree of complexity as the standard. See *id.* at 590-92. For example, a 55 mile per hour speed limit is significantly less complex than a standard proscrib-

spite the best intentions, rulemakers are not omniscient. Their limited knowledge and foresight make it exceedingly difficult to take into account the complexity that many situations demand.<sup>71</sup> Although investigation and experience may tend to overcome such limitations, the law of diminishing returns applies: "Further investigation and greater deliberation are almost always possible, but after a point would yield little improvement in the quality of the resulting law."<sup>72</sup> Moreover, finality and closure are also important values, which may offset the requirements of making, learning, and applying rules.<sup>73</sup>

Cost savings in applying rules may offset the incremental cost of promulgating them.<sup>74</sup> Assuming an individual will expend resources to become informed about the content of a rule or a standard, predicting results under a standard will generally be more costly than applying a rule. With a standard, the predictor must first give content to the standard by identifying relevant factors affecting the decision. In the case of a rule, however, this is unnecessary insofar as the rule has already defined these factors.<sup>75</sup>

It might be argued that the choice between rules and standards thus reduces to an empirical calculus of likely economic costs, with a social

ing "excessive," "unreasonable," or "unsafe" speeds, as it fails to take into account the factors that might be considered by a sensitive decisionmaker in applying the standard.

<sup>71</sup> See *id.* at 569 ("The problem is that the ideal content of the law . . . is not immediately apparent.")

<sup>72</sup> *Id.* at 579. In addition, there are practical limits in describing procedural details. As Schauer points out:

[A]ny set of norms leaves to the applier of those norms some room for action, and . . . the action exercised in that room is not rule-based, at least not based on or constrained by *legal* rules. Consequently, it is a mistake to assume that *any* legal official is solely in the business of rule-application, for most such officials will be operating at least in part within an area in which the rules allow that official to choose among mutually exclusive but equally legally permissible options. In this sense, law is necessarily at least in part something other than the process of rule application.

Schauer, *supra* note 33, at 682-83 (footnote omitted).

<sup>73</sup> Cf. Larry Alexander, *The Gap*, 14 HARV. J.L. & PUB. POL'Y 695, 696 (1991) ("[T]o avoid even worse consequences than our imperfect rules produce, we need to have some finality attached to our decisions.")

<sup>74</sup> See Kaplow, *supra* note 46, at 572. Professor Posner suggests the possibility that rules could become "so numerous that people subject to them cannot learn them." POSNER, *supra* note 8, at 48. He suggests that "[s]tandards that capture lay intuitions about right behavior (for example, the negligence standard) and that therefore are easy to learn may produce greater legal certainty than a network of precise but technical, nonintuitive rules covering the same ground." *Id.* This is no doubt true, but the comparison is not necessarily helpful. If there is great consensus as to the content of a standard, it is doubtful that "technical, nonintuitive rules" will be enacted in its place, in lieu of an attempt to conceptualize and articulate the basis for that standard.

<sup>75</sup> See *id.* at 569-571. The additional cost might include greater factfinding costs, as well as deliberative costs. See ALFRED C. AMAN, JR. & WILLIAM T. MAYTON, *ADMINISTRATIVE LAW* 70 (1993).

objective toward maximizing net benefits available from rules.<sup>76</sup> The frequency with which conduct affected by a rule occurs is an important variable in this analysis. When similar events occur frequently, the incremental cost of promulgating a rule is likely to be less than the total incremental costs incurred by many different decisionmakers giving content to a comparatively indeterminate standard.<sup>77</sup> Conversely, an investment in promulgating rules may not be justified when the regulated events may occur infrequently (or perhaps never), or when such events are unpredictable and variable.<sup>78</sup> On the side of the rule-followers, the differential costs of learning and understanding complex rules as opposed to broader standards also merit consideration.<sup>79</sup>

Assessing the relative costs and benefits is exceedingly difficult, requiring context-specific data that is unlikely to generate precise results. Moreover, economic efficiency is not always accepted as the paramount criteria for law or justice, especially by those who emphasize the importance of individual rights.<sup>80</sup> The weight accorded to values of stability, predictability and constraint, including procedural matters concerning who is the appropriate decisionmaker, will ultimately be important factors in the decision, as will convictions about the relative importance of preventing rule exploitation. These and other issues are discussed below in the context of federal tax law.

## II. RULE OF LAW VALUES IN FEDERAL TAX LAW

Federal tax law is highly rule-oriented. Instead of a vague and open standard such as "each taxpayer should pay his or her fair share of federal taxes," the Internal Revenue Code attempts to provide relatively determinate parameters for assigning tax burdens to particular transactions and events.<sup>81</sup> Although tax law generally invites taxpayers to plan in reliance upon rules, the current approach to tax administration reserves significant discretion to the Government in developing and applying those rules in particular circumstances. Some manifestations of this dis-

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<sup>76</sup> See Kaplow, *supra* note 46, at 572.

<sup>77</sup> See *id.* at 584-85.

<sup>78</sup> See *id.* at 600.

<sup>79</sup> See RICHARD A. POSNER, *ECONOMIC ANALYSIS OF LAW* § 20.3, at 545 (4th ed. 1992) ("[W]hile standards increase information costs by expanding the scope of inquiry, they reduce them by enabling lay people to understand the law without the aid of expensive experts.").

<sup>80</sup> See *id.* at 545-46 (noting that there are rights-based concerns with cost-benefit analyses).

<sup>81</sup> An ancient Chinese system of taxation parceled out tax quotas from the emperor successively down to lower government officials, with tax liability for each citizen ultimately determined by the local official's understanding of the constituents' ability to pay. See PHILIP D. OLIVER & FRED W. PEEL, JR., *TAX POLICY* 1 (1996). As Oliver and Peel point out: "The United States, which prides itself on having a 'government of laws' and not a 'government of men,' obviously prefers a taxing system based on laws of general application." *Id.*

cretion, such retroactive rulemaking and dynamic rule-revision power, cast doubt upon the importance of Rule of Law values in the realm of taxation.

#### A. THE VALUE OF "RULENESS" IN TAX LAW

Statutory law governing federal taxation has become increasingly specific, voluminous, and complex.<sup>82</sup> Focusing on the modern income tax statutes since ratification of the Sixteenth Amendment in 1913, the relevant statutory provisions have expanded from sixteen pages to hundreds of pages in the current Internal Revenue Code.<sup>83</sup> Much of this expansion reflects the adoption of relatively specific, closed systems of rules to replace more general, open provisions which had been left to interpretation by the courts.<sup>84</sup>

The Code is generally effective in providing predictable results for many transactions commonly affected by the income tax. "Rulelessness" in tax law permits taxpayers to predict their tax obligations, and to plan their activities accordingly.<sup>85</sup> As some judges have noted, planning in

<sup>82</sup> See JOHN F. WITTE, *THE POLITICS AND DEVELOPMENT OF THE FEDERAL INCOME TAX* 5-6 (1985) ("The statement that there is a general trend toward a constantly more complex tax code, and that the code has evolved into a multifaceted policy tool, needs little elaboration and will come as no surprise to those versed in tax policy.").

<sup>83</sup> See Colliton, *supra* note 19, at 265; see also Paul, *supra* note 19, at 158 n.19 (number of code sections relating to the income tax increased 578% from 1954-94; words in Code and regulations increased by 369% and 730%, respectively, over same period).

<sup>84</sup> See generally Colliton, *supra* note 19 (arguing that the expansion of the Code has resulted in adopting specific, complex rules instead of broad standards, with a corresponding shift in power away from the courts, which formerly provided content to those standards).

<sup>85</sup> See Linda A. Schwartzstein, *Smoke and Mirrors: Tax Legislation, Uncertainty and Entrepreneurship*, 6 CORNELL J.L. & PUB. POL'Y 61, 76-77 (discussing importance of stability and certainty to entrepreneurial decisionmaking and activities). Adam Smith included certainty in ascertaining a citizen's tax obligation among the four basic maxims of taxation, based in part on concerns about the potential for abuse of discretion:

The tax which each individual is bound to pay ought to be certain, and not arbitrary. The time of payment, the manner of payment, the quantity to be paid, ought all to be clear and plain to the contributor, and to every other person. Where it is otherwise, every person subject to the tax is put more or less in the power of the tax-gathered [sic], who can either aggravate the tax upon any obnoxious contribution, or extort, by the terror of such aggravation, some present or perquisite to himself. The uncertainty of taxation encourages the insolence and favours the corruption of an order of men who are naturally unpopular, even where they are neither insolent nor corrupt. The certainty of what each individual ought to pay is, in taxation, a matter of so great importance that a very considerable degree of inequality, it appears, I believe, from the experience of all nations, is not near so great an evil as a very small degree of uncertainty.

ADAM SMITH, *AN INQUIRY INTO THE NATURE AND CAUSES OF THE WEALTH OF NATIONS* 777-78 (The Modern Library 1937) (1776). The other three maxims are: (1) "The subjects of every state ought to contribute towards the support of the government, as nearly as possible, in proportion to their respective abilities;" (2) "Every tax ought to be levied at the time, or in the manner, in which it is most likely to be convenient for the contributor to pay it . . ."; and (3) "Every tax ought to be so contrived as both to take out and to keep out of the pockets of the

reliance on tax rules is expected behavior—even a “right”—with no moral opprobrium attached:

In our system, avoidance of a tax by remaining outside the ambit of the law that imposes it is every person’s right. “Over and over again courts have said that there is nothing sinister in so arranging one’s affairs as to keep taxes as low as possible. Everybody does so, rich or poor; and all do right, for nobody owes any public duty to pay more than the law demands: taxes are enforced exactions, not voluntary contributions. To demand more in the name of morals is mere cant.”<sup>86</sup>

Courts sometimes emphasize the importance of predictable results by suggesting that following a settled rule is more important than determining the correct result in each particular case.<sup>87</sup>

Despite this support for the importance of knowable, reliable rules, the Government has also embraced a view of tax law that preserves its flexibility to raise revenue or reallocate tax burdens in particular circumstances. Retroactive legislation, judicially fashioned “anti-abuse” powers, and dynamic rule-revision powers exercised by the Internal Revenue Service cast doubt on the importance of Rule of Law values in federal tax law. Several examples are discussed below.

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people as little as possible, over and above what it brings into the public treasury of the state.”  
*Id.*

<sup>86</sup> *United States v. Thompson/Center Arms Co.*, 504 U.S. 505 (1992) (Souter, J.) (quoting *Commissioner v. Newman*, 159 F.2d 848, 850-51 (2d Cir. 1947) (L. Hand, J. dissenting), cert denied, 331 U.S. 859 (1947)). See also *Commissioner v. First Security Bank of Utah*, 405 U.S. 394, 399 (1972); *McClendon v. Commissioner*, 135 F.3d 1017, 1025 (5th Cir. 1998); *Yosha v. Commissioner*, 861 F.2d 1351, 1363 (7th Cir. 1988); *United States v. Dunbar*, 669 F.2d 1351, 1363 (10th Cir. 1982); *Sullivan v. United States*, 618 F.2d 1001, 1008 (3d Cir. 1980); *United States v. Considine*, 502 F.2d 246, 248 (9th Cir. 1973).

<sup>87</sup> See *Washington Energy Co. v. United States*, 94 F.3d 1557, 1561 (Fed. Cir. 1996) (“[T]he interest that all prospective parties before the court have in uniformity and predictability of outcome must be given its due. We thus temper the independence of the analysis in which we engage by according great weight to the decisions of other circuits on the same question. Moreover, as courts of appeals have long recognized, the need for uniformity of decision applies with special force in tax matters.”); *Pacific First Federal Savings Bank v. Commissioner*, 961 F.2d 800, 803 (9th Cir. 1992) (“[I]n the realm of national tax law, ‘it is more important that the applicable rule of law be settled than it be settled right.’”) (citation omitted). Many of the decisions invoking this principle rely on Justice Brandeis’ dissenting opinion in *Burnet v. Coronado Oil & Gas Co.*, 285 U.S. 393, 405-07 (1931), which justified adherence to stare decisis in cases not involving constitutional principles based on the importance of settled rules, stating in part: “Stare decisis is usually the wise policy, because in most matters it is more important that the applicable rule of law be settled than it be settled right.” *Id.* at 406. Professor Posner suggests that this principle has an economic meaning in those circumstances when an overinclusive rule has been adopted in lieu of a broad, vague standard, which is efficient when the sanction for violating the rule is mild and the costs of transacting around the rule are low. See POSNER, *supra* note 79 at 544.

## B. RETROACTIVE LEGISLATION

Congress has sometimes chosen to compromise Rule of Law values by enacting tax legislation with a retroactive effective date. The Supreme Court generally acquiesces in this choice, refusing to recognize a taxpayer "right" to rely on legislation as enacted if Congress later chooses to alter the rules assigning tax burdens. Although the Court does not entirely dismiss the values of notice and reliability, it gives them limited weight in its constitutional calculus, as evidenced by the recent decision in *United States v. Carlton*.<sup>88</sup>

In *Carlton*, the Court rejected a due process challenge to a statutory amendment imposing a retroactive estate tax burden. As originally enacted in 1986, section 2057 of the Code allowed an estate tax deduction for half the value of stock sold to an employee stock ownership plan (ESOP), without regard to whether the decedent had owned the stock at the time of death.<sup>89</sup> This provision allowed an estate to reduce its estate tax obligation voluntarily, without any significant reduction in the economic value of the estate passing from the decedent.<sup>90</sup> Approximately one year after enactment, Congress amended section 2057 to cure a putative mistake in the statute by limiting the deduction to those decedents who had died owning the applicable stock, and this amendment applied retroactively to the effective date of the original enactment.<sup>91</sup>

Carlton, the executor of the estate in controversy, had purchased and sold stock in reliance on the original statute, before any announcement of intent to change the statute to take away the tax benefit on which Carlton had relied.<sup>92</sup> The parties stipulated that Carlton engaged in the stock transaction on behalf of the estate specifically because of the tax benefits under section 2057.<sup>93</sup> Nevertheless, the Court effectively gave no weight to the taxpayer's reliance on the statute and rejected Carlton's due process challenge to its retroactive amendment:

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<sup>88</sup> 512 U.S. 26 (1994).

<sup>89</sup> *See id.* at 31.

<sup>90</sup> Costs in connection with the purchase and sale of stock, along with any price variation between the purchase and sale, would appear to be the only potential economic detriments to the estate in connection with this transaction. In the transaction at issue here, Carlton purchased 1.5 million MCI shares at an average price of \$7.47 per share, and then resold them two days later at an average price of \$7.05 per share, for a total loss of \$631,000. However, the estate would have reduced the applicable estate tax by more than \$2.5 million as a result of this transaction. *See id.* at 28.

<sup>91</sup> Section 2057 was enacted on October 22, 1986. *See id.* at 28-29. The amendment was enacted on December 22, 1987. *See id.* It should be noted that Congress apparently had second thoughts about this statute, as it was repealed for estates of decedents who died after December 19, 1989. *See id.* at 28, n.1.

<sup>92</sup> *See id.* at 29.

<sup>93</sup> *Id.* at 28-29.

Although Carlton's reliance is uncontested—and the reading of the original statute on which he relied appears to have been correct—his reliance alone is insufficient to establish a constitutional violation. *Tax legislation is not a promise, and a taxpayer has no vested right in the Internal Revenue Code.* Justice Stone explained in *Welch v. Henry*, 305 U.S., at 146-147, 59 S. Ct., at 125-126: "Taxation is neither a penalty imposed on the taxpayer nor a liability which he assumes by contract. It is but a way of apportioning the cost of government among those who in some measure are privileged to enjoy its benefits and must bear its burdens. Since no citizen enjoys immunity from that burden, its retroactive imposition does not necessarily infringe due process . . ." <sup>94</sup>

The absence of advance notice of the change was similarly rejected, as the Court suggested that taxpayers bear the risk of retroactive adjustment of their liability.<sup>95</sup>

Thus, despite the fact that the taxpayer correctly interpreted and followed the rule contained in section 2057, the Court allowed Congress to change the results of following that rule after Carlton had acted in reliance upon it.<sup>96</sup> The importance of corrective action to reallocate tax burdens apparently outweighed any reliance interest of the taxpayer. As the Court explained:

First, Congress' purpose in enacting the amendment was neither illegitimate nor arbitrary. Congress acted to correct what it reasonably viewed as a mistake in the original 1986 provision that would have created a significant and unanticipated revenue loss. There is no plausible contention that Congress acted with an improper motive, as by targeting estate representatives such as Carlton after deliberately inducing them to engage in ESOP trans-

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<sup>94</sup> *Id.* at 33 (emphasis added) (citation in original).

<sup>95</sup> *Id.* (citation omitted).

<sup>96</sup> It is interesting to note that the Court did not attempt to interpret the original statute as precluding Carlton from obtaining the desired benefit. A purposivist interpretive theory might have been invoked to impose the additional condition of ownership by the decedent, which Congress later included in the amendment. However, it may not have done so because the existence of a limiting purpose prior to the amendment was not entirely clear. If Congress intended to create an incentive to sell stock to ESOPs through providing a "windfall" reduction of estate tax liability, it is not self-evident why that purpose would be restricted to those who own stock at death. The Joint Committee Explanation, which was produced after the 1987 amendment, suggests that the purpose of the change with respect to section 2057 was "to provide relief from estate taxes and to encourage the increased transfer of employer securities to ESOPs." JOINT COMMITTEE ON TAXATION, GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986 844 (1987).



actions. Congress, of course, might have chosen to make up the unanticipated revenue loss through general prospective taxation, but that choice would have burdened equally "innocent" taxpayers. Instead, it decided to prevent the loss by denying the deduction to those who had made purely tax-motivated stock transfers. We cannot say that its decision was unreasonable.<sup>97</sup>

Further, the Court emphasized that only a short period of retroactivity was involved, and that this was consistent with past congressional practices.<sup>98</sup>

Justice O'Connor, writing separately, was careful to point out that the Court's due process analysis did not disparage the executor's motivation to reduce the estate's taxes by reliance on the statute as originally written. "Like all taxpayers, Carlton was entitled to structure the estate's affairs to comply with the tax laws while minimizing tax liability."<sup>99</sup> However, Justice O'Connor also agreed that retroactivity was rationally related to the legitimate interest of raising revenue and noted that flexibility in apportioning the government's need for revenue over a modest prior period did not offend due process. Although "the governmental interest in revising the tax laws must at some point give way to the taxpayer's interest in finality and repose," that point was not reached here.<sup>100</sup>

Justices Scalia and Thomas also filed concurring opinions, based on their view that the Due Process Clause lacks any substantive component.<sup>101</sup> Although they found that this retroactive amendment was "harsh and oppressive," the Due Process Clause afforded no relief.<sup>102</sup> Thus, an

<sup>97</sup> *Carlton*, 512 U.S. at 32.

<sup>98</sup> *Id.* at 32-33. Compare the recent case of *Eastern Enterprises v. Apfel*, 524 U.S. 498, 118 S.Ct. 213 (1998), where the Court held that the Coal Industry Retiree Health Benefit Act, which imposed a \$5 million liability on a coal operator on the basis of employment relationships from more than 35 years before, was unconstitutional. A plurality reached this decision by reference to the Takings clause, but Justice Kennedy rejected this analysis in favor of a substantive due process analysis. Like the plurality, Justice Kennedy pointed to a long history of disfavoring retroactive economic legislation. *See id.* at 2158-59. However, Kennedy pointed to *Carlton* as reflecting the tradition that "the degree of retroactive effect is a significant determinant in the constitutionality of a statute." *Id.* at 2159. He agreed with the majority that the 35-year span in this case was "unprecedented in scope." *Id.*

<sup>99</sup> *Carlton*, 512 U.S. at 35.

<sup>100</sup> *Id.* at 37-38.

<sup>101</sup> *See id.* at 28. However, others have found a clear historical link between the legislative obligation to enact "general" laws, the related prohibition against retroactive rulemaking, and the due process concept. *See* Ralph U. Whitten, *The Constitutional Limitations on State Choice of Law: Due Process*, 9 *HAST. CONST. L.Q.* 851, 869-70 (1982). As discussed *supra* in footnote 98, Justice Kennedy's concurring opinion in *Eastern Enterprises* seems to follow this position.

<sup>102</sup> *See Carlton*, 512 U.S. at 39-40:

aggrieved taxpayer's remedy was with Congress, not the Court, regardless of any "harshness" or "oppression" associated with this retroactive rulemaking.

Although retroactive rulemaking by Congress is subject to democratic constraints,<sup>103</sup> traditional objections to retroactive rulemaking are rooted in part in concerns about protecting minority rights from the will of the majority. As Justice Kennedy observed in a later case:

If retroactive laws change the legal consequences of transactions long closed, the change can destroy the reasonable certainty and security which are the very objects of property ownership. As a consequence, due process protection for property must be understood to incorporate our settled tradition against retroactive laws of great severity. Groups targeted by retroactive laws, were they to be denied all protection, would have a justified fear that a government once formed to protect expectations now can destroy them. Both stability of investment and confidence in the constitutional system, then, are secured by due process restrictions against severe retroactive legislation.<sup>104</sup>

In *Carlton*, the Court concluded that no rights arise from the Code itself, thus leaving the estate's property subject to further claims by the Government. The Court's suggestion that "[t]here is no plausible contention that Congress acted with an improper motive, as by targeting estate representatives such as Carlton after deliberately inducing them to engage in ESOP transactions"<sup>105</sup> rings hollow from Carlton's perspec-

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To pass constitutional muster the retroactive aspects of the statute need only be "rationally related to a legitimate legislative purpose." . . . Revenue raising is certainly a legitimate legislative purpose, see U.S. Const., Art. I, s 8, cl. 1, and any law that retroactively adds a tax, removes a deduction, or increases a rate rationally furthers that goal. I welcome this recognition that the Due Process Clause does not prevent retroactive taxes, since I believe that the Due Process Clause guarantees no substantive rights, but only (as it says) process

. . . .

*Id.* <sup>103</sup> See Richard L. Doernberg & Fred S. McChesney, *Doing Good or Doing Well? Congress and the Tax Reform Act of 1986*, 62 N.Y.U. L. REV. 891, 896 (1987) (reviewing JEFFREY H. BIRNBAUM AND ALAN S. MURRAY, *SHOWDOWN AT GUCCI GULCH: LAWMAKERS, LOBBYISTS, AND THE UNLIKELY TRIUMPH OF TAX REFORM*):

Tax reform generally cannot be explained as an altruistic attempt by politicians to improve the Code. It is, rather, a political decision about whose constituents will pay how much to the Treasury. And as with other political decisions, individuals and firms will do what they can to influence the outcome of tax legislation.

*Id.*

<sup>104</sup> *Eastern Enterprises*, 118 S.Ct. at 2159 (Kennedy, J., concurring).

<sup>105</sup> See *supra* text accompanying note 98.

tive, as he did exactly what the rule prescribed. Carlton followed the tax incentive of section 2057, only to find out later that this incentive was not meant for the estate he was administering.

To the extent that Congress' decision is justified by reference to the need to correct a mistake, this proves too much. Section 2057 was not an obvious scrivener's error, which could arguably have provided constructive notice of the need for future correction.<sup>106</sup> Here, the correcting amendment continued to allow other estates that already owned the shares in question to take advantage of the significant benefits that Carlton tried to obtain. If the real mistake here was a misapprehension of the revenue effect, then that concept is too flexible to be a principled basis for selectively raising taxes on a retroactive basis. In effect, Congress could justify any modification that raised more revenue as the correction of a past mistake.

*Carlton* demonstrates that Rule of Law values such as notice and reliability will seldom, if ever, rise to a level of constitutional significance in tax cases when Congress chooses to retroactively adjust tax liability.<sup>107</sup> By rejecting a concept of taxpayer "rights" in reliance upon the Code and a corresponding duty upon the Government to keep its "promises" reflected in the Code,<sup>108</sup> the Court ensures that modest periods of retroactivity are acceptable. Long-standing traditions against retroactive legislation apparently mean little in this context.<sup>109</sup>

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<sup>106</sup> A current example of a scrivener's error can be found in I.R.C. § 1017(a)(2), which generally requires basis reduction for excluded income from the discharge of indebtedness if "under subsection (b)(2)(D) of section 108 . . . any portion of such amount is to be applied to reduce basis." Taken literally, this provision would be meaningless because § 108(b)(2)(D) refers to a reduction of a capital loss carryover, not basis. However, § 108(b)(2)(E) involves basis, and it is the only reference that makes sense in this context. This obvious scrivener's error should not preclude basis reduction under § 1017(a)(2).

<sup>107</sup> Despite Justice O'Connor's suggestion that the government's interest in revising the tax laws must at some point give way to the taxpayer's interest in finality and repose, Justices Scalia and Thomas suggest that the majority's analysis "guarantees that all retroactive tax laws will henceforth be valid." *Carlton*, 512 U.S. at 40.

<sup>108</sup> See *supra* text accompanying note 88.

<sup>109</sup> See Comment, *The Aftermath of United State v. Carlton: Taxpayers Will Have to Pay for Congress's Mistakes*, 40 N.Y.U. L. REV. 599, 601-02 (1996) ("In *Carlton*, the Supreme Court ignored hundreds of years of consistent antipathy to ex post facto lawmaking when it applied the mere rationality test, which is the least exacting due process standard, to the retroactive legislation."). See also *Eastern Enterprises*, 486 U.S. at 770-71 (plurality):

Retroactivity is generally disfavored in the law, *Bowen v. Georgetown Univ. Hospital*, 488 U.S. 204, 208, 109 S.Ct. 468, 469-470, 102 L.Ed.2d 493 (1988), in accordance with "fundamental notions of justice" that have been recognized throughout history, *Kaiser Aluminum & Chemical Corp. v. Bonjorno*, 494 U.S. 827, 855, 110 S.Ct. 1570, 1586-1587, 108 L.Ed.2d 842 (1990) (SCALIA, J., concurring). See also, e.g., *Dash v. Van Kleeck*, 7 Johns. 477, 503 (N.Y.1811) ("It is a principle in the English common law, as ancient as the law itself, that a statute, even of its omnipotent parliament, is not to have a retrospective effect"); H. Broom, *Legal Maxims* 24 (8th ed. 1911) ("Retrospective laws are, as a rule, of questionable policy, and con-

### C. JUDICIALLY CREATED "ANTI-ABUSE" DOCTRINES

Legislative amendments are not the only way to modify the outcome produced by applying particular Code provisions. Codification of tax law into an extensive and complex framework of rules has not prevented courts from deviating from statutory text that produces an undesirable result, often on grounds that following the text would violate an underlying legislative purpose.<sup>110</sup> "Substance over form" and its variations, including "step transaction" and "business purpose" doctrines, are prominent examples of judicially-developed interpretive doctrines that courts use to avoid textual constraints, particularly when the text produces a result unfavorable to the Government.<sup>111</sup> Judicial attitudes to-

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trary to the general principle that legislation by which the conduct of mankind is to be regulated ought to deal with future acts, and ought not to change the character of past transactions carried on upon the faith of the then existing law"). In his Commentaries on the Constitution, Justice Story reasoned, "[r]etro-spective laws are, indeed, generally unjust; and, as has been forcibly said, neither accord with sound legislation nor with the fundamental principles of the social compact." 2 J. Story, Commentaries on the Constitution § 1398 (5th ed. 1891).

*Id.* (citations in original). The plurality in *Eastern Enterprises* identified tax legislation as one area of law in which "retroactivity is generally tolerated." *See id.* at 771-72. Lon Fuller mentions the pervasive retroactive effects of changes in laws as an instrumental argument for retroactive taxation, although he does not conclude that it is a sufficient argument to overturn Rule of Law values. *See FULLER, supra* note 7, at 59-60. For example, denying the deductibility of mortgage interest could reduce the valuation of homes, thereby imposing a burden on homeowners who purchased in reliance on that deductibility. This burden is distinct from the prospective effects from denying the interest deduction in future years. From an economic perspective, debate has focused on the desirability of transition rules to limit the impact of such changes. For an intriguing argument in favor of transition relief, *see* Kyle D. Logue, *Tax Transitions, Opportunistic Retroactivity, and The Benefits of Government Precommitment*, 94 MICH. L. REV. 1129 (1996) (arguing in part that failing to provide transition relief makes tax incentives more costly to implement).

<sup>110</sup> *See, e.g.,* Deborah A. Geier, *Interpreting Tax Legislation: The Role of Purpose*, 2 FLA. TAX REV. 492, 493 (1995):

[T]ax law has a rich history of nonliteral interpretation in order to avoid results that one person or another has considered to be inconsistent with the purpose of the statute as a whole. This tradition is illustrated by the common law doctrines variously named as substance over form, sham transaction, step transaction, business purpose, and assignment of income.

*Id.* *See also* Coverdale, *supra* note 14, at 1504 (arguing against "antitextual" interpretations of the Code, which occur in tax with "unusual frequency"); Lawrence Zelenak, *Thinking About Nonliteral Interpretations of the Internal Revenue Code*, 64 N.C. L. REV. 622, 624 (1986) ("Literal interpretations, based on the language of the Code, often conflict with interpretations based on the structure or policy of the Code.").

<sup>111</sup> *See* Joseph Isenbergh, *Musings on Form and Substance in Taxation*, 49 U. CHI. L. REV. 859, 863-64 (1982).

There has developed a welter of rules and extrastatutory standards that impose particular scrutiny on transactions with results unfavorable to the Treasury. These standards are enshrined in celebrated cases . . . that stand as bulwarks against overreaching by taxpayers. It is from these cases that the basic weapons in the Commissioner's arsenal are derived—the business purpose doctrine, the step transaction doctrine, "substance over form," and others.

ward the role of purpose in tax law interpretation, particularly in circumventing rule-based constraints, have important implications for Rule of Law values.

The interpretive approaches of textualism and purposivism illustrate two contrasting views of rule-based constraint. Textualism focuses primarily on the enacted text as the basis for interpretation, limiting the scope of the inquiry into matters of purpose. Professor Zelinsky provides a useful description of a textualist approach in taxation:

Since the statute as enacted by Congress and the President is . . . the fundamental source of the tax law, those who interpret and apply it should respect the statutory text and should view the text as the primary and initial basis for resolving tax controversies. Adjudicators should resort to secondary sources—case law, regulations, administrative authority, notions of tax policy (even when dressed up as unexpressed statutory purpose)—only after the possibilities of statutory-based solutions have been exhausted. Courts should not lightly declare the Code ambiguous or its literal command unreasonable since any such declaration necessarily displaces the statute adopted by the elected officeholders with ultimate responsibility for the tax law. Since the Code is a relatively new and continually updated text, it requires less liberal construction than older texts which, by definition, could not have been drafted with an understanding of contemporary conditions and which often use words whose connotations have changed with the passage of time.<sup>112</sup>

Those adhering to textual-based approaches might disagree as to the range of materials that courts may consult in interpreting statutes. For example, textualists may disagree as to whether legislative history is an

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*Id.* See also Geier, *supra* note 110, at 495:

In the tax world, most see the tension between textualism and purposivism as arising when a taxpayer wants a textualist approach and the IRS wants to deviate from the textual, form-conscious approach in favor of a purposive approach. This perception is exemplified by the hoary substance-over-form doctrine (with its variants, the step transaction and business purpose doctrines), under which the IRS challenges the taxation of a transaction according to its form in favor of taxation according to the transaction's underlying substance.

*Id.*

<sup>112</sup> Edward A. Zelinsky, *Text, Purpose, Capacity, and Albertson's: A Response to Professor Geier*, 2 FLA. TAX. REV. 717, 730 (1996). Professor Geier's description of textualism is much more closely associated with "literalism." See *id.*; Deborah A. Geier, *Commentary: Textualism and Tax Cases*, 66 TEMP. L. REV. 445, 448-49 (1993); Geier, *supra* note 110, at 511, 514.

appropriate consideration.<sup>113</sup> Textualists, however, emphasize the primacy of text in interpretation and are reluctant to resort to other sources in order to justify results that the statutory language will not bear.<sup>114</sup>

On the other hand, purposive interpretive approaches are more amenable to circumventing the statutory language in order to satisfy other goals relating to the purpose of the statute. Some purposivists tolerate a broad range of sources for purpose, including the ultimate policy goals of particular legislation.<sup>115</sup> Others focus more narrowly on the structure of the Code itself as the source for purpose.<sup>116</sup> This narrower focus reflects an attempt to constrain discretion, albeit one which is not limited by the language of the statute.<sup>117</sup>

*Gregory v. Helvering*<sup>118</sup> is a prominent example from among the many cases in which a court honored the Commissioner's request to abandon textual constraints, to the detriment of a taxpayer who relied upon them.<sup>119</sup> In this familiar tale, Gregory was the sole shareholder of a

<sup>113</sup> See Coverdale, *supra* note 14, at 1509-10. Professor Coverdale's approach rejects so-called "anti-textual" interpretations of the Code, which he defines as "interpretations which impose on the text—including not merely a few isolated words of the section or sections under discussion but all applicable provisions read in the broad context of the Code—a meaning that Congress could not reasonably be expected to express in the text it actually enacted." *Id.* at 1503-04. This approach relies on the "primacy of enacted text", but rejects other aspects of textualist theory, as he would allow the use of legislative history. *See id.* at 1509. He also suggests "minimal reasonableness and respect for human rights are such essential characteristics of law that a court should not apply a statute in a way the violates these values in a fundamental way, even though the statute's text may seem to require doing so." *Id.* at 1509 n.28. However, his remedy—declaring the statute unconstitutional—would presumably be different than a remedy of simply reinterpreting the text in a manner that the text itself would not bear. *See id.*

<sup>114</sup> *See id.* at 1509-10. Professor Coverdale would allow an anti-textual interpretation only to prevent an absurd result. *See id.* at 1505 n.16. *See also* Livingston, *supra* note 40, at 680-81 (noting that Hart and Sacks' approach to legislative purpose is limited by the meaning the statutory word will bear).

<sup>115</sup> *See* Geier, *supra* note 110, at 514-19 (discussing different approaches to legislative purpose).

<sup>116</sup> *See id.* at 497. Professor Geier defines "structure" as "the theoretical construct that overarches the sum total of the entire Internal Revenue Code and is intended to be captured by it." *Id.* This includes "such ideas as the same dollars should not be taxed to the same person more than once or deducted by the same person more than once," and that an income tax is "trying to reach . . . consumption and net increases in wealth." *See id.*

<sup>117</sup> Professor Geier believes that her concept of the "structure" of the Code is distinguishable from an approach that relies on the "ultimate purpose" of a statute, which might not be sufficient to "curb strong-willed judges from implementing what they see as the correct policy for the country." *Id.* at 514. It is clear that she views constraint as important: "I, too, wish judges to be constrained from using outcome-based approaches and have thus struggled to fashion my own set of constraints, outlined both here and elsewhere, within the nomenclature of purpose." *Id.* at 516. As discussed *infra*, however, others question whether this approach is an effective means of constraint.

<sup>118</sup> 293 U.S. 465 (1935).

<sup>119</sup> For an extended discussion of *Gregory* and similar cases involving the abandonment of textual constraints, see Coverdale, *supra* note 14, at 1529-38. Professor Coverdale charac-

corporation ("United") which had among its assets highly appreciated stock in another corporation ("Monitor").<sup>120</sup> In order to obtain cash from the disposition of the Monitor stock, Gregory had three basic options: (1) United could sell the stock and distribute cash to her; (2) United could distribute the stock in kind to Gregory, who could then sell the stock for cash; or (3) United could transfer the Monitor shares to a separate corporation controlled by Gregory, and then the separate corporation could liquidate, thereby distributing the shares to Gregory, who could then sell the stock for cash.<sup>121</sup>

If tax effects were ignored, each option would generate similar economic results. However, during the year at issue, the form of this transaction could generate dramatically different tax consequences, with the first alternative generating the highest total tax and the third generating the lowest total tax.<sup>122</sup> Not surprisingly, Gregory chose the third alternative. The Commissioner challenged this plan, claiming that it was "without substance and must be disregarded,"<sup>123</sup> and the Supreme Court upheld the Commissioner's determination.

The Court found that the transaction was:

[s]imply an operation having no business or corporate purpose—a mere device which put on the form of a corporate reorganization as a disguise for concealing its real character, and the sole object and accomplishment of which was the consummation of a preconceived plan, not to reorganize a business or any part of a business, but

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terizes *Gregory* as "a defining case in tax law." *Id.* at 1529. See also Zelenak, *supra* note 110, at 667 (citing *Gregory* as "perhaps the most influential case in the development of the progovernment interpretive bias").

<sup>120</sup> See *Gregory*, 293 U.S. at 467.

<sup>121</sup> See Coverdale, *supra* note 14, at 1529-30.

<sup>122</sup> The first alternative would have generated both corporate-level tax on the sale and personal income tax on the distribution of the cash dividend. The second alternative would have avoided the corporate-level tax, but it would have generated a personal income tax on the dividend distributed in kind, which would be measured by reference to the property's fair market value when distributed. Gregory could then resell the Monitor stock for its fair market value without tax consequences. The third alternative would have also avoided corporate-level tax if the reorganization provisions were respected, but it would avoid the personal income tax on the distribution of the Monitor stock, which would not constitute a taxable dividend. Gregory's sale of the stock would not be tax-free, but it would generate less taxable income than a dividend because she would be allowed to recover a portion of her basis from the United Stock, which would be allocated to the Monitor stock after the reorganization and liquidation. See generally Coverdale, *supra* note 14, at 1530; MARTIN D. GINSBERG & JACK S. LEVIN, *MERGERS, ACQUISITIONS, AND BUYOUTS* § 603.1, n.6 (1997).

<sup>123</sup> See *Gregory*, 293 U.S. at 467. The Commissioner taxed Gregory as though "United Corporation had paid her a dividend consisting of the amount realized from the sale of the Monitor shares." *Id.*

to transfer a parcel of corporate shares to [Gregory]  
 . . . .<sup>124</sup>

Although the Court recognized that the taxpayer's motivation to avoid taxation "will not alter the result or make unlawful what the statute allows,"<sup>125</sup> it found that the transaction in this case was not what the statute meant by "reorganization:"

The whole undertaking, though conducted according to the terms of [the applicable statute], was in fact an elaborate and devious form of conveyance masquerading as a corporate reorganization, and nothing else. The rule which excludes from consideration the motive of tax avoidance is not pertinent to the situation, because the transaction upon its face lies outside the plain intent of the statute. To hold otherwise would be to exalt artifice above reality and to deprive the statutory provision in question of all serious purpose.<sup>126</sup>

Here, the "plain intent" of the statute was apparently based on something other than the text of the statute, resting instead upon the court's view of the economic reality of this transaction and the purpose of the reorganization provisions.

Corporate-level taxes are now imposed on corporate distributions of appreciated property, regardless of whether the corporation is liquidating.<sup>127</sup> Thus, a rule-based solution has been enacted to address, in part, the differential tax treatment that presumably gave rise to Gregory's tax strategy. However, the requirement of a "business purpose" in reorganization transactions still generates controversy, despite the issuance of regulations to provide guidance in this area.<sup>128</sup>

*Gregory* is still included in many leading casebooks and treatises on corporate taxation, presumably because of the judicial approach to tax law that is embodied in that case.<sup>129</sup> This approach had obviously detri-

<sup>124</sup> *Id.* at 469.

<sup>125</sup> *Id.* at 468-69.

<sup>126</sup> *Id.* at 470. It is curious that the Court disavows the significance of motive, and yet characterizes the form of conveyance as "devious." Although "devious" can be defined in more neutral terms that refer to an indirect or circuitous nature, it also reflects pejoratively on the taxpayer. See THE NEW ROGET'S THESAURUS IN DICTIONARY FORM (1964) (listing "dishonorable, crooked, deceitful, fraudulent (dishonesty)" as synonyms for "devious").

<sup>127</sup> See I.R.C. § 311(b) (1997).

<sup>128</sup> See generally GINSBERG & LEVIN, *supra* note 122, at § 609.1-2. The Service will issue private letter rulings on business purpose aspects of reorganization transactions under section 355. See Rev. Proc. 96-30, 1996-19 I.R.B. 8 (providing guidelines for such ruling requests).

<sup>129</sup> See SAMUEL C. THOMPSON, JR., TAXATION OF BUSINESS ENTITIES 59-62 (1994); PAUL MCDANIEL ET. AL., FEDERAL INCOME TAXATION OF CORPORATIONS 535-42 (1997).



mental effects on Mrs. Gregory and her reliance on the applicable rules. As Professor Coverdale observes:

We do not know what Mrs. Gregory would have done if the statute had clearly made the sale of the Monitor stock fully taxable no matter what form it took. She might have decided to leave the Monitor stock in United and to obtain the funds she needed in some other way. In reaching her decision to sell, she should have been able to rely on the laws enacted by Congress. Even if one thinks that Mrs. Gregory's use of part of her basis in the United Stock to avoid recognition of part of the gain on the disposition of the Monitor stock constituted abusive tax avoidance, there comes a point where "the harm of uncertainty becomes greater than the good of avoidance prevention."<sup>130</sup>

Those who follow in Gregory's footsteps now have notice that concepts of purpose may be invoked to challenge the tax treatment of transactions that comply with the language of the Code.<sup>131</sup> To the extent that business purpose or other structural principles of the Code can be identified, they may constrain judicial choices in the "Dworkian" sense, so that decisions based on structure are, in theory, not entirely outside the Rule

<sup>130</sup> Coverdale, *supra* note 14, at 1538 (citation omitted). As Professor Zelenak points out, Gregory's effects extend far beyond the reorganization provisions:

The courts and the Service have viewed the 'underlying assumptions and purposes' of the reorganization provisions as generally requiring nonliteral interpretations in the government's favor to prevent taxpayers from gaining unintended tax benefits from the application of these provisions. This understanding of the structures and policies underlying the reorganization provisions may be correct. Problems have arisen, however, because nonliteral interpretations of the reorganization provisions have come to be seen as the prototypical cases of the nonliteral interpretation of the Code. Because judicial opinions in reorganization cases generally apply progovernment nonliteral interpretations, the assumption seems to have developed—largely unconsciously perhaps—that progovernment nonliteral interpretations are somehow more legitimate than protaxpayer nonliteral interpretations.

Zelenak, *supra* note 110, at 669.

<sup>131</sup> See McDANIEL, *supra* note 129, which states in part:

As far as corporate reorganizations are concerned, the business purpose doctrine has been incorporated into Treas. Reg. § 1.368-1(c) and -2(g), but the Gregory decision and the ramifications of the business purpose doctrine stand primarily as judicial warnings that *some* provisions are off limits in *some* situations. This combination of the existence of a rule permitting transactions to be disregarded but uncertainty as to when the rule will be applied has an *in terrorem* effect that dampens the enthusiasm of some would-be tax manipulators but prompts others to take a chance where little is at risk if the scheme fails. But it is difficult to see how the Internal Revenue Code could be applied successfully without the safeguards afforded by the Gregory doctrine and its various facets. It is a technique of statutory interpretation difficult to apply but essential to our tax system as it now operates.

*Id.* at 542 (emphasis in original).

of Law.<sup>132</sup> However, it is questionable whether such structural principles are separable from routine policy choices.<sup>133</sup>

First, the "structure" of the tax code may reflect multiple purposes, and identifying which purpose should control in a given case, and whether that purpose provides an adequate basis for abandoning a textually-based interpretation, is highly indeterminate.<sup>134</sup> In theory, a judge with the wisdom of Dworkin's Hercules might be able to ascertain the proper structural principle or principles in each case, and to weight them appropriately in reaching a tax result.<sup>135</sup> However, taxpayers and their advisors administering these provisions may not possess that same wisdom—and neither will the Revenue Agents seeking to enforce them. Litigation may ultimately clarify the role of purpose in a particular context, but the immediate effect is to undermine the reliability of rules and to impose administrative costs on taxpayers chosen to be test cases.

Second, purposive approaches may also mask a policy bias toward protecting the public fisc, at the expense of particular taxpayers who

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<sup>132</sup> See Dworkin's views on discretion discussed *supra* note 43. Professor Geier similarly argues that a decision which "ignored the literal words of the statute in order to protect the fundamental structure [of the Code]" was not outside the rule of law. Instead, it is part of the collaborative effort between Congress and the courts, in which the statute includes that larger concept of structure. See Geier, *supra* note 110, at 508.

<sup>133</sup> Several commentators have questioned whether purposivism based on "structure" is an adequate constraint, and have suggested adherents are really "substituting their own policy preferences for those embodied in the statute and calling that substitution the implementation of underlying purpose." See generally Zelinsky, *supra* note 112, at 718-21 (1996) (questioning premises of Geier's analysis, including whether "courts can reliably glean from tax provisions an underlying purpose that justifies disregard of statutory text"); Livingston, *supra* note 40, at 679 (arguing that "[s]upporters of purposive interpretation tend to exaggerate the logic and consistency of the Code, and to overstate the authority of tax scholars as interpreters of basic tax principles").

<sup>134</sup> See Zelinsky, *supra* note 133, at 718-21 (critiquing Professor Geier's approach to purposivism theories); Livingston, *supra* note 40, at 702 ("Perhaps the most serious critique of purposivism is the problem of indeterminacy. According to this critique, since a statute may have more than one purpose, purposive analysis is unlikely to provide a definitive resolution to any case."). Professor Livingston questions whether purposivism actually describes the approach that courts have used to decide cases involving nonliteral interpretations. Instead, he suggests that purpose "is likely to be a rhetorical device, with courts seizing upon one or another possible purpose in order to justify a result actually determined by textual, historical, or contextual interpretive methods." *Id.*

<sup>135</sup> See DWORKIN, *supra* note 16, at 105-30. Dworkin "invented" Hercules as an ideal judge, "a lawyer of superhuman skill, learning, patience, and acumen" as a model for ascertaining and applying principles to resolve hard cases. *Id.* at 105. Legislative intention or purpose is one source of such principles. See *id.* Dworkin contrasts Hercules with Herbert, a hypothetical judge who believes that "when the positive rules of law are vague or indeterminate, the litigants have no institutional right at all, so that any decision he might reach is a piece of fresh legislation." *Id.* at 129. Hercules, on the other hand, believes that his decision is constrained by such institutional rights, and that belief constrains his pursuit of a result. See *id.* Dworkin readily admits that no one has the wisdom of Hercules. See *id.* at 129-30. Moreover, even some of Hercules' decisions will be controversial. See *id.* at 117.

have relied on the statutory text.<sup>136</sup> This bias may also be reflected in part by the decline of the interpretive rule that requires strict construction of tax statutes against the government.<sup>137</sup> The strict construction princi-

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<sup>136</sup> See William S. Blatt, *Lost on a One-Way Street: The Taxpayer's Ability to Disavow Form*, 70 OR. L. REV. 381, 393-94 (1991) (discussing emergence of values of communal good and increasing judicial sympathy for taxation); Zelenak, *supra* note 110, at 666-670 (referring to "progovernment bias" in the application of nonliteral interpretations of the Code); Coverdale, *supra* note 14, at 1505 ("[S]ome federal judges seem to feel called upon to protect federal revenues, even at the cost of twisting beyond recognition provisions that Congress has enacted . . ."). Courts have been reluctant to apply purposive approaches in favor of taxpayers. For example, in *Cornelius v. Commissioner*, 494 F.2d 465 (5th Cir. 1974), the court rejected the taxpayer's argument based on the legislative intent in enacting Subchapter S in favor of a textual approach, stating in part:

Though we could discuss at great length the relative merits and equities of the competing approaches urged upon us by taxpayers and the Commissioner, we must be mindful that in cases of statutory construction and legislative intent, "it is our judicial function to apply statutes on the basis of what Congress has written, not what Congress might have written."

*Id.* at 469 (quoting *United States v. Great N. Ry.*, 343 U.S. 562, 575 (1952)). Criticisms of that statute by "tax sophisticates and commentators" were thought to be "properly addressed to the Congress and not to the courts." See *id.* The court defined its own role more modestly, stating in part: "Ours has been the more mundane assignment of contouring the codified curlicues of Subchapter S to the Code's synoptic minutiae. Being mere mortals unendowed with cosmic tax wisdom, we have performed our task as well as our fallible mentalities and compositions will permit." *Id.* at 472.

The court also rejected the taxpayer's attempt to recharacterize debt as equity based on the economic substance, stating in part:

This Court has never hesitated to pierce the paper armor of a taxpayer's characterization of a particular transaction in order to reach its true substance . . . [W]e have done so in situations similar to this one to determine whether shareholder advances to a closely held corporation are to be considered as debts or as contributions to capital. In each such instance, however, we have done so at the request of the Commissioner to prevent a taxpayer from unjustifiably using his own forms and labels as a shield from the incidence of taxation. *A taxpayer's attempt to pierce his own armor does not merit the same consideration.*

*Id.* at 471 (emphasis added).

Sometimes a purpose-based approach against a taxpayer in a particular case will generate taxpayer-friendly results in later cases. Professor Zelenak points to *Corn Prods. Ref. Co. v. Commissioner*, 350 U.S. 46 (1955), as an example of "Pyrrhic victory" in obtaining judicial acceptance of a purposive approach to limit the definition of capital assets subject to capital gains treatment, which had a reciprocal effect of allowing taxpayers to characterize capital losses as arguably ordinary. See Zelenak, *supra* note 110, at 644-47. Professor Zelenak suggests that *Corn Products* exemplifies the "Law of Moses' Rod": "Every stick crafted to beat on the head of a taxpayer will, sooner or later, metamorphose into a large green snake and bite the Commissioner on the hind part." *Id.* at 646 (quoting Martin Ginsburg, *The National Office Mission*, 27 TAX NOTES 99, 100 (1985)). In *Arkansas Best Corp. v. Commissioner*, 485 U.S. 212 (1988), the Supreme Court overruled *Corn Products* in favor of a narrower textual approach that would have produced the same result in the original case, but which would have avoided much of the uncertainty in later cases. See generally MARVIN A. CHIRELSTEIN, *FEDERAL INCOME TAXATION* 330-36 (8th ed. 1997).

<sup>137</sup> See Blatt, *supra* note 136, at 399; Coverdale, *supra* note 14, at 1522 n.9 (noting the "long-abandoned complex of doctrines concerning strict construction of the tax laws against the government. The current trend is to construe tax statutes broadly in the government's favor.").

ple was applied in early tax cases, such as *Old Colony Railroad Co. v. Commissioner*:<sup>138</sup> "[When there is] doubt as to [the] connotation of [a] term, and another meaning might be adopted, the fact of its use in a tax statute would incline the scale to the construction most favorable to the taxpayer."<sup>139</sup> Similarly, the principle that "[i]f the words [of a statute] are doubtful, the doubt must be resolved against the government and in favor of the taxpayer" was often cited.<sup>140</sup>

This principle appears to be oriented toward protecting the citizen's property rights from government claims that are not clearly prescribed in advance.<sup>141</sup> However, more recent decisions have cast doubt on the continuing viability of such a rights-oriented approach for interpretation.<sup>142</sup> A Rule of Lenity favoring citizens against the government may still be

<sup>138</sup> 284 U.S. 552 (1931).

<sup>139</sup> *Id.* at 562.

<sup>140</sup> See, e.g., *United States v. Merriam*, 263 U.S. 179, 188 (1923) (income tax); *Miller v. Standard Nut Margarine Co.*, 284 U.S. 498, 508 (1932) (excise tax).

<sup>141</sup> *Merriam* cites *Gould v. Gould*, 245 U.S. 151, 153 (1917), as support for this proposition. Although *Gould* involved construction of the income tax, it traces this principle to earlier cases involving duties. See *id.* (citing *American Net and Twine v. Worthington*, 141 U.S. 468 (1891) (duty on "gilling twine"); *Benziger v. United States*, 192 U.S. 38 (1904) (duties on plaster casts)). In the context of duties, the principle arguably reflects a preference for free trade. In an income tax context, however, strict construction appears rooted in an ideal of protecting taxpayers' property rights. The *Merriam* court grounds this principle in English law, quoting from Lord Cairns in *Partington v. Attorney General*, L.R. 4 H.L. 100, 122 (Court of Exchequer, 1869):

If the person sought to be taxed comes within the letter of the law, he must be taxed, however great the hardship may appear to the judicial mind to be. On the other hand, if the crown, seeking to recover the tax, cannot bring the subject within the letter of the law, the subject is free, however apparently within the spirit of the law the case might otherwise appear to be. In other words, if there be admissible in any statutes what is called an equitable construction, certainly such a construction is not admissible in a taxing statute, where you can simply adhere to the words of the statute."

*Merriam* at 188. See also *Eidman v. Martinez*, 184 U.S. 578, 583 (1902):

It is an old and familiar rule of the English courts, applicable to all forms of taxation, and particularly to special taxes, that the sovereign is bound to express its intention to tax in clear and unambiguous language, and that a liberal construction be given to words of exception confiding the operation of duty, though the rule regarding exemptions from general laws imposing taxes may be different.

*Id.* (citations omitted).

<sup>142</sup> See *Wolder v. Commissioner*, 493 F.2d 608 (2d Cir. 1974), which states in part "One also doubts the present day validity of the underlying philosophical premise of *Merriam* . . ." The principle is nevertheless still invoked from time to time in recent cases. See, e.g., *Royal Caribbean Cruises Ltd. v. United States*, 95-2 USTC ¶ 70,050 (S.D. Fla 1995), which stated in part:

The United States argues that this principle [of resolving ambiguities in favor of the taxpayer] is 'outdated' because the rule of law now is to defer to IRS interpretations of statutes . . . [T]he court agrees that IRS interpretations are entitled to deference. However, that does not change the rule that if no interpretation or legislative history clarifies an ambiguity in a statute, that ambiguity is to be resolved in favor of the taxpayer.

applied where criminal penalties are at stake,<sup>143</sup> but taxes are generally not viewed in the same light as criminal penalties.<sup>144</sup> The immediate economic effect of paying a criminal fine or a tax may be similar, as the payer parts with property in both cases. However, a criminal fine is assessed in order to punish wrongdoing, whereas a tax merely apportiones the cost of government among those who presumably benefit therefrom, albeit usually in a general and attenuated sense.<sup>145</sup> Viewing the Code as an allocation mechanism that is constantly subject to revision, as the

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*Id.* See also *Security Bank Minnesota v. Commissioner*, 994 F.2d 432 (8th Cir. 1993), *aff'd* 98 T.C. 33 (1992) (applying principle that doubt is to be resolved in favor of the taxpayer to produce a taxpayer-favorable result when judges differed as to the correct interpretation).

<sup>143</sup> For a relatively recent case invoking the Rule of Lenity in the context of constructing an ambiguous criminal statute, see *United States v. Thompson/Center Arms Company*, 504 U.S. 505 (1992). Thompson/Center Arms Company ("Thompson") manufactured and sold a pistol and a kit that the purchaser could use to convert the pistol into a rifle with either a 21-inch barrel or a 10-inch barrel. See *id.* at 507-08. At issue was whether Thompson could be considered to be manufacturing "short barreled rifles" (i.e., those with a barrel less than 16 inches long), which would subject Thompson to special taxes as well as criminal penalties. The Court considered the language of the applicable statute and concluded that it was ambiguous as to whether sale of the pistol and kit constituted "making" such a firearm, but the Rule of Lenity applied in criminal cases was critical in resolving this ambiguity in favor of Thompson:

The key to resolving the ambiguity lies in recognizing that although it is a tax statute we construe now in a civil setting, the NFA has criminal applications that carry no additional requirement of willfulness. Making a firearm without approval may be subject to criminal sanction, as is possession of an unregistered firearm and failure to pay the tax on one. It is proper, therefore, to apply the rule of lenity and resolve the ambiguity in Thompson/Center's favor.

*Id.* at 517-18 (citations omitted) (plurality opinion). The concurring opinion of Justice Scalia, who was joined by Justice Thomas, also agreed that the Rule of Lenity should be applied, but disagreed as to the source of ambiguity. See *id.* at 519-23. Significantly, a majority of the justices seized upon the potential for criminal sanctions to apply the Rule of Lenity to construct a tax statute. However, they failed to cite a similar rule of construction applied in many earlier tax cases—that ambiguities in tax statutes are to be construed in favor of the taxpayer.

<sup>144</sup> See MERTENS LAW OF FEDERAL INCOME TAXATION § 4.14 (1999) ("Retroactive taxation is allowed because taxation is neither a penalty imposed on the taxpayer nor a liability which the taxpayer assumes by contract. Instead, it is a method of apportioning the cost of government among those who enjoy its benefits and who must bear the resulting burdens."). See also Fuller's discussion of the tension between taxation and criminal law in THE MORALITY OF LAW, *supra* note 7, at 59-61.

<sup>145</sup> See *Compania General de Tabacos De Filipinas v. Collector of Internal Revenue*, 275 U.S. 87, 100 (1927) (Holmes, J., dissenting):

It is true . . . that every exaction of money for an act is a discouragement to the extent of the payment required, but that which in its immediacy is a discouragement may be part of an encouragement when seen in its organic connection with the whole. Taxes are what we pay for civilized society . . . . A penalty on the other hand is intended altogether to prevent the thing punished.

*Id.* One court prefaced its judgment in a tax case, apparently with tongue-in-cheek: "If Justice Holmes was correct that 'taxes are what we pay for civilized society,' then the question in this case is how much civilization the taxpayer will be required to purchase." *Shimberg v. United States*, 577 F.2d 283, 284 (5th Cir. 1978) (footnote omitted) (citing *Compania*, 275 U.S. at 100).

Court did in *Carlton*, reflects this policy bias away from rule-based constraints as a source of protection for the property rights of taxpayers.

Using a purposive approach to depart from textually-based interpretations also moves tax law further toward an elitist orientation, where the true meaning of texts are accessible only to a chosen few.<sup>146</sup> Such an orientation undermines society's ability to comprehend and evaluate compliance with the Rule of Law by minimizing the possibility of achieving consensus based on language, and emphasizing instead a secular faith in a priesthood of tax mystics.<sup>147</sup> Moreover, this orientation makes it difficult for Congress to legislate, as it too must comprehend the mystical implications of its chosen language in future tax administration.<sup>148</sup>

Some commentators have suggested that the sophistication of a statute's "audience" justifies an interpretation affected by purpose, even though the text of the statute might not bear such an interpretation.<sup>149</sup> This assumes that particular statutes have identifiable audiences who are represented by a member of the cadre of *cognoscenti*, who can provide appropriate notice of legal requirements in advance of their application. However, we do not have two sets of tax laws—a simple set for non-

<sup>146</sup> See Livingston, *supra* note 40, at 679 (arguing that purposivism tends to "overstate the authority of tax scholars as interpreters of basic tax principles").

<sup>147</sup> This concern also supports the presumption that statutory words should be interpreted in their ordinary sense. See *Hantzis v. Commissioner*, 638 F.2d 248, 257 (1st Cir. 1981) (Keeton, J., concurring):

A word used in a statute can mean, among the *cognoscenti*, whatever authoritative sources define it to mean. Nevertheless, it is a distinct disadvantage of a body of law that it can be understood only by those who are expert in its terminology. Moreover, needless risks of misunderstanding and confusion arise, not only among members of the public but also among professionals who must interpret and apply a statute in their day-to-day work, when a word is given an extraordinary meaning that is contrary to its everyday usage.

*Id.* Cf. DWORKIN, *supra* note 16, at 130 ("[T]hrough we, as social critics, know that mistakes will be made, we do not know when because we are not Hercules either.").

<sup>148</sup> Professor Livingston argues that developing purposivist principles in a dynamic fashion

suggests that scholars, in some cases, may have a standing equal or superior to that of the legislature (and perhaps the courts) charged with formal responsibility for making and interpreting law. In this scenario, the legislature would make an initial decision to adopt the income tax, UCC, or similar law, but in doing so implicitly would accept principles—largely unknown to itself—that later generations of "experts" would have the right and responsibility to expound. The legislature could overrule the experts, but unless it did so in clear and convincing fashion, the interpretation of the experts would hold.

Livingston, *supra* note 40, at 689. See also Coverdale, *supra* note 14, at 1556-57 (arguing that anti-textual interpretations allow courts to circumvent Congressional policymaking authority).

<sup>149</sup> See Zelenak, *supra* note 109, at 664-66 (statutes addressed to specialists should receive a more contextual interpretation).

specialists and a more complex set for tax cognoscenti.<sup>150</sup> Even small transactions can generate complex tax issues, and tax law must be applied by taxpayers with varying levels of resources to devote to tax advice. Both the sophisticated and unsophisticated are affected by the indeterminacy generated by purposivism, and we should not assume that the impact of purposivism is limited to those who “deserve” it. As Professor Livingston points out:

It is perhaps unrealistic to expect lay people to understand the tax law without academic assistance. But is it too much to expect of tax lawyers? Must practitioners learn not only the law as written, but a series of hidden purposes that may be hurled at them at any moment, sometimes in direct contravention of statutory language. And what of judges—must they learn an entirely different set of interpretive presumptions, only to be applied in tax cases? The notion of tax uniqueness may be appealing to tax scholars, but has little if any doctrinal sanction. In its more extreme versions, tax purposivism is not merely a questionable descriptive theory; it may be inconsistent with the rule of law.<sup>151</sup>

#### D. AGENCY DISCRETION IN MAKING, INTERPRETING, AND APPLYING TAX RULES

The Treasury Department<sup>152</sup> also exercises discretion in making and applying law to taxpayers.<sup>153</sup> Discretionary powers to engage in retroac-

<sup>150</sup> For a proposal that would allow taxpayers to choose between the current system and a radically simplified tax system, see Stephen Moore, *The Alternative Maximum Tax*, WALL ST. J., Jan. 14, 1997, at A20.

<sup>151</sup> Livingston, *supra* note 39, at 711-12.

<sup>152</sup> For convenience, the Treasury Department will be referred to generally as “the Treasury.” The Internal Revenue Service, a part of the Treasury Department, will be referred to as “the Service.”

<sup>153</sup> This discretionary power is rooted in practical considerations, as explained in *Bob Jones University v. United States*, 461 U.S. 574 (1983):

[E]ver since the inception of the tax code, Congress has seen fit to vest in those administering the tax laws very broad authority to interpret those laws. In an area as complex as the tax system, the agency Congress vests with administrative responsibility must be able to exercise its authority to meet changing conditions and new problems. Indeed as early as 1918, Congress expressly authorized the Commissioner “to make all needful rules and regulations for the enforcement” of the tax laws. Revenue Act of 1918, ch. 18, § 1309, 40 Stat. 1057, 1143 (1919). The same provision, so essential to efficient and fair administration of the tax laws, has appeared in tax codes ever since, see 26 U.S.C. § 7805(a) (1976); and this Court has long recognized the primary authority of the IRS and its predecessors in construing the Internal Revenue Code, *See, e.g., Commissioner v. Portland Cement Co.*, 450 U.S. 156, 169, 101 S.Ct. 1037, 1045, 67 L.Ed.2d 140 (1981); *United States v. Cor-*

tive rulemaking and selectively enforce existing rules raise Rule of Law concerns, which are discussed below.

### 1. Regulations

Congress has delegated broad authority to the Treasury to "prescribe all needful rules and regulations for the enforcement of [the Code] . . . ." <sup>154</sup> Regulations promulgated under this general authority are often referred to as interpretive regulations. <sup>155</sup> In some circumstances, Congress has also granted specific authority to the Treasury to promulgate regulations that implement statutes that have been purposely left open or incomplete. <sup>156</sup> Such regulations are often referred to as legislative regulations. <sup>157</sup>

Both interpretive and legislative regulations receive deference from courts considering their validity. <sup>158</sup> Treasury regulations are generally sustained if they do not conflict with the Code, <sup>159</sup> even though the tax-

rell, 389 U.S. 299, 306-307, 88 S.Ct. 445, 449, 19 L.Ed.2d 537 (1967); *Boske v. Comingore*, 177 U.S. 459, 469-470, 20 S.Ct. 701, 705, 44 L.Ed. 846 (1900).

Congress, the source of IRS authority, can modify IRS rulings it considers improper; and courts exercise review over IRS actions. In the first instance, however, the responsibility for construing the Code falls to the IRS. Since Congress cannot be expected to anticipate every conceivable problem that can arise or to carry out day-to-day oversight, it relies on the administrators and on the courts to implement the legislative will. Administrators, like judges, are under oath to do so.

*Id.* at 596-97 (citations in original). However, as discussed below, the Court does not necessarily defer to agency interpretations that have not been reduced to a formal interpretation. See *infra* note 158 and accompanying text.

<sup>154</sup> See I.R.C. § 7805(a) (1997).

<sup>155</sup> See Ellen P. April, *Muffled Chevron: Judicial Review of Tax Regulations*, 3 FLA. TAX REV. 51, 56 (1996).

<sup>156</sup> See, e.g., I.R.C. § 472(f) (1997) (directing the promulgation of regulations "permitting the use of suitable published governmental indexes in such manner and circumstances as determined by the Secretary for purposes of [the LIFO method]").

<sup>157</sup> See, April, *supra* note 155, at 56-57. Professor April notes that in administrative law, the distinction between legislative and interpretive regulations is based on whether the regulation "creates new law or has a self-executing legal effect." *Id.* at 56. However, in tax law, the distinction is generally based on the source of authority for the regulation. See *id.*

<sup>158</sup> See *id.* The extent to which courts generally follow the paradigm of *Chevron U.S.A. v. Natural Resources Defense Council*, 67 U.S. 837 (1984), in reviewing regulations is unclear. See generally April, *supra* note 155, at 52; John F. Coverdale, *Court Review of Tax Regulations and Revenue Rulings in the Chevron Era*, 64 GEO. WASH. L. REV. 35 (1995).

<sup>159</sup> See *Hachette U.S.A., Inc. v. Commissioner*, 105 T.C. 234, 251 (1995) (regulation sustained when no evidence of a conflict between the regulations and the language or purpose of the statute). Deference to interpretations embodied in regulations should be contrasted with litigating positions, which do not receive the same treatment. See also *Bowen v. Georgetown Univ. Hosp.*, 488 U.S. 204, 212-13 (1988):

We have never applied the principle [of deference to agency interpretation] to agency litigating positions that are wholly unsupported by regulations, rulings, or administrative practice. To the contrary, we have declined to give deference to an agency counsel's interpretation of a statute where the agency itself has articulated no position on the question, on the ground that "Congress has delegated to the adminis-



payer's interpretation of the Code may be as good as, or better than, the Treasury's interpretation.<sup>160</sup> Although the degree of deference is difficult to gauge, legislative regulations generally receive even greater deference than interpretive regulations.<sup>161</sup>

The courts' willingness to accord special weight to an agency's interpretation embodied in a regulation has been justified in part by the agency's perceived competence in policymaking. As one commentator has observed: "the resolution of ambiguities in statutes is sometimes a question of policy as much as it is one of law, narrowly understood, and . . . agencies are uniquely well situated to make the relevant policy decisions."<sup>162</sup> In part, this competence may be attributed to special expertise in particular substantive areas, as compared with generalist judges.<sup>163</sup> Applying that expertise over a broad range of experiences may also contribute to greater consistency in application, as compared to results of independent interpretations in different judicial fora.<sup>164</sup>

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trative official and not to appellate counsel the responsibility for elaborating and enforcing statutory commands." . . . Deference to what appears to be nothing more than an agency's convenient litigating position would be entirely inappropriate.

*Id.* (citations omitted).

<sup>160</sup> See, e.g., *Atlantic Mutual Insurance Co v. Commissioner*, 118 S.Ct. 1413, 1418 (1998); *Hospital Corp. of America v. Commissioner*, 107 T.C. 116, 134 (1996).

<sup>161</sup> See Coverdale, *supra* note 158, at 63.

<sup>162</sup> Cass Sunstein, *Law and Administration After Chevron*, 90 COLUM. L. REV. 2071, 2086 (1990). See also Antonin Scalia, *Judicial Deference to Administrative Interpretation of Law*, 1989 DUKE L. J. 511 (1989).

<sup>163</sup> See Sunstein, *supra* note 162, at 2086-90; Coverdale, *supra* note 158, at 68. See also Scalia, *supra* note 162, at 514. The validity of this observation is a specialized court such as the Tax Court is less clear. Different approaches to deference tend to lead to disuniformity in results depending on the choice of forum. See, e.g., Linda Galler, *Emerging Standards for Judicial Review of IRS Revenue Rulings*, 72 B.U. L. REV. 841 (1992).

<sup>164</sup> See *United Muffler Dealer's Ass'n v. United States*, 440 U.S. 472 (1979), which explains the justification for deference as follows:

We do this because "Congress has delegated to the [Secretary of the Treasury and his delegate, the] Commissioner [of Internal Revenue], not to the courts, the task of prescribing 'all needful rules and regulations for the enforcement' of the Internal Revenue Code. 26 U.S.C. § 7805(a)." *United States v. Correll*, 389 U.S., at 397, 88 S.Ct. at 449. That delegation helps ensure that in "this area of limitless factual variations," *ibid.*, like cases will be treated alike. It also helps guarantee that the rules will be written by "masters of the subject," *United States v. Moore*, 95 U.S. 760, 24 L.Ed. 588, 589 (1878), who will be responsible for putting the rules into effect.

*Id.* at 477 (citations in original). Professor Galler questions whether agency expertise is an appropriate basis for deference in tax cases, based in significant part because IRS lawyers may not have more experience or expertise than their private bar counterparts. See Galler, *supra* note 163, at 852-56. The fact that policymakers do not always comprehend the effect of their decisions is cited as further evidence of this questionable assumption. See *id.* But see Coverdale, *supra* note 158, at 68 n.226 (arguing that the expertise comparison should reflect the institutional experience and purpose, rather than that of individuals, and that "numerous members of the Treasury and IRS staff involved in drafting and reviewing a particular regulation would generally be expected to be collectively better informed about and more attuned to

Moreover, the agency has some level of political accountability through the Executive, whereas sitting federal judges do not.<sup>165</sup> Justice Scalia has noted that principles of separation of powers may justify deference to government positions when official agency interpretations are at stake:

When, in a statute to be implemented by an executive agency, Congress leaves an ambiguity that cannot be resolved by text or legislative history, the "traditional tools of statutory construction," the resolution of that ambiguity necessarily involves policy judgment. Under our democratic system, policy judgments are not for the courts but for the political branches; Congress having left the policy question open, it must be answered by the Executive.<sup>166</sup>

This approach provides an important background rule against which Congress can legislate, since "Congress now knows that the ambiguities it creates, whether intentionally or unintentionally, will be resolved, within the bounds of permissible interpretation, not by the courts but by a particular agency, whose policy biases will ordinarily be known."<sup>167</sup> When there is no official agency interpretation, however, courts have refused to accord specific deference to a mere litigating position held by the Service.<sup>168</sup>

Deference to agency interpretations embodied in prospectively applicable regulations does not present a significant threat to Rule of Law values. Changing the locus of rulemaking from the Legislative to the Executive branch may implicate other concerns,<sup>169</sup> but regulations with

technical problems of tax administration than members of the private bar who represent the taxpayer").

<sup>165</sup> See Sunstein, *supra* note 162, at 2087-88 n.80 (noting that courts are not wholly independent to the extent that shifts in the judiciary occur as a result of shifts in the administration). However, Congress may have put the issue in agency hands to escape political accountability. See Logue, *supra* note 109, at 1188-89.

<sup>166</sup> Scalia, *supra* note 162, at 515.

<sup>167</sup> *Id.* at 517.

<sup>168</sup> See, e.g., *CSI Hydrostatic Testers, Inc. v. Commissioner*, 103 T.C. 398, 409 (1994), *aff'd*, 23 F.3d 136 (5th Cir. 1995) (*per curiam*) ("In short, unless an agency's interpretation of a statute or regulation is a matter of public record and is an interpretation upon which the public is entitled to rely when planning their affairs, it will not be accorded any special deference."). See also *Bowen v. Georgetown Univ. Hosp.*, 488 U.S. 204 (1988) (litigating position merits no deference). The extent of deference given to Revenue Rulings is controversial. See *infra* notes 190-93 and accompanying text.

<sup>169</sup> For example, challenges to the delegation of rulemaking powers have been rooted in concerns about the need for democratic responsibility in connection with policy decisions, and concerns about the judicial capacity for review without adequate guidelines for agency rulemaking. See generally ALFRED C. AMAN, JR. & WILLIAM T. MAYTON, *ADMINISTRATIVE LAW* 16-33 (1993) (discussing parameters of delegation doctrine).

rule-like characteristics provide taxpayers with notice of their obligations and facilitate planning.<sup>170</sup> Moreover, they facilitate consistent treatment of taxpayers by announcing the official agency position to those who must enforce those rules.

Retroactive rulemaking or rule-revision power in the hands of the agency enforcing those rules violates concepts of notice and stability that are deeply embedded in the Rule of Law. It also threatens the perceived fairness of the tax system to the extent that the Commissioner, who is charged with enforcing tax laws, may be perceived as using this authority to affect the outcome of particular cases in which existing rules produce an undesirable result.<sup>171</sup>

Prior to the 1996 enactment of the Taxpayer Bill of Rights 2,<sup>172</sup> the Treasury had extensive authority to issue regulations with retroactive effects.<sup>173</sup> Although courts sometimes imposed limits on retroactive effects based on due process grounds, such relief was generally limited to changes affecting long-standing regulations, where notice and reliance interests are presumably greatest.<sup>174</sup> The Taxpayer Bill of Rights 2 limits, but does not eliminate, the power to promulgate retroactive regula-

<sup>170</sup> Although Treasury regulations are exempt from formal requirements of the Administrative Procedures Act, the Treasury nevertheless follows notice and comment procedures in promulgating regulations, which gives interested taxpayers an opportunity for input into their formulation. See Coverdale, *supra* note 158, at 52. Public input does not guarantee a particular result, but it may increase the perception of democratic legitimacy. See *id.* at 86.

<sup>171</sup> See Benjamin J. Cohen & Catherine A. Harrington, *Is the Internal Revenue Service Bound by its Own Regulations and Rulings?*, 51 *TAX LAW.* 675, 695-96 (1988) (noting that retroactive revocation of Rulings and regulations generates "erosion of public confidence in the administration of the tax law"); Coverdale, *supra* note 158, at 87 (noting "the importance, in a system of voluntary compliance, of assuring citizens that the tax collector does not have the last word on the application of the tax laws.").

<sup>172</sup> P.L. 104-168, 110 Stat. 1452 (1996).

<sup>173</sup> See I.R.C. § 7805(b) (1995) ("The Secretary may prescribe the extent, if any, to which any ruling or regulation, relating to the internal revenue laws, shall be applied without retroactive effect.") Although this provision did not expressly grant authority for retroactive regulations, the implication of such power from this statute is widely understood. See, e.g., Toni Robinson, *Retroactivity: The Case for Better Regulation of Federal Tax Regulators*, 48 *OHIO ST. L.J.* 773, 813 (1987); Logue, *supra* note 109, at 1134-35; Cohen & Harrington, *supra* note 171, at 675-85.

<sup>174</sup> See Logue, *supra* note 109, at 1135 n.2; Cohen & Harrington, *supra* note 171, at 680-81. For a recent case upholding a retroactive change in temporary regulations, see *Hospital Corp. of America v. Commissioner*, 107 T.C. 116 (1996). At issue was the proper method of computing an exclusion from income for uncollectable accounts under the so-called "nonaccrual experience method" permitted by I.R.C. § 448(d)(2). The IRS had promulgated temporary regulations in 1987 that provided a method of computing a bad debt exclusion that supported the taxpayer's position. However, approximately ten months later, the IRS amended those regulations to adopt a formula that favored the Government. The court found that the amended regulations did not contravene the statute, and even though the taxpayer's method might have been a better interpretation, the amended regulation was upheld as a valid exercise of agency discretion. See *id.* at 138. "To be valid, [the regulations] need not be the only, or even the best, construction of section 448(d)(5). Rather, [the regulations] need only be a reasonable interpretation of congressional intent. 'The choice among reasonable interpretations is

tions. Section 7805(b) of the Code now provides that regulations generally cannot become effective before the earliest of the following dates:

- (A) The date on which such regulation is filed with the Federal Register.
- (B) In the case of any final regulation, the date on which any proposed or temporary regulation to which such final regulation relates was filed with the Federal Register.
- (C) The date on which any notice substantially describing the expected contents of any temporary, proposed, or final regulation is issued to the public.<sup>175</sup>

Exceptions limit this protection against retroactive rulemaking. For example, retroactivity is allowed for "regulations filed or issued within 18 months of the enactment of the statutory provision to which the regulation relates."<sup>176</sup> This exception seems to recognize the practical reality of lag times when issuing guidance, and the limited duration seems generally consistent with the time periods approved in connection with retroactive tax legislation.<sup>177</sup> The Treasury also retains express authority to issue retroactive regulations "to prevent abuse."<sup>178</sup> In other circumstances, retroactive effective dates may be permitted only with the consent of Congress.<sup>179</sup>

In explaining the reasons for changing prior law, the House Ways and Means Committee report states only that: "The Committee believes that it is generally inappropriate for Treasury to issue retroactive regulations."<sup>180</sup> While this statement may suggest a reaffirmation of Rule of

for the Commissioner, not the courts.'" *Id.* at 134 (citations to *Chevron* and progeny omitted) (quoting *National Muffler Dealers Ass'n v. United States*, 440 U.S. 472, 488 (1979)). Although the Treasury had originally adopted a formula that was similar to the formula used by the taxpayer, the court sustained the amended formula: "Under the circumstances of the instant case where the Secretary acted quickly—within 10 months of promulgation of the Original Temporary Regulations—to amend temporary regulations that the concluded erroneously interpreted the statute, he was entitled to alter his interpretation of the statute on further reflection." *Id.* at 135. In contrast, see *Tate & Lyle, Inc. v. Commissioner*, 103 T.C. 656 (1994) (invalidating legislative regulations under I.R.C. § 267 which attempted retroactive application of more than 5 years).

<sup>175</sup> I.R.C. § 7805(b) (1997).

<sup>176</sup> I.R.C. § 7805(b)(2) (1997).

<sup>177</sup> See also I.R.C. § 7805(e) (1997) (requiring temporary regulations to expire within three years after issuance). Query what the effect of such expiration will be on existing law if no final regulations are promulgated. Presumably, temporary regulations will be considered applicable only during the period of their validity, but not thereafter.

<sup>178</sup> I.R.C. § 7805(b)(3) (1997).

<sup>179</sup> See I.R.C. § 7805(b)(6) (1997).

<sup>180</sup> H.R. REP. NO. 104-506 (1996), reprinted in 1996 U.S.C.C.A.N. 1143. Cohen and Harrington point out that the House Ways and Means Subcommittee on Oversight provided an expanded explanation, which included a desire to protect taxpayers "who seek in good faith to comply with the statutory tax law" from additional taxes, penalties, and interest that may result

Law values, the toleration of exceptions also reflects the flexibility to address pragmatic concerns, such as protecting the public fisc from "abuse." The exception for "abuse" is problematic, as "abuse" may mean nothing more than following the applicable rules and reaching results that the Government does not desire.<sup>181</sup> The scope of this exception is unclear, and it remains to be seen whether it will be exercised independently of Congress' power to authorize retroactive regulations.<sup>182</sup>

## 2. *Other Administrative Guidance*

Restrictions on retroactivity in Code section 7805(b) apply only to regulations, so that the Treasury retains discretionary authority to impose retroactive changes through other administrative guidance, such as Revenue Rulings.<sup>183</sup> Although the legal status of such guidance is generally understood to be less significant than regulations, taxpayers nevertheless rely on such guidance as a probable indication of the Government's enforcement position.<sup>184</sup>

Section 6110(j)(3) of the Code expressly limits the precedential status of written determinations (e.g., private letter rulings and technical advice memoranda).<sup>185</sup> According to one treatise, the Service views the issuance of private letter rulings as a public service; it is not legally required to issue them.<sup>186</sup> The Service can therefore change positions stated in private letter rulings, and courts generally will not recognize an expectation of reliance on them by anyone other than the person to whom the ruling was issued.<sup>187</sup> Although this means that similarly situated taxpayers may be treated differently, courts rarely accord relief on this basis,

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from taking a position that differs from that reflected by subsequently enacted regulations. Cohen & Harrington, *supra* note 171, at 697.

<sup>181</sup> Cf. Coverdale, *supra* note 14, at 1506 n.18 (arguing that "loopholes" are not an objectively defined category).

<sup>182</sup> Moreover, the restrictions on retroactivity do not apply to "any regulation relating to internal Treasury Department policies, practices, or procedures." See I.R.C. § 7805(b)(5) (1997). This exception may also put taxpayers at risk, to the extent that procedural requirements or practices can affect legal outcomes.

<sup>183</sup> See I.R.C. § 7805(b)(8) (1997) ("The Secretary may prescribe the extent, if any, to which any ruling (including any judicial decision or any administrative decision other than by regulation) relating to the internal revenue laws shall be applied without retroactive effect.").

<sup>184</sup> See Peter J. Meadows & William A. Dobrovir, *Who Killed Guidance*, TAX NOTES, October 14, 1996, at 221-22 (emphasizing importance of IRS interpretations to taxpayers).

<sup>185</sup> See I.R.C. § 6110(j)(3) (1997). However, taxpayers frequently try to circumvent these rules by using written determinations as evidence of prior government interpretations and practices. See MICHAEL I. SALTZMAN, IRS PRACTICE AND PROCEDURE ¶ 3.03, at 3-48 (2d ed. 1991) (citing cases).

<sup>186</sup> MICHAEL D. ROSE & JOHN C. CHOMMIE, FEDERAL INCOME TAXATION 772 (3d ed. 1988).

<sup>187</sup> SALTZMAN, *supra* note 185, ¶ 3.03, at 3-48.

preferring government flexibility to administer the tax system to the equality concerns of particular taxpayers.<sup>188</sup>

Revenue Rulings are not subject to section 6110(j)'s restrictions on precedential status. The Service issues Revenue Rulings with the stated aim of promoting uniformity in the interpretation of the Code.<sup>189</sup> They can be cited in judicial proceedings, but the Service specifically cautions that they "do not have the force and effect of Treasury Department Regulations."<sup>190</sup>

Recently, commentators have argued over the status of deference, if any, that courts accord to Revenue Rulings. Professor Galler has argued that federal courts other than the Tax Court have begun to accord greater deference to the Government's position in a Revenue Ruling as an interpretation of the Code, which approaches the deference given to regulations.<sup>191</sup> Professor Caron has argued that no such change in deference has occurred.<sup>192</sup> Although this dispute is significant in ascertaining the extent to which courts will bind taxpayers based on adverse Rulings, the Commissioner retains the power to revoke a ruling, despite taxpayer reliance.<sup>193</sup>

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<sup>188</sup> For an exception, see *International Business Machines v. United States*, 343 F.2d 914 (Ct. Cl. 1965), *cert. denied* 382 U.S. 1028 (1966), where the government was required to provide IBM with the same tax treatment given to its major competitor.

<sup>189</sup> See Rev. Proc. 89-14, 1989-1 C.B. 814, § 5:

The purpose of publication of revenue rulings and revenue procedures in the Bulletin is to promote uniform application of the tax laws by Service employees and to assist taxpayers in attaining maximum voluntary compliance by informing Service personnel and the public of National Office interpretations of the internal revenue law, related statutes, treaties, and regulations, and statements of Service procedures affecting the rights and duties of taxpayers.

*Id.*

<sup>190</sup> See *id.* at § 7(4) ("Revenue rulings published in the Bulletin do not have the force and effect of Treasury Department regulations (including Treasury Decisions), but are published to provide precedents to be used in the disposition of other cases, and may be cited and relied upon for that purpose."). This different status may be attributable to the fact that Revenue Rulings are generally issued without the benefit of public comment and review, which typically occurs prior to the promulgation of regulations. See BORIS I. BITTKER & LAWRENCE LOKKEN, 4 FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS ¶ 110.5.1 (2d ed. 1992); SALTZMAN, *supra* note 184, at ¶ 3.03.

<sup>191</sup> See Galler, *supra* note 163; Linda Galler, *Judicial Deference to Revenue Rulings: Reconciling Divergent Standards*, 56 OHIO ST. L.J. 1037 (1995).

<sup>192</sup> Paul L. Caron, *Tax Myopia Meets Tax Hyperopia: The Unproven Case of Increased Judicial Deference to Revenue Rulings*, 57 OHIO ST. L.J. 637 (1996).

<sup>193</sup> See generally Cohen & Harrington, *supra* note 171, at 690:

Cases decided subsequent to [*Dixon v. Commissioner*, 381 U.S. 68 (1965)] have generally upheld the authority of the Commissioner to revoke or modify a Revenue Ruling or acquiescence retroactively to correct a "mistake of law." The result is the same even where the taxpayer has acted in reliance on an erroneous Revenue Ruling. However, abuse of discretion may be found where the retroactive withdrawal or modification has an inordinately harsh effect. Also, abuse of discretion may be

As noted above, the Taxpayer Bill of Rights 2 apparently leaves unchanged the Commissioner's power to revoke or modify Revenue Rulings on a retroactive basis.<sup>194</sup> Granting such flexibility to the Service may be justified in part because of the relatively weak legal status of the Revenue Ruling. In this context, taxpayers are effectively on notice that a Revenue Ruling is potentially unreliable.<sup>195</sup> Moreover, a contrary rule, which did not allow retroactive corrections of mistakes in law, might have a chilling effect on the issuance of guidance.<sup>196</sup>

Despite notice of unreliability, retroactive revocation or modification of Revenue Rulings is troubling from a Rule of Law perspective. If Revenue Rulings are intended to affect administration and compliance efforts, then retroactive modification of their terms creates an environment of instability, as well as the potential for unequal treatment of those engaged in similar transactions during the same tax years. As a practical matter, such treatment is likely to be just as troubling to a taxpayer as a retroactive statutory change. The erosion of taxpayer confidence in, and respect for, a tax system that permits the government to change positions after inducing reliance should be considered in evaluating discretion's role in the effective enforcement of the tax laws.<sup>197</sup> Pragmatically, the Service has exercised considerable constraint in using such authority.<sup>198</sup> Nevertheless, continued recognition of legal authority to impose retroac-

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found where the retroactive withdrawal or modification creates a distinction between taxpayers that has no rational basis.

*Id.* (footnotes omitted).

<sup>194</sup> See I.R.C. § 7805(b) (1997).

<sup>195</sup> See *Dixon*, 381 U.S. at 76 ("The absence of notice does not prove an abuse, since . . . petitioners were not justified in relying on the acquiescence as precluding correction of the underlying mistake of law and the retroactive application of the correct law to their case. Since no reliance was warranted, no notice was required.")

<sup>196</sup> See generally *Meadows & Dobrovir*, *supra* note 184.

<sup>197</sup> See *Cohen & Harrington*, *supra* note 171, at 695-96:

[T]he resulting inequity and the consequent erosion of public confidence in the administration of the tax law may pose a greater threat to effective enforcement than would occasional estoppel [of the Commissioner] based on mistake of law. The force of the pragmatic argument is strengthened at a time when it is generally thought necessary to defuse a growing sense of public frustration with the administration of the tax law.

*Id.* Cf. *William H. Caudill, Ninth Circuit Invalidates Anti-Abuse Rule; Is Reg. 1.701-2 Similarly Flawed?*, 83 J. TAX'N 380, 381 (1995) ("Unclear, subjective anti-abuse rules tend to erode the confidence the broad taxpaying public has for the tax laws as a whole.")

<sup>198</sup> See *Cohen & Harrington*, *supra* note 171, at 700-01 (citing opposition to Taxpayer Bill of Rights 2 by ABA Tax Section and New York State Bar Association based on belief that IRS reasonably and appropriately administered retroactive power). In addition, the New York State Bar Association argued that retroactive regulations served as a significant constraint against taxpayers who take the most aggressive positions. *Id.* at 701.

tive change remains a troubling source for potential erosion of Rule of Law values.<sup>199</sup>

### 3. *Enforcement Discretion*

Rules of general application ensure that a rulemaker choosing to impose retroactive changes must contemplate their potential impact on all affected taxpayers, thus reducing, but not eliminating, the possibility of changes that are invidiously directed toward particular taxpayers.<sup>200</sup> Discretion in applying rules to particular taxpayers potentially threatens Rule of Law values associated with planning and reliance upon rules,<sup>201</sup> as well as related values of equality, consistency, and impersonal justice.<sup>202</sup>

Judicial review provides protection from enforcement discretion, but the level of protection varies based on the extent to which the Commissioner's discretion is bounded by rule-like proscriptions. When the Commissioner is applying a rule, courts may determine whether the rule is applicable, and if so, whether it has been applied correctly—or at least falls within the boundaries of reasonable interpretation that are consistent with deferential standards of review.<sup>203</sup>

The Commissioner has recently attempted to circumvent the constraining power of rules by promulgating regulations that assert her authority to contravene rule-based limitations when necessary to serve

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<sup>199</sup> See *id.* at 699 (quoting testimony from hearings in connection with the Taxpayer Bill of Rights 2 that "retroactive application of adverse rules and regulations can undermine the integrity of the tax system and taxpayer confidence in the fairness of the system.").

<sup>200</sup> It should be noted that some federal tax provisions, usually found outside the Code, may be viewed as specifically targeted toward providing special benefits to particular taxpayers. Many transition rules are of this sort. For example, see Pub. L. No. 99-514, § 801(d)(4), which essentially provides an exception from limitations on the cash method that were otherwise enacted in I.R.C. § 448 for certain taxpayers:

Each member of an affiliated group of corporations . . . shall be allowed to use the cash receipts and disbursement s method of accounting for any trade or business of providing engineering services with respect to taxable years ending after December 31, 1986, if the common parent of such group:

(A) was incorporated in the State of Delaware in 1970,

(B) was the successor to a corporation that was incorporated in the State of Illinois in 1949, and

(C) used a method of accounting for long-term contracts of accounting for a substantial part of its income from the performance of engineering services.

*Id.* Although arguably framed in general terms, it is difficult to believe that this provision was not targeted to a particular taxpayer.

<sup>201</sup> See, e.g., Epstein, *supra* note 1, at 151-52 (noting that Dicey and Hayek both feared the broad discretion given to administrative agencies).

<sup>202</sup> See, e.g., Michael C. Dorf, *Prediction and the Rule of Law*, 42 U.C.L.A. L. Rev. 651, 681 (1995); Scalia, *supra* note 32, at 1178.

<sup>203</sup> See Scalia, *supra* note 32, at 1177.



broader considerations of legislative purpose.<sup>204</sup> However, the Code itself reflects a longstanding tradition of deferring to the Commissioner's enforcement discretion, rather than prescribing rule-like boundaries, in certain areas.<sup>205</sup> The Commissioner's authority under section 446 of the Code to determine whether methods of accounting "clearly reflect income" is a prominent example of delegated discretionary authority with a controversial history of judicial application. As discussed below, the prospect of achieving determinacy through clear reflection jurisprudence is doubtful, but rule-based approaches can reinforce Rule of Law values in this area.

### III. THE COMMISSIONER'S "CLEAR REFLECTION" AUTHORITY

Federal income tax is only assessed against that portion of income meeting the statutory definition of "taxable income."<sup>206</sup> "Taxable income" is, in turn, defined in relation to other provisions in the Code.<sup>207</sup> The Code does not adopt a single theoretical benchmark for measuring taxable income, and this lack of consensus is understandable, given that economic and accounting disciplines tolerate considerable variation in

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<sup>204</sup> An example of this controversial practice is found in the so-called "partnership anti-abuse rules" in Treas. Reg. § 1.701-2 (1997). See, e.g., Richard M. Lipton, *Controversial Partnership Anti-Abuse Prop. Regs. Raise Many Questions*, 81 J. TAX'N 68 (1994); J.D. Dell, *The Proposed Partnership Anti-Abuse Regulations—Prudent Tax Policy or Partnership Paranoia?*, 21 J. REAL. EST. TAX'N 3 (1994). The final version of these regulations states in part:

The provisions of subchapter K and the regulations thereunder must be applied in a manner that is consistent with the intent of subchapter K as set forth in paragraph (a) of this section (intent of subchapter K). Accordingly, if a partnership is formed or availed of in connection with a transaction a principal purpose of which is to reduce substantially the present value of the partners' aggregate federal tax liability in a manner that is inconsistent with the intent of subchapter K, the Commissioner can recast the transaction for federal tax purposes, as appropriate to achieve tax results that are consistent with the intent of subchapter K, in light of the applicable statutory and regulatory provisions and the pertinent facts and circumstances.

Treas. Reg. § 1.701-2(b) (1997). The regulations expressly provide this authority applies "even though the transaction may fall within the literal words of a particular statutory or regulatory provision." *Id.* Whether this approach is valid is questionable, as the Ninth Circuit held that a similar anti-abuse provision under timber depletion regulations was invalid. See generally Caudill, *supra* note 197, at 380-81 (discussing *RLC Indus. v. Commissioner*, 48 F.3d 413 (9th Cir. 1995), which upheld a taxpayer challenge to Treas. Reg. § 1.611-3(d)(5)). *RLC Industries* is discussed *infra* notes 339-357 and accompanying text.

<sup>205</sup> See, e.g., I.R.C. § 482 (1997) (discretionary authority to allocate income and deductions among taxpayers if "necessary in order to prevent evasion of taxes or clearly to reflect the income"); I.R.C. § 446 (1997) (discretion governing determination of whether accounting method will "clearly reflect income").

<sup>206</sup> See I.R.C. § 1 (1997) (imposing tax on individual "taxable income"); I.R.C. § 11 (1997) (imposing tax on corporate "taxable income").

<sup>207</sup> See I.R.C. § 63 (1997) (defining taxable income as gross income minus deductions allowed by chapter 1 of Subtitle A of the Internal Revenue Code).

measuring income.<sup>208</sup> Even if there was consensus, tax systems ultimately have a practical orientation, which includes generating revenue in an administratively feasible and politically palatable manner.<sup>209</sup> The current tax system also seeks to accomplish numerous other policy goals apart from raising revenue, which tends to detract from its theoretical purity.<sup>210</sup>

The annual accounting concept injects added complexity into the process of measuring taxable income, as many aspects of income and expense do not fit neatly into an annual accounting cycle.<sup>211</sup> Methods of accounting are used to determine when items of income and expense are taken into account for tax purposes, and section 446 of the Code generally allows taxpayers to choose their own methods of accounting,<sup>212</sup> sub-

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<sup>208</sup> For example, among economic measures, the Haig-Simons model is perhaps the most widely used in defining personal income. The Haig-Simons model defines personal income as "the algebraic sum of (1) the market value of rights exercised in consumption and (2) the change in the value of the store of property rights between the beginning and end of the period in question." J.B. McCombs, *An Historical Review and Analysis of Early United States Tax Policy Scholarship: Definition of Income and Progressive Rates*, 64 ST. JOHN'S L. REV. 471 (1990) (quoting H. Simons, PERSONAL INCOME TAXATION 50 (1938)). This approach bears the disadvantage of considerable indeterminacy. See Victor Thuronyi, *The Concept of Income*, 46 TAX L. REV. 45, 46 (1990) ("Despite its wide acceptance, Haig-Simons income remains elusive and ambiguous, since the terms 'consumption' and 'accumulation' are open ended."). Thuronyi also points out that Haig-Simons is incomplete, as compared with the neoclassical approach to income, which includes such items as "leisure" and "public goods" in the income measure. *Id.* With respect to economic measures of income generally, Thuronyi observes:

[T]he term 'economic income' . . . is commonly employed as if it were a relatively well-defined or well-understood concept. The fact that some use economic income as a workable concept while others question its validity suggests the that nature of the concept is not well understood and has not been fully explored, despite the inordinate volume of literature on the subject." The variability of measures of income accepted in accounting is also well-established.

*Id.* See also *Thor Power Tool v. Commissioner*, 439 U.S. 522, 544 (1978) ("Accountants have long recognized that 'generally accepted accounting principles' are far from being a canonical set of rules that will ensure identical accounting treatment of identical transactions.") (footnote omitted).

<sup>209</sup> See John S. Nolan, *The Merit of an Income Tax Versus A Consumption Tax*, 12 AM J. TAX POL'Y 207, 210 (1995). As Nolan points out, "[t]he U.S. income tax is not, of course, a 'pure' income tax." Political and administrative constraints on Haig-Simons are well recognized. See McComb, *supra*, note 208. For example, the realization concept generally prevents the change in market value of assets from being taken into account for tax purposes, and imputed income from the use of property or from services of family members is outside the tax base. See generally Chirelstein, *supra* note 136, at 22-25, 72-74 (discussing imputed income and realization).

<sup>210</sup> As the Second Circuit once observed: "The tax laws are such a hodgepodge of exceptions, qualifications, special interests and sometimes logically inconsistent treatment that they cannot be treated as symmetrical exegesis." *Burke v. Commissioner*, 533 F.2d 768, 772 n.7 (2d Cir. 1976). This view of tax law would appear to be at odds with those who argue for an interpretive approach based on the "structure" or "purpose" of tax law.

<sup>211</sup> See generally STEPHEN F. GERTZMAN, FEDERAL TAX ACCOUNTING ¶ 12.01-.02 (2d ed. 1993).

<sup>212</sup> See I.R.C. § 446(a) (1997).

ject to the Commissioner's determination that the chosen method will "clearly reflect income."<sup>213</sup>

Those seeking to ascribe meaning to the "clear reflection" concept as a limitation on the Commissioner's discretionary authority encounter a conundrum: how can one know if the "reflection" is "clear" when the "image" of "income" is not clearly "focused"? As a leading treatise points out:

The statutory phrase [i.e., "clearly reflect income"] is not only hopelessly vague but circular to boot, since the "income" that must be clearly reflected by the taxpayer's accounting method is *taxable* income, not financial, economic, or any other variety of income. In short, income is clearly reflected by an accounting method if the ultimate result of using the method is taxable income.<sup>214</sup>

Case law reflects the difficulty of the quest to give meaning to this concept. The statutory framework and some illustrative cases are discussed below.

#### A. SECTION 446: DISCRETION GOVERNING ACCOUNTING METHODS

Section 446 of the Code is the principal locus of the Commissioner's "clear reflection" authority and a key provision governing the adoption of, and changes in, methods of accounting. The Code does not provide a comprehensive definition of methods of accounting or the items of income or expense to which they apply. However, regulations do make clear that methods include not only the overall approach for taking into account revenue and expenses (such as the cash method or an accrual method), but also the specific approach used for particular items of income or expense.<sup>215</sup> Moreover, the method concept is inextricably linked with matters of timing, as opposed to characterization, as the following guidance indicates:

A material item is any item that involves the proper time for the inclusion of the item in income or the taking of the item as a deduction. In determining whether a taxpayer's accounting practice for an item involves timing, generally the relevant question is whether the practice permanently changes the amount of the taxpayer's lifetime income. If the practice does not permanently affect the taxpayer's lifetime income, but does or could change

<sup>213</sup> See I.R.C. § 446(b) (1997).

<sup>214</sup> BITTKER & LOKKEN, *supra* note 190, at ¶ 105.1.4 (footnote omitted).

<sup>215</sup> See Treas. Reg. § 1.446-1(a)(1) (1997).

the taxable year in which income is reported, it involves timing and is therefore a method of accounting.<sup>216</sup>

Section 446(a) provides the general rule that "[t]axable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books."<sup>217</sup> This provision imposes the so-called "book conformity" requirement—i.e., that taxpayers generally must compute their taxable income in accordance with the method in which they keep their books.<sup>218</sup> This provision also implies two other points, which are important to understanding the clear reflection requirement.

First, more than one method of accounting is often appropriate. Regulations provide in part that "no uniform method of accounting can be prescribed for all taxpayers. Each taxpayer shall adopt such forms and systems as are, in his judgment, best suited to his needs."<sup>219</sup> Second, the taxpayer—not the government—is initially empowered to choose among available methods, which are not otherwise proscribed by law.<sup>220</sup> Section 446(a) thus respects taxpayer discretion in choosing methods, suggesting a practical orientation towards adapting tax accounting methods to the taxpayer's business and financial accounting environment.

Taxpayers measure various items of income and expense for purposes other than tax reporting, and financial accounting methods are

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<sup>216</sup> Rev. Proc. 97-27, 1997-1 C.B. 681. The Service sometimes uses other terms, such as "submethods of accounting" to refer to more particularized descriptions of accounting methods. See, e.g., Rev. Proc. 98-1, 1998-1 I.R.B. 7 ("If two or more items or sub-methods of accounting are interrelated, the national office ordinarily will not issue a letter ruling on a change in accounting method involving only one of the items or sub-methods."); *id.* at 55 (clarifying that separate user fees apply to "a request for change in accounting method that involves several unrelated items or submethods of accounting.")

<sup>217</sup> I.R.C. § 446(a) (1997).

<sup>218</sup> See generally GERTZMAN, *supra* note 211, at ¶ 2.02[1]. As Gertzman explains, the book conformity requirement "does not prevent a taxpayer from using a nonbook method for reporting particular items of income or expense if such nonconforming method is otherwise required or permitted." *Id.* Gertzman also points out that the permitted use of certain non-book methods "seems obvious from the fact that many methods of accounting for tax purposes are not generally acceptable for financial accounting and reporting purposes (e.g., the cash and installment methods) or were established solely for tax purposes (e.g., methods of tax depreciation)." *Id.* at n.15.

<sup>219</sup> Treas. Reg. § 1.446-1(a)(2) (1997). The regulations describe the taxpayer's choices as including the cash method, an accrual method, other methods specifically prescribed in the Code or regulations, or a combination of these methods. See Treas. Reg. § 1.446-1(c) (1997).

<sup>220</sup> See Treas. Reg. § 1.446-1(e)(1) (1997):

A taxpayer filing his first return may adopt any permissible method of accounting in computing taxable income for the taxable year covered by such return. See section 446(c) and paragraph (c) of this section for permissible methods. Moreover, a taxpayer may adopt any permissible method of accounting in connection with each separate and distinct trade or business, the income from which is reported for the first time.

designed to be adaptable to the needs of particular industries and even particular enterprises.<sup>221</sup> Allowing taxpayer choice in these matters tends to reduce the compliance costs and other indirect economic burdens imposed by the tax system.<sup>222</sup> However, the resulting variation in accounting methods is also likely to produce different measures of taxable income for particular tax years. Although such differences may even out over a longer period of transactions, the effect on a particular year's tax receipts could be significant.<sup>223</sup>

Congress and the Treasury have developed specific rules that limit taxpayer choices of accounting methods.<sup>224</sup> In addition to those specific rules governing methods of accounting, a taxpayer must also satisfy the Commissioner's discretionary authority under section 446(b), which states: "If 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."<sup>225</sup> Thus, section 446(b) grants authority to the Commissioner to select a method of accounting if the taxpayer fails to adopt a method.<sup>226</sup> In addition, the Com-

<sup>221</sup> See DONALD E. KIESO & JERRY J. WEYGANDT, *INTERMEDIATE ACCOUNTING* 32-50 (7th ed. 1992).

<sup>222</sup> On the general nature and magnitude of these costs, see ROBERT E. HALL & ALVIN RABUSHKA, *THE FLAT TAX* 5-19 (2d ed. 1995).

<sup>223</sup> See GERTZMAN, *supra* note 211, at ¶ 1.01[2] (demonstrating different income results from adopting different tax accounting methods). Gertzman also points out that a timing difference of one year generates tax benefits that exceed the time value of taxes deferred for one year, which has resulted in heightened scrutiny of tax accounting methods. *See id.*

<sup>224</sup> See generally I.R.C. §§ 446-475 (1997) and related regulations, which govern methods of accounting. For additional cost capitalization rules with important implications for methods of accounting, see I.R.C. § 263A (1997) and related regulations.

<sup>225</sup> I.R.C. § 446(b) (1997).

<sup>226</sup> For an example of a taxpayer who had failed to adopt a method of accounting, see *Schouten v. Commissioner*, T.C. Memo 1991-155. Once a method is adopted, the taxpayer generally must seek permission to change to another method. *See* Treas. Reg. § 1.446-1(e)(2)(i) (1997). If an accounting method is changed, section 481 of the Code generally permits the Government to recompute and adjust taxable income effects from using that method, even if those effects pertain to years that are closed by the statute of limitations. The Service has attempted to retain flexibility in defining when methods are adopted, presumably to protect its authority over method changes and to retain its authority to impose new methods. *See* Notice 98-31, which contains the following language in a proposed Revenue Procedure governing changes in methods of accounting:

Although a method of accounting may exist . . . without a pattern of consistent treatment of an item, a method of accounting is not adopted in most instances without consistent treatment. The treatment of a material item in the same way in determining gross income or deductions in two or more consecutively filed tax returns (without regard to any change in status of the method as permissible or impermissible) represents consistent treatment of that item for purposes of [Treas. Reg.] § 1.446-1(e)(2)(ii)(a). If a taxpayer treats an item properly in the first return that reflects the item, however, it is not necessary for the taxpayer to treat the item consistently in two or more consecutive tax returns to have adopted a method of accounting.

missioner has authority to determine whether a taxpayer's chosen method does not "clearly reflect income," and upon making such a determination, to change the taxpayer's method to another method that "does clearly reflect income."<sup>227</sup>

Clear reflection authority casts doubt on whether a taxpayer's chosen method, which is not otherwise proscribed by law, will ultimately be respected. Treasury Regulations under section 446 assert that compliance with the "clear reflection" requirement is always a matter for the Commissioner's discretion: "[N]o method of accounting is acceptable unless, in the opinion of the Commissioner, it clearly reflects income."<sup>228</sup> However, the regulations under section 446 provide only limited guidance as to the appropriate criteria for basing such an opinion. For example, the regulations state in part:

A method of accounting which reflects the consistent application of generally accepted accounting principles in a particular trade or business in accordance with accepted conditions or practices in that trade or business will *ordinarily* be regarded as clearly reflecting income, provided all items of gross income and expense are treated consistently from year to year.<sup>229</sup>

Elsewhere, the regulations also provide the following guidance for the recognition of income by accrual-method taxpayers: "The method used by the taxpayer in determining when income is to be accounted for will *generally* be acceptable if it accords with generally accepted accounting principles, is consistently used by the taxpayer from year to year, and is consistent with the Income Tax Regulations."<sup>230</sup>

These regulations suggest that consistent application of an accounting method that complies with generally accepted accounting principles ("GAAP") and the applicable Treasury regulations should be acceptable. However, important "hedging" words are included: "ordinarily" and "generally." Unfortunately, they provide no guidance as to the circumstances in which the Commissioner would take exception to a method that complies with GAAP and the regulations.

The only other set of regulations under section 446 which affirmatively seek to provide additional content to the "clear reflection" concept

I.R.S. Notice 98-31, 1998-22 I.R.B. 681.

<sup>227</sup> I.R.C. § 446(b) (1997).

<sup>228</sup> Treas. Reg. § 1.446-1(a)(2) (1997).

<sup>229</sup> *Id.* (emphasis added).

<sup>230</sup> Treas. Reg. § 1.446-1(c)(1)(ii)(C) (1997) (emphasis added). It should be noted that the word "generally" was added to this regulation in 1992. See T.D. 8408 (April 10, 1992), 57 F.R. 12411, 12419. The preamble to these regulations, which implemented the economic performance rules of I.R.C. § 461(h), did not explain the reason for this change.

are the regulations governing hedging transactions.<sup>231</sup> These regulations provide in part:

The method of accounting used by a taxpayer for a hedging transaction must clearly reflect income. To clearly reflect income, the method used must reasonably match the timing of income, deduction, gain, or loss from the hedging transaction with the timing of income, deduction, gain, or loss from the item or items being hedged. Taking gains or losses into account in the period in which they are realized may clearly reflect income in the case of certain hedging transactions. For example, where a hedge and the item being hedged are disposed of in the same taxable year, taking realized gain or loss into account on both items in that taxable year may clearly reflect income. In the case of many transactions, however, taking gains and losses into account as they are realized does not result in the matching required by this section.<sup>232</sup>

These "hedging" regulations also contain appropriate "hedging" language. The regulations suggest that the matching requirement in this context is quite fluid and only the Commissioner has authority to determine when it is satisfied.

Section 446 is not the only provision that invokes the "clear reflection" requirement. Section 471(a), which provides the general rule for inventories, invokes a similar concept:

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.<sup>233</sup>

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<sup>231</sup> See Treas. Reg. § 1.446-4 (1997).

<sup>232</sup> Treas. Reg. § 1.446-4(b) (1997). Arguably, a matching principle is also inherent in the capitalization requirement that is one of the "essential features" of taxpayer records. See Treas. Reg. § 1.446-1(a)(4)(ii) (1997). However, as will be discussed below, this matching principle is quite fluid, and it is not uniformly applied throughout the Code. Many instances of mismatching are both tolerated and prescribed in the Code, making this a difficult principle to apply in constraining the Commissioner's discretion.

<sup>233</sup> I.R.C. § 471(a) (1997). Note that this provision requires conformity to the "best accounting practice", and it also expands the Commissioner's discretion to determine that method which "most clearly reflects income." The latter requirement suggests that clear reflection authority under section 471 may exceed that under 446. This distinction, however, is often ignored. See GERTZMAN, *supra* note 211, ¶ 6.04[1][b][ii], at 6-10.

Section 482 provides in part that the Secretary is empowered to allocate tax attributes among related taxpayers if "necessary in order to prevent evasion of taxes or clearly to reflect the income."<sup>234</sup> More than forty other regulations refer to a "clear reflection" concept in some form.<sup>235</sup> Thus, the scope of clear reflection authority presents a broad-based problem in tax law with a significant impact on tax administration.

## B. JUDICIAL APPROACHES TO "CLEAR REFLECTION" ISSUES

Courts evaluating the parameters of the "clear reflection" concept under section 446 generally defer to the Commissioner's determination as to "clear reflection" and her prescription of an alternative method. Nevertheless, the Commissioner's clear reflection authority is not unlimited, as courts sometimes find in the taxpayer's favor. As discussed below, an abuse of discretion standard has emerged as the judicial basis for evaluating clear reflection authority. The persistence of taxpayer choice among methods has contributed to the difficulty in applying this standard, as no single method can be adopted as a benchmark for others. The constraints on the Commissioner's authority that have emerged lack rule-like clarity.

### 1. *Abuse of Discretion Standard*

The Commissioner's authority under section 446(b) potentially involves two different determinations: (1) whether the taxpayer's chosen method of accounting clearly reflects income; and (2) if not, assigning an alternative method that does clearly reflect income. From the face of the statute, one might argue that only the second determination—assigning an alternative method of accounting—is a matter clearly left to the "opinion of the Secretary." However, regulations take the position that the Commissioner's discretion extends to both determinations.<sup>236</sup> Courts

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<sup>234</sup> I.R.C. § 482 (1997).

<sup>235</sup> A LEXIS search of the CFR database as of August 20, 1998 produced forty-seven regulations that contain the following search terms: "Title(26) and proper or properly or clear or clearly w/s reflect! w/s income". These regulations include the partnership anti-abuse regulation discussed above, which requires, with certain exceptions, that "the tax consequences under subchapter K to each partner of partnership operations and of transactions between the partner and the partnership must accurately reflect the partner's economic agreement and clearly reflect the partner's income (collectively, property reflection of income)." Treas. Reg. § 1.701-2(a) (1997). This anti-abuse regulation reiterates that the Commissioner may determine that: "[t]he methods of accounting used by the partnership or a partner should be adjusted to reflect clearly the partnership's or the partner's income." Treas. Reg. § 1.701-2(b)(3) (1997).

<sup>236</sup> See Treas. Reg. § 1.446-1(a)(2) (1997).



have generally agreed, applying an abuse of discretion approach in both situations.<sup>237</sup>

The Supreme Court has long favored deference to the Commissioner's clear reflection authority. According to the Court, "[t]he Commissioner has broad powers in determining whether accounting methods used by a taxpayer clearly reflect income."<sup>238</sup> Consequently, "[the Commissioner's] interpretation of the statute's clear-reflection standard should not be interfered with unless clearly unlawful"<sup>239</sup> or "plainly arbitrary."<sup>240</sup> The taxpayer bears a "heavy burden" to show unlawful or arbitrary action,<sup>241</sup> which exceeds the burden that taxpayers otherwise bear in tax litigation, *i.e.*, to overcome the presumption of correctness that

<sup>237</sup> See, e.g., *Commissioner v. Asphalt Products, Inc.*, 796 F.2d 843, 847 (6th Cir. 1986), *rev'd on other grounds*, 482 U.S. 117 (1987). The Court of Federal Claims briefly departed from this approach in *Travelers Ins. Co. v. United States*, 35 Fed. Cl. 138 (1996), and *Mulholland v. United States*, 28 Fed. Cl. 320 (1993), *aff'd*, 22 F.3d 1105 (Fed. Cir.1994) (Table), in which the Court treated the Commissioner's determination as to whether the taxpayer's method clearly reflects income as a matter for de novo review. In *Dana Corp. v. United States*, 38 Fed. Cl. 356, 363 n.3. (1997), the Court later clarified that this approach was not appropriate, as the Commissioner's discretion extends to both determinations. Further, in *Connecticut Yankee Atomic Power Company v. United States*, 38 Fed. Cl. 721 (1997), the Court suggested that de novo review was limited to those situations in which the Commissioner did not challenge the taxpayer's selection of a method.

<sup>238</sup> *United States v. Hughes Properties*, 476 U.S. 593, 603 (1986) (quoting *Commissioner v. Hansen*, 360 U.S. 446, 467, 79 S. Ct. 1270, 1282, 3 L.Ed.2d 1360 (1959)). See also *Thor Power Tool Co. v. Commissioner*, 439 U.S. 522, 532 (1979); *American Automobile Assn. v. United States*, 367 U.S. 687, 697-98 (1961).

<sup>239</sup> *Thor Power Tool Co.*, 439 U.S. at 532-33 (quotations omitted). See also *United States v. Catto*, 384 U.S. 102 (1966); *Schlude v. Commissioner*, 372 U.S. 128, 133-134 (1963); *American Automobile Assn.*, 367 U.S. at 697-98 (1961); *Automobile Club of Michigan v. Commissioner*, 353 U.S. 180, 189-90 (1957); *Brown v. Helvering*, 291 U.S. 193, 203 (1934); *Lucas v. Structural Steel Co.*, 281 U.S. 264, 271 (1930).

<sup>240</sup> *Thor Power Tool Co.*, 439 U.S. at 533.

<sup>241</sup> *Id.* See also *Asphalt Products Co. v. Commissioner*, 796 F.2d 843, 848 (6th Cir.1986), *aff'g in part and rev'g in part*, *Akers v. Commissioner*, T.C.M. 1984-208, *rev'd on other grounds*, 482 U.S. 117 (1987) (per curiam), which stated in part:

§ 446 gives the Commissioner discretion with respect to two determinations. The Commissioner first determines whether the accounting method chosen by a taxpayer clearly reflects income. If the Commissioner concludes that the taxpayer's chosen method does not meet this standard, he has the further discretion to require that computations be made under the method which, in his opinion, does clearly reflect income. It would be difficult to describe administrative discretion in broader terms.

*Id.* at 847. *Asphalt Products* also suggests that a taxpayer could sustain its burden by showing that the alternative method chosen by the Commissioner does not clearly reflect income. See *id.* Courts have rejected the Commissioner's change of a taxpayer's accounting method from an incorrect method to another incorrect method. See *Harden v. Commissioner*, 223 F.2d 418, 421 (10th Cir.1955), *rev'g* 21 T.C. 781 (1954); *Prabel v. Commissioner*, 91 T.C. 1101, 1112 (1988), *aff'd* 882 F.2d 820 (3d Cir.1989). See also *Southern California Sav. & Loan v. Commissioner*, 95 T.C. 35, 44 (1990) (Wells, J., concurring) ("Section 446(b) authorizes respondent to require accounting changes that produce clearer reflections of income, not greater distortions of income."); *Kroger Co. v. Commissioner*, 73 T.C.M. (CCH) 1637 (1997).

attaches to the Commissioner's determinations in Tax Court,<sup>242</sup> or to prove an overpayment of tax in refund litigation.<sup>243</sup> However, the nature of proof required to sustain this burden is far from clear.

To the extent that the "income" being "reflected" is "taxable income," and "taxable income" is a product of applying the Code and Regulations to particular facts, then compliance with the Code and Regulations should arguably provide a conclusive basis for satisfaction of the "clear reflection" requirement.<sup>244</sup> However, this has not proved true. Compliance with the Code and Regulations is a relevant factor, but courts are also willing to take into account other facts and circumstances in determining whether a taxpayer's method clearly reflects income.<sup>245</sup> Moreover, the likelihood of sustaining the taxpayer's method seems to increase with the particularity of the method described and authorized by the Code or regulations. As discussed below, however, even this point is not entirely free from doubt.

## 2. Taxpayer Choice Among Methods

As noted above, section 446(c) specifically allows taxpayers to choose among overall accounting methods, including the cash method, accrual methods, or other hybrid methods.<sup>246</sup> Taxpayer choice emerged early in the modern income tax era, and it has persisted in some form ever since. The income tax enacted in 1913 originally required the accrual method for income, but cash method accounting for expenses, with the exception of farmers, who were permitted to use the cash method for both income and expenses.<sup>247</sup> Regulations promulgated in 1914 allowed

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<sup>242</sup> See, e.g., *RLC Indus. v. Commissioner*, 98 T.C. 457, 491 (1992); *RECO Indus. v. Commissioner*, 83 T.C. 912, 920 (1984).

<sup>243</sup> See PAULA M. JUNGHANS & JOYCE K. BECKER, *FEDERAL TAX LITIGATION* ¶ 18.02[1] (2d ed. 1992) (explaining the "double burden of proof" on taxpayers in refund litigation: proving the Service's assessment is erroneous and that the taxpayer is entitled to a refund).

<sup>244</sup> Some courts have made statements to this effect. See, e.g., *Fidelity Assoc., Inc. v. Commissioner*, T.C.M. 1992-142 ("Respondent may not reject, as not providing a clear reflection of income, a method of accounting employed by the taxpayer which is specifically authorized by the Internal Revenue Code or Treasury regulations and which has been applied on a consistent basis."); *Hallmark Cards, Inc. v. Commissioner*, 90 T.C. 26, 31 (1988) ("Respondent's broad authority to determine whether a taxpayer's accounting method clearly reflects income is limited, in that he may not reject, as not providing a clear reflection of income, a method of accounting employed by the taxpayer which is specifically authorized in the Code or regulations and has been applied on a consistent basis.").

<sup>245</sup> Several factors have been considered, including: (1) compliance with GAAP; (2) principles of matching income and expenses; (3) industry customs and practices; and (4) comparing results with those under other methods of accounting. See generally *RLC Indus. v. Commissioner*, 98 T.C. 457 (1992); GERTZMAN, *supra* note 211, at ¶ 2.02[2].

<sup>246</sup> See I.R.C. § 446(c) (1997).

<sup>247</sup> See Donald Schapiro, *Prepayments and Distortion of Income Under Cash Basis Tax Accounting*, 30 TAX L. REV. 117, 129-31 (1975). There has been some confusion as to the requirements of the early forms of the income tax. For example, Gertzman indicates that the

accrual basis deductions for business expenses,<sup>248</sup> followed by the Revenue Act of 1916 which expressly allowed both the cash or accrual methods for all taxpayers, provided that such method clearly reflected income.<sup>249</sup>

The fact that the Code permits variation in accounting methods, rather than adopting a single model as an ideal for tax purposes, has magnified the scope and difficulty of clear reflection controversies.<sup>250</sup> This problem was aptly described in *Knight-Ridder Newspapers, Inc. v. United States*:<sup>251</sup>

[The cash and accrual methods] are the two most common accounting methods and could be said to emblemize the polar nature of the human spirit. The cash method—simple, plodding, elemental—stands firmly in the physical realm. It responds only through the physical senses, recognizing only the tangible flow of currency. Money is income when this raw beast actually feels the coins in its primal paw; expenditures are made only when the beast can see that it has given the coins away.

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1913 Act had originally contemplated the cash method, and that the Revenue Act of 1916 was the first act that specifically authorized a method other than the cash method. See GERTZMAN, *supra* note 211, at ¶¶ 2.02[1][a]; 3.02. Schapiro explains the origin of such a view of the 1913 Act to Law Opinion 1059, 1921 C.B. 147, which erroneously stated that the Revenue Act of 1916 was the first time that any method other than the cash method was allowed. See Schapiro, *supra* at 134. As Schapiro points out, the 1913 Act imposed tax on income “arising or accruing” from all sources. See *id.* at 139 n.35.

<sup>248</sup> Schapiro, *supra* note 247, at 129 n.36.

<sup>249</sup> *Id.* at 132-42. Schapiro points out that sections 8(g) and 13(d) of the 1916 Act provided:

[A taxpayer] keeping accounts upon any basis other than that of actual receipts and disbursements, unless such basis does not clearly reflect his [or its] income, may, subject to regulations made by the Commissioner of Internal Revenue, with the approval of the Secretary of the Treasury, make his return upon the basis upon which his accounts are kept, in which case the tax shall be computed upon his [or its] income.

*Id.* at 132 n.45 (quoting the act). Although this could be viewed as limiting the clear reflection requirement to methods other than the cash method, Schapiro points out that the Ways and Means Committee report made it clear that both cash and accrual methods were subject to the clear reflection requirement, as that report states in part:

Present law requires that the income tax shall be levied on the accrued basis. As two systems of bookkeeping are in use in the United States, one based on the cash or receipt basis and the other on the accrual basis, it was deemed advisable to provided in the proposed measure that an individual or corporation may make return of income on either the cash or accrued basis, if the basis selected clearly reflects income.

*Id.* at 133 (quoting H.R. REP. NO. 64-922 (1916)).

<sup>250</sup> See Schapiro, *supra* note 247, at 117-19.

<sup>251</sup> 743 F.2d 781 (11th Cir. 1984).

The accrual method, however, moves in a more ethereal, mystical realm. The visionary prophet, it recognizes the impact of the future on the present, and with grave foreboding or ecstatic anticipation, announces the world to be. When it becomes sure enough of its prophecies, it actually conducts life as if the new age has already come to pass. Transactions producing income or deductions spring to life in the eyes of the seer though nary a dollar has moved.

The Internal Revenue Code, the ultimate arbiter, stands to the side, shifting its eyes uneasily from the one being to the other. The Code is possessed of great wisdom and tolerance. It knows that man must generally choose his own way. Therefore, it leaves to the Taxpayer the original choice of which accounting method to use . . . .

Yet the Code also understands that either extreme possesses inherent weaknesses and can become blinded to reality. Thus the Code and subsequent Treasury Regulations empower the Secretary of the Treasury and the Commissioner of Internal Revenue to cure the blindness. Section 446(b) of the Code provides that 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.<sup>252</sup>

As the *Knight-Ridder* court also points out, the Code provides an inadequate foundation for limiting the Commissioner's clear reflection authority in this context:

Of course, in deciding whether the Commissioner has abused his discretion, we immediately face an age-old philosopher's dilemma: how can we mere mortals know who sees the truth most vividly? How can we know whether the primal cash method or the mystical accrual method sees income more clearly without knowing what income really is? If it is really cash on hand, then the cash method is more accurate. If it is really fixed obligations, then the accrual method is more accurate. By embracing both conceptions, the Code provides no general baseline against which to assess the accuracy of an accounting method. In effect, we risk being led in circular

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<sup>252</sup> *Id.* at 787-88.

fashion to arbitrarily choose one method as accurately reflecting income. When another method differs from it, that other must not clearly reflect income.<sup>253</sup>

As discussed below, courts have nevertheless struggled to provide a predictable basis for decisions regarding clear reflection, with only limited success.

### 3. Cash Method "Distortion"

Controversies affecting cash method taxpayers sometimes involve eligibility for the cash method, an issue which can be resolved by reference to particular Code provisions that restrict the use of the cash method.<sup>254</sup> For example, section 471 and its applicable regulations effectively require accrual method accounting with respect to the purchase and sale of merchandise inventories.<sup>255</sup> In this context, eligibility for the cash method turns on the existence of merchandise inventories as an income-producing factor in the taxpayer's business.<sup>256</sup> Thus, the Commissioner's enforcement discretion to require an accrual method is subject to a rule-like constraint, as the Code and regulations provide an accessible standard for evaluating whether the taxpayer's method complies with those provisions.

However, the role of discretion in applying that standard is still controversial. If compliance with the Code or regulations involves a matter of interpretation, then the proper extent of the deference that should be accorded to the Commissioner's interpretation is disputed. For example, if the appropriateness of the cash method turns on the existence of mer-

<sup>253</sup> *Id.* at 788.

<sup>254</sup> *See, e.g.*, I.R.C. §§ 447, 448, 471 (1997).

<sup>255</sup> I.R.C. § 471(a) (1997) states:

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.* Regulations provide in part that "[i]n order to reflect taxable income correctly, inventories at the beginning and end of each taxable year are necessary in every case in which the production, purchase, or sale of merchandise is an income-producing factor." Treas. Reg. § 1.471-1 (1997). Regulations also provide, however, that "the Commissioner may authorize a taxpayer to continue the use of a method of accounting consistently used by the taxpayer, even though not specifically authorized by the regulations in this part, if, in the opinion of the Commissioner, income is clearly reflected by the use of such method." Treas. Reg. § 1.446-1(c)(2)(ii) (1997). Courts may allow taxpayers with inventories to continue using the cash method if they can prove that the cash method produces a "substantial identity of results" with the accrual method. *See* *Wilkinson-Beane, Inc. v. Commissioner*, 420 F.2d 352 (1st Cir. 1970); *Asphalt Products Inc. v. Commissioner*, 796 F.2d 843, 849 (6th Cir. 1986), *rev'd on other grounds*, 482 U.S. 117 (1987); *Ansley-Sheppard-Burgess Co. v. Commissioner*, 104 T.C. 367, 377 (1995); *Thompson Electric v. Commissioner*, 69 T.C.M. (CCH) 2328 (1995).

<sup>256</sup> *See* Treas. Reg. § 1.471-1 (1997).

chandise inventories, should a court faced with the question of whether such inventories exist defer to the Commissioner's interpretation of that term? Recent decisions take the position that definitional questions regarding the scope of merchandise inventories are well within the ken of the judiciary and note that deference to the Commissioner on the existence of inventory is arguably unnecessary and inappropriate.<sup>257</sup> However, some commentators have asserted that an abuse of discretion standard should apply in this context, arguing that deference to the Commissioner's interpretation is appropriate in light of the Commissioner's perceived expertise in enforcing the tax laws.<sup>258</sup>

When a taxpayer's use of the cash method violates applicable provisions of the Code or Regulations, clear reflection authority is at its apex because it is supported by the rules that prescribe parameters for taxpayer behavior. Nevertheless, courts have allowed cash method taxpayers with inventories to prevail against the Commissioner's clear reflection authority by demonstrating that their noncomplying method produces a "substantial identity of results" with the Commissioner's preferred method.<sup>259</sup>

Courts using the "substantial identity of results" approach to uphold the taxpayer's use of a noncomplying method may effectuate the principle that "the law cares not for trifles."<sup>260</sup> However, such an approach may be short-sighted: a limited disparity in current-year income measurement does not ensure against future understatements in tax liability as a consequence of failing to use the accrual method. Continued use of noncomplying methods presents a risk of future harm to the public fisc, which given limited resources for monitoring and enforcement, might go undetected.

The risk may be justified by the desire to avoid wasteful expenditures for accounting systems and personnel, which the taxpayer might have to absorb if forced to change to an accrual method. From the taxpayer's perspective, these costs are functionally equivalent to a tax, as they represent a required commitment of resources to comply with a gov-

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<sup>257</sup> See, e.g., *Hewlett Packard Co. v. United States*, 71 F.3d 398, 403 (Fed. Cir. 1995); *Honeywell Inc. v. Commissioner*, 64 T.C.M. (CCH) 437 (1992) (concluding that "rotatable" parts were capital assets, not inventory, despite Commissioner's contentions to the contrary). Cf. *RLC Indus. v. Commissioner*, 58 F.3d 413 (9th Cir. 1995) (finding facts and applying regulations to those facts is judicial function for which Commissioner's discretion is not appropriate).

<sup>258</sup> See W. Eugene Seago, *Clear Reflection of Income Under Section 446(b)*, 62 TAX NOTES 355 (1994) (arguing that the same abuse of discretion standard should apply to questions of law, such as the existence of merchandise inventories).

<sup>259</sup> See *Wisconsin-Ridder Newspapers, Inc. v. United States*, 743 F.2d 781 (11th Cir. 1984).

<sup>260</sup> See *Wisconsin Dep't of Revenue v. William Wrigley, Jr., Co.*, 505 U.S. 214, 231 (1992) ("[T]he venerable maxim *de minimis non curat lex* ('the law cares not for trifles') is part of the established background of legal principles against which all enactments are adopted, and which all enactments (absent contrary indication) are deemed to accept." ).

ernment mandate. However, if additional tax liabilities do not arise in future years, this required expenditure is wasteful, generating no direct benefits for either the taxpayer or the government.

The decided cases do not expressly state this justification, but if it is the animating principle behind the "substantial identity of results" approach, it raises challenging policy questions. For example, should our tax system be administered so that compliance with the rules is not required if the costs outweigh the benefits in each particular case? In other words, is a cost-benefit analysis an appropriate consideration in determining whether tax rules must be followed? If so, should that analysis take into account each taxpayer's cost structures? One might prefer to grant discretion to override the applicable rules if it means achieving a pareto superior result.<sup>261</sup> However, such a preference presupposes that discretion would not inject additional costs into other cases, thus offsetting this benefit.<sup>262</sup> Further, it presupposes that discretion will be administered fairly and consistently, so as not to benefit some taxpayers while burdening their competitors. Although the "substantial identity of results" doctrine may constrain enforcement discretion in a taxpayer-friendly manner, departing from the applicable rules on a case-by-case basis still presents prudential concerns.

Other controversies do not involve eligibility for the cash method, but instead involve so-called "distortions" arising from application of the cash method.<sup>263</sup> Origins of this authority can be traced to Committee reports from the Revenue Act of 1924, which suggest that discretionary authority should be used to address "distortion" from prepaid items that were properly allocable over multiple periods:

The necessity for [the Commissioner's clear reflection power] arises in cases in which a taxpayer pays in one year interest or rental payments or other items for a period of years. If he is forced to deduct the amount in the

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<sup>261</sup> See POSNER, *supra* note 5, at 54-55 (defining a "Pareto superior" change as one which "makes at least one person better off and no one worse off.").

<sup>262</sup> See *id.* at 55 ("The condition that no one else be affected by a 'voluntary' transaction can only rarely be fulfilled.").

<sup>263</sup> The term "distortion" is in quotations because it reflects a judgment about the results of a particular accounting method as compared with an "ideal." Unfortunately, the "ideal" is difficult to define objectively, given the variation permitted in methods of accounting, and particularly those concessions to tax administration that are tolerated in the cash method. *Cf.* Coverdale, *supra* note 14, at 1506-07 n.18:

I speak of "what courts consider loopholes" because loopholes are not an objectively defined category. The fact that a provision allows a taxpayer to delay or avoid tax may be an inadvertent result; an expected, although undesired, effect accepted as the price of achieving some other result; or a desired result. It is often difficult to see into which category a particular result falls into.

year in which paid, it may result in a distortion of his income which will cause him to pay either more or less taxes than he properly should.<sup>264</sup>

In *Security Flour Mills v. Commissioner*,<sup>265</sup> the Supreme Court interpreted this legislative history as indicating that clear reflection power applies to "distortion" in both cash and accrual methods. The court stated that clear reflection power:

was intended to take care of fixed liabilities payable in fixed installments over a series of years. For example, a tenant would not be compelled to accrue, in the first year of a lease, the rental liability covering the entire term nor would he be permitted, if he saw fit to pay all the rent in advance, to deduct the whole payment as an expense of the current year. But we think it was not intended to upset the well understood and consistently applied doctrine that cash receipts or matured accounts due on the one hand, and cash payments or accrued definite obligations on the other, should not be taken out of the annual accounting system and, for the benefit of the Government or the taxpayer, treated on a basis which is neither a cash basis nor an accrual basis, because so to do would, in a given instance, work a supposedly more equitable result to the Government or to the taxpayer.<sup>266</sup>

Thus, although the Commissioner's clear reflection authority could affect the manner in which multi-period obligations are taken into account under the cash or accrual method, neither the Government nor taxpayers are vested with power to disrupt the annual accounting concept based solely on equitable considerations, whatever they may be.

The boundary between appropriate exercise of clear reflection power and inappropriate meddling with the annual accounting concept, as suggested by *Security Flour Mills*, is controversial. Determining whether an expenditure should be treated as a currently deductible "expense" or as a nondeductible change in the form of investment capital presents an important conceptual question, which is considered by some commentators to be at the heart of income tax theory.<sup>267</sup> However, practical considerations also weigh heavily in deciding these issues. The

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<sup>264</sup> H.R. REP. NO. 68-179, at 11 (1924); S. REP. NO. 68-398, at 10-11.

<sup>265</sup> 321 U.S. 281 (1944).

<sup>266</sup> *Id.* at 285-86.

<sup>267</sup> See e.g., Calvin Johnson, *The Illegitimate "Earned" Requirement in Tax and Nontax Accounting*, 50 TAX L. REV. 373, 411 n.126 (1995) (distinguishing prepaid expenses from capital items); Schapiro, *supra* note 247, at 122-26, 128 (noting "timeless question of distinguishing between income and capital").



cash method's simplicity and clarity provide benefits for taxpayers and the government, which could be destroyed by a quest for theoretical purity.<sup>268</sup>

Courts have sometimes sought to evaluate "distortion" in this context by reference to matching expenses with the period in which they generate taxable income, a concept with roots in financial accounting.<sup>269</sup> According to the Joint Committee on Taxation, concerns about matching costs and income provided a basis for enacting limitations on eligibility for the cash method in section 448:

The Congress believed that the cash method of accounting frequently fails to reflect accurately the economic results of a taxpayer's trade or business over a taxable year. The cash method of accounting recognizes items of income and expense based on the taxable year in which funds are received or disbursed. This may result in the recognition of income and expense items without regard to the taxable year in which the economic events giving rise to the items occurred and a potential mismatching of income with related expenses. For these reasons, the cash method generally is not in accord with generally accepted accounting principles.<sup>270</sup>

However, the significance of the matching concept as a guiding principle for clear reflection in connection with the cash method must be tempered by the practical recognition that mismatching is an inherent problem in tax law. Courts have recognized that many Code provisions fail to match income and expenses in the current period, even under an accrual method.<sup>271</sup> Thus, it is difficult to ascertain when, if ever, mismatching should result in a failure to clearly reflect income. For example, in *Van Raden v. Commissioner*,<sup>272</sup> the court stated in part:

The cash method of accounting will usually result in some distortion of income because the benefits derived from payments for expenses or materials extend to varying degrees into more than one annual accounting

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<sup>268</sup> See GERTZMAN, *supra* note 211, at ¶ 3.01[1] ("[T]he cash method has characteristics that often make it desirable for tax reporting purposes: (1) It is comparatively simple to use and easy to audit; (2) it is imbued with certainty as to the actual realization of income and expense; and (3) it provides for payment of the tax at the time when the taxpayer is most likely to have the ability to pay.") (footnote omitted).

<sup>269</sup> See Schapiro, *supra* note 247, at 121.

<sup>270</sup> JOINT COMMITTEE ON TAXATION, GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986 474 (1987).

<sup>271</sup> See, e.g., *Public Service Co. of New Hampshire v. Commissioner*, 78 T.C. 445, 457 (1982); *Orange & Rockland Utilities, Inc. v. Commissioner*, 86 T.C. 199, 216-17 (1986).

<sup>272</sup> 71 T.C. 1083 (1979), *aff'd*, 650 F.2d 1046 (9th Cir. 1981).

period. If the cash method is consistently utilized and no attempt is made to unreasonably prepay expenses or purchase supplies in advance, the distortion is not material and over a period of years the distortions will tend to cancel out each other.<sup>273</sup>

As the *Van Raden* court suggests, some mismatching is to be expected under the cash method; only "unreasonabl[e]" mismatching should be corrected.<sup>274</sup>

Using an accrual method as a benchmark for matching under the cash method is inappropriate, given the fact that the Code permits both methods. Courts have dismissed the possibility that the cash method may produce significantly lower tax liability than the accrual method as an insufficient basis for finding that a taxpayer's method fails to clearly reflect income.<sup>275</sup>

Regulations provide some guidance in determining what is "unreasonable" through attempting to prescribe the parameters for expenditures that must be capitalized: "If an expenditure results in the creation of an asset having a useful life which extends substantially beyond the close of the taxable year, such an expenditure may not be deductible, or may be deductible only in part, for the taxable year in which made."<sup>276</sup> This language, however, is not sufficiently determinate to generate a clear and

<sup>273</sup> *Id.* at 1104. See also *Hospital Corp. of America v. Commissioner*, 71 T.C.M. (CCH) 2319 (1996).

<sup>274</sup> Cf. *Fidelity Associates, Inc. v. Commissioner*, 63 T.C.M. (CCH) 2327 (1992) (applying "material distortion" standard for mismatching in accrual context). See also GERTZMAN, *supra* note 211, at ¶ 3.08[5]:

The inherent mismatching of related items of income and expense under the cash method (as contrasted with the accrual method) is acknowledged and accepted. It is not a basis for denial of the cash method. Technical accounting precision is simply not required. Thus, any inherent mismatching, which is due to the normal application of the cash method to the transactions of a taxpayer as they occur in the ordinary course of business should not be a basis for asserting that the cash method fails to reflect income clearly.

*Id.* (footnotes omitted).

<sup>275</sup> See *Ansley-Shepard-Burgess v. Commissioner*, 104 T.C. 367, 377 (1995) (rejecting "substantial identity of results" requirement in case not involving inventories). See also *RLC Indus. v. Commissioner*, 98 T.C. 457, 494-95 (1992) (Commissioner can't impose method based solely on maximizing tax); *Hospital Corp. of America v. Commissioner*, 71 T.C.M. (CCH) 2319 (1996) (rejecting the amount of deferral under cash method vs. accrual method as basis for authority to change method).

<sup>276</sup> *Treas. Reg.* § 1.461-1(a) (1997). See also *Treas. Reg.* § 1.446-1(a)(4)(ii) (1997) ("Expenditures made during the year shall be properly classified as between capital and expense. For example, expenditures for such items as plant and equipment, which have a useful life extending substantially beyond the taxable year, shall be charged to a capital account and not to an expense account."); *Treas. Reg.* § 1.263(a)-2(a) (1997) (Capital expenditures include "[t]he cost of acquisition, construction, or erection of buildings, machinery and equipment, furniture and fixtures, and similar property having a useful life substantially beyond the taxable year.").

consistent understanding of which expenditures can be expensed, or expensed only in part, during the year.<sup>277</sup>

Some courts have taken a pragmatic approach to resolving interperiod expense allocation problems by invoking a "one-year rule" to determine whether a prepayment can be expensed.<sup>278</sup> Although some disagreement may exist as to the parameters for a "one-year rule,"<sup>279</sup> a rule-based solution effectively narrows the Commissioner's clear reflection authority by reference to a specific time period. Such an approach allows mismatching of income and expenses, and recognizes that some taxpayers may "distort" or "manipulate" their incomes through accelerating or deferring payments under the cash method. However, the temporal scope of such "distortion" or "manipulation" is clearly limited, thus reducing the scope of the Commissioner's discretion and the corresponding number of controversies in this area.

Other guidance as to the parameters of "distortion" under the cash method has identified facts and circumstances that may be troubling to the Government, but it hardly rises to the level of a rule. For example, in Revenue Ruling 79-229, the Service listed "some of the factors" considered in determining whether a material distortion exists, including "the useful life of resulting assets during and beyond the taxable year paid," "the materiality of the expenditure in relation to the taxpayer's income for the year," "the purpose for paying in advance," "the customary, legitimate business practice of the taxpayer," "the amount of the expenditure in relation to past purchases and the time of year the expenditure was made," and "whether the taxes paid by a taxpayer consistently deducting prepaid . . . costs over a period of years are reasonably comparable to the taxes that would have been paid had the same taxpayer consistently not paid in advance."<sup>280</sup>

Motivation is an important factor in the analysis contemplated by the ruling, as it clearly indicates that tax-motivated payments lacking sufficient business justifications are subject to challenge.<sup>281</sup> However, determining tax liability based on taxpayer motivation, rather than

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<sup>277</sup> For discussion of the need for guidance under analogous provisions in section 263, see American Bar Association Section of Taxation Committee on Tax Accounting, *Report on Capitalization Issues Raised Under Sections 162 and 263 by Indopco, Inc. v. Commissioner*, 50 TAX LAW. 181 (1996) (discussing need for guidance concerning specific application of law governing capitalization).

<sup>278</sup> See GERTZMAN, *supra* note 211, at ¶ 3.05[1][b] (citing cases).

<sup>279</sup> See *id.*

<sup>280</sup> See Rev. Rul. 79-229, 1979-2 C.B. 210.

<sup>281</sup> See *id.* Prior to repeal by section 7721(b) of the Omnibus Budget Reconciliation Act of 1989, P.L. 101-239, 103 Stat. 2106, section 6621(c) of the Code permitted the Commissioner to impose a penalty on a "tax motivated transaction," which included "any use of an accounting method specified in regulations prescribed by the Secretary as a use which may result in a substantial distortion of income for any period."

objective rules, creates a tension with the basic idea of planning based on rules fixed and announced beforehand. As discussed above, structuring transactions to reduce the total tax burden is not wrong in itself,<sup>282</sup> and determining when "abuse" occurs is a challenging and indeterminate process.<sup>283</sup> As one leading commentator has noted:

[W]here manipulation occurs in the use of the cash method (e.g., by accelerating deductions or by deferring the receipt of income), a valid question exists as to whether the method clearly reflects income. On one hand, it is not illogical to argue that such manipulation prevents the method from clearly reflecting income. On the other hand, it may reasonably be argued that if a taxpayer runs the business risks associated with deferring collections or accelerating payment, the cash method does clearly reflect the income associated with such transactions as they actually occurred.<sup>284</sup>

Congress has reduced the number of clear reflection controversies and the potential amount of tax deferral permitted under the cash method by enacting rules to limit eligibility for the cash method for many large corporate taxpayers.<sup>285</sup> However, many taxpayers are still eligible for the cash method and potentially subject to the Commissioner's clear reflection power. Rule-based solutions, such as codification of a one-year rule to constrain the Commissioner's clear reflection authority, deserve further attention here.

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<sup>282</sup> See *supra* section III.A.

<sup>283</sup> See generally Joshua D. Rosenberg, *Tax Avoidance and Income Measurement*, 87 MICH. L. REV. 365 (1988). Professor Rosenberg observes in part:

Many have responded to this apparent dilemma by claiming that tax avoidance ought to be irrelevant to the determination of tax liability. But the fact remains that the system is subject to abuse and that avoidance-motivated taxpayers do abuse the system. Because the system focuses on transactions rather than on income, and because those transactions themselves are not always defined in a way that correlates with their underlying purpose, the system is easily subject to manipulation. Taxpayers can tailor their conduct in ways that increase the distortions in the system, decrease their share of tax liability, and produce results that are economically either meaningless, or worse, undesirable. Unfortunately, purely legislative correction of the mismeasurements that create the problems is sometimes impossible, and is always too late. As long as many of the country's best lawyers continue to be so well paid for finding and maximizing the mismeasurements that lead to abuse, it is likely that the lawyers and their clients will almost always remain at least a year or two ahead of legislators' attempts to close down the mines.

*Id.* at 444 (footnotes omitted).

<sup>284</sup> See GERTZMAN, *supra* note 211, at ¶ 3.08[5].

<sup>285</sup> For example, the enactment of section 448 was expected to generate more than \$2.8 billion in additional tax revenue during the tax years 1987-91. See JOINT COMMITTEE ON TAXATION, GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986 480 (1987).

Prepayment issues are recurring problems for cash method taxpayers, and the "rough justice" of a rule is likely to be preferable to the uncertainty of a facts and circumstances analysis in this context. Litigation is an expensive form of policymaking, especially if results are highly fact-sensitive and thus provide effective guidance in only closely related cases. Moreover, discretionary justice is unlikely to produce consistency in taxpayer compliance or government enforcement efforts, which provides a powerful argument favoring movement toward rule-based decisionmaking in this context. As discussed below, similar considerations have led to rule-based solutions to timing issues with respect to deductions for accrual-basis taxpayers.

#### 4. *Accrual Method "Distortion"*

Unlike the cash method, which links deductions to payments, accrual methods permit taxpayers to take deductions into account in advance of actual payments. Prior to 1984, neither the Code nor the Regulations provided any express time limit on the period of deferral between accrual and ultimate payment. As a general rule, courts did not impose such limitations either.<sup>286</sup> Accrual generally depended on the "all-events test," which required a liability to be taken into account during the taxable year in which "all the events have occurred that establish the fact of the liability, [and] the amount of the liability can be determined with reasonable accuracy."<sup>287</sup>

In 1984, Congress added the so-called "economic performance" requirement to the all-events test.<sup>288</sup> Code section 461(h) and related regulations<sup>289</sup> currently provide detailed rules to implement the "economic performance" requirement, which seeks to address the problem of "premature accruals."<sup>290</sup> Prior to the economic performance rules, the Commissioner attempted to use clear reflection power to challenge "distortions" in this context. Clear reflection cases involving tax years

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<sup>286</sup> See JOINT COMMITTEE ON TAXATION, GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE DEFICIT REDUCTION ACT OF 1984 259 (1984) ("The courts generally have held that the length of time between accrual and performance does not affect whether an amount is properly accruable.")

<sup>287</sup> Treas. Reg. § 1.461-1(a)(2)(1997).

<sup>288</sup> See I.R.C. § 461(h)(1997). Section 461(h)(1) provides the following general rule: "[I]n determining whether an amount has been incurred with respect to any item during any taxable year, the all events test shall not be treated as met any earlier than when economic performance with respect to such item occurs." The statute expressly provides several principles that define economic performance, but leaves the development of other principles to regulations. Section 461(h)(2) suggests that regulations can preempt the statutory provisions, stating in part: "Except as provided in regulations prescribed by the Secretary, the time when economic performance occurs shall be determined under the following principles . . . ."

<sup>289</sup> See T.D. 8408, 1992-1 C.B. 155.

<sup>290</sup> See JOINT COMMITTEE ON TAXATION, GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE DEFICIT REDUCTION ACT OF 1984 258 (1984).

that predate the economic performance rules are nevertheless instructive as to the scope of the Commissioner's authority, and particularly the extent to which courts permit the Commissioner to exercise that authority despite taxpayer compliance with existing rules.

*Ford Motor Company v. Commissioner*<sup>291</sup> is a noteworthy case that recognized extensive clear reflection power in connection with deductions for accrued liabilities. Compliance with the all-events test, as required by the then-applicable regulations, was insufficient to protect the taxpayer from the Commissioner's clear reflection authority. By way of background, the taxpayer, Ford Motor Company ("Ford"), had entered into settlement agreements with tort claimants in order to resolve product liability claims. These agreements obligated Ford to make periodic payments over varying periods of time. Some agreements required payments over a fixed term of years, while others required payments over a term that was tied in some manner to the claimant's lifespan.<sup>292</sup> In many cases, Ford expected payments to extend for forty years or more.<sup>293</sup>

In order to fund the payment obligations under these agreements, Ford purchased single premium annuity contracts, which were structured to provide payouts matching the amounts owed to claimants each year.<sup>294</sup> These annuity contracts did not extinguish Ford's liability; Ford remained ultimately responsible to the claimants under the agreements if payments were not made. Pursuant to the accrual method, Ford had deducted an amount that included the total current and future payments under the agreement.<sup>295</sup> Ford claimed that this treatment was required for tax purposes because the liabilities satisfied the "all-events test."<sup>296</sup> As income from the annuity contracts was earned, Ford reported it pursuant to section 72 of the Code.<sup>297</sup>

The Commissioner used her clear reflection authority to challenge Ford's deduction, and both the Tax Court and the Sixth Circuit agreed

<sup>291</sup> 71 F.3d 209 (6th Cir. 1995), *aff'g* 102 T.C. 87 (1994).

<sup>292</sup> *See id.* at 211. There were actually three types of agreements: Type I involved periodic payments for a definite period; Type II involved payments for the claimant's lifetime; and Type III requiring payments for the longer of a definite period or the claimant's lifetime. *See id.*

<sup>293</sup> *See id.*

<sup>294</sup> *See id.*

<sup>295</sup> Although Ford deducted \$10.6 million in connection with its original return for 1980, which represented only those amounts that had been paid in 1980 plus those amounts due under fixed period settlement agreements, it later also sought to deduct estimated amounts based on actuarial estimates for those agreements that were tied to life expectancies. *See id.* at 211.

<sup>296</sup> *Id.* at 213. It should be noted that the "all-events test" is not optional. If satisfied, the taxpayer had no option but to accrue and report the expense for tax purposes in the applicable year. During the years at issue, no applicable authority allowed a taxpayer to defer a deduction to a later year.

<sup>297</sup> *See id.*

that this discretionary challenge was proper in this context. Although both courts assumed that Ford had satisfied the "all-events test" and thus complied with the then-applicable regulations, they nevertheless agreed with the Commissioner's determination that such compliance did not clearly reflect income in these circumstances.<sup>298</sup> Moreover, they allowed the Commissioner to put Ford on an alternative method, which Ford could not otherwise have adopted. According to the Sixth Circuit, "The Commissioner's discretion to impose an alternate method of accounting under § 446(b) is not limited to methods that Ford could have adopted on its own."<sup>299</sup>

The Commissioner's clear reflection challenge was based on putative "distortion" that resulted from failing to take into account the time value of money in computing the applicable deductions in this case. In fact, the Commissioner argued that current tax savings generated by the immediate deduction of the accrued future payments made Ford better off than if it had never incurred the liabilities.<sup>300</sup> Although Ford disputed this contention,<sup>301</sup> the accrual method undeniably bestowed an economic benefit on Ford (with a corresponding reduction in tax revenues for the government) as compared with deferring deductions until payments were made.<sup>302</sup>

Congress had recognized that time-value-of-money problems lurked within the accrual method, and it had enacted the economic performance rules of section 461(h) in 1984 to address these concerns.<sup>303</sup> However, the applicable statutes and regulations did not address these concerns during the years at issue. Thus, the case presented the question of whether the Commissioner could use her clear reflection power to supply

<sup>298</sup> See *id.*

<sup>299</sup> *Id.* at 217. The Commissioner required Ford to deduct the cost of the annuity contracts currently, and to exclude the future income from the contracts. This approach is decidedly contrary to § 72 and to the cash method, which would allow a deduction only when payments were made. Although the Court suggests that the Commissioner's method was more beneficial to Ford than the cash method, that conclusion is questionable. In net present value terms, assuming the discount rate equals the rate of return in the annuity and tax rates are stable in all applicable periods, the results should be comparable.

<sup>300</sup> See *Ford Motor Co.*, 71 F.3d at 214-15.

<sup>301</sup> See *id.* at 215.

<sup>302</sup> To illustrate, assume that an accrual basis taxpayer accrues a deduction of \$100 for a liability that will not be paid for one year. Assume further that the applicable tax rate is 50% and the applicable interest rate is 10%. The accrual basis taxpayer receives a current tax benefit of \$50 (50% of the \$100 deduction), while the present value of the tax benefit obtained by the cash basis taxpayer who deducts the payment next year is only about \$45.45 (\$50/1.10). The accrual basis taxpayer is thus economically better off than the cash basis taxpayer by about \$4.55. Alternatively, the Treasury is worse off by the same amount because tax receipts are deferred. Through increasing the deferral period, the tax rate, or the interest rate, the economic benefit of deferral is also increased versus the cash method.

<sup>303</sup> See I.R.C. § 461(h)(2)(c), which effectively places accrual method taxpayers on the cash method for purposes of taking into account payments for tort liabilities.

limiting principles that were not yet provided in the statute or regulations.

Any "distortion" here is arguably different than the "distortion" from accruing and deducting multiperiod payment liabilities, such as leases, to which clear reflection power had clearly extended.<sup>304</sup> While leases provide future benefits in the form of property rights, the settlement agreements relate to liabilities arising from past activities. Ford obtained no significant future benefit from these agreements that would be comparable to the future periodic use of leased property. The agreements did not merely convert assets from one form to another, as in the case of converting cash (or a promise to pay cash in the future) into some other valuable asset that would not be consumed until a future period.

Invoking time-value-of-money concepts in this context is necessarily a selective activity.<sup>305</sup> The economic benefit that Ford obtained was potentially available to any taxpayer deducting an accrued liability in advance of payment. Although denying a deduction for an accrued liability based on a lengthy delay between accrual and payment was not completely unprecedented,<sup>306</sup> such authority was not universally accepted, as other courts had refused to take into account delay in payment after the all-events test had been satisfied.<sup>307</sup> Moreover, courts have gen-

<sup>304</sup> See *Security Flour Mills v. Commissioner*, 321 U.S. 281, 287 (1944).

<sup>305</sup> As the Tax Court pointed out:

we want to make clear that the mere fact that a deduction which accrues prior to the time payment is made (the timing factor) does not, by itself, cause the accrual to run afoul of the clear reflection of income requirement. Inherent in the use of an accrual method is the fact that a deduction may be allowed in advance of payment. Our holding in the instant case is not intended to draw a bright line that can be applied mechanically in other circumstances.

*Ford Motor Co. v. Commissioner*, 102 T.C. 87, 104 (1994). Likewise, Judge Gerber pointed out in his dissenting opinion in *Ford*, "[B]usinesses may accrue and pay obligations based on differing facts and circumstances. It is arbitrary to establish a rule that any particular length of time, *ipso facto*, would result in the denial of an otherwise accruable deduction." *Id.* at 111 (Gerber, J., dissenting).

<sup>306</sup> See *Mooney Aircraft v. United States*, 420 F.2d 400 (5th Cir. 1969) (denying deduction for bonds issued to aircraft purchasers which were redeemable upon retirement of aircraft based on delay). Judge Gerber, dissenting in *Ford*, also suggests that the result in *Mooney Aircraft* could have also been based on a finding that the all-events test had not been met, rather than based on clear reflection power. See *Ford Motor Co.*, 102 T.C. at 112 (Gerber, J., dissenting). Gertzman refers to *Mooney Aircraft* as "one of the most troubling" cases in this area. GERTZMAN, *supra* note 211, at ¶ 4.04[4].

<sup>307</sup> In *United States v. Hughes Properties*, 476 U.S. 593 (1986), the Supreme Court had rejected potential delay between accrual and payment as a basis for challenging a casino operator's accrued deduction for the amount of progressive jackpots for slot machines that had become fixed and determinable by year end. See *id.* at 604-05. The Government had also raised the possibility for tax avoidance under the taxpayer's accrual method, suggesting that "a casino operator could put extra machines on the floor on the last day of the tax year with whatever initial jackpots it specifies and with whatever odds it likes, and then, on the taxpayer's theory, could take a current deduction for the full amount even though payment of the jackpots might not occur for many years . . ." *Id.* However, that possibility was insufficient



erally rejected attempts by taxpayers and the government to invoke time-value-of-money concepts in interpreting statutes without a clear indication that Congress intended such concepts to be included.<sup>308</sup>

The result in *Ford* suggests that the Commissioner has broad authority to depart from the requirements imposed by the existing structure of rules, adding new requirements when the Government's interest demands. Here, no other method of reporting these expenses was arguably appropriate for an accrual method taxpayer under the existing statutes and regulations.<sup>309</sup> Not only was the Commissioner empowered to find that the taxpayer's method did not clearly reflect income, but she was

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to upset the taxpayer's method. First, although delay was undoubtedly involved, the Court found that "none of the components that make up this parade of horrors . . . took place here." *Id.* at 605. The Court went on to state that "[i]n any event, the Commissioner's ability, under § 446(b) of the Code . . . to correct any such abuse is the complete practical answer to the Government's concern." *Id.* at 605. A majority of the Tax Court in *Ford* interpreted this reference to clear reflection authority as supporting the invocation of time-value of money principles in different circumstances. See *Ford Motor Co.*, 102 T.C. at 96. However, the example considered by the Supreme Court suggests that manipulation, not the time of delay between accrual and payment, would be the basis for exercising such authority.

Other cases in lower courts have similarly allowed deductions despite considerable delay between accrual and payment. See *Burnham Corp. v. Commissioner*, 90 T.C. 953 (1988), *aff'd*, 878 F. 2d 86 (2d Cir. 1989) (allowing deduction for payments extending over 16 years; rejecting *Mooney Aircraft* rationale when payments began immediately after accrual); GERTZMAN, *supra* note 211, at ¶ 4.04 n.352 (citing cases allowing delays of several years). It should be noted that in *Burnham Corp.*, the Commissioner had initially attempted to invoke time value of money principles to require the taxpayer to discount future payments to present value. See *Burnham Corp.*, 90 T.C. at 959. However, the Commissioner abandoned that position, making compliance with the all-events test the issue at trial. In *Ford*, a majority of the Tax Court distinguished *Burnham* based on the Commissioner's concession on that issue, which was not conceded in *Ford*. However, this distinction fails to adequately explain the Supreme Court's apparent rejection of time-value-of-money principles in *Hughes Properties*. It also fails to explain the Tax Court's rejection of present value principles in other contexts, as discussed *infra* note 308.

<sup>308</sup> See *City of New York v. Commissioner*, 103 T.C. 481 (1994), *aff'd*, 70 F.3d 142 (D.C. Cir. 1995) (rejecting taxpayer's use of time value of money principles for purposes of applying private loan financing test of I.R.C. § 141(c)); *Follender v. Commissioner*, 89 T.C. 943 (1987) (rejecting Commissioner's use of present value principles to determine "at risk" amount under § 465). In *City of New York*, the Tax Court distinguished the Supreme Court's decision in *Dickman v. Commissioner*, 465 U.S. 330 (1984), in which the Court recognized that interest-free demand notes resulted in a taxable gift. Prior to that decision, most courts had concluded otherwise. In the Tax Court's view, the result in *Dickman* was based on a "detailed analysis of the statutory language and legislative purpose underlying the Federal gift tax provisions at issue." *City of New York*, 103 T.C. at 496-97. The Tax Court found that such a purpose was not evident in connection with section 141. See *id.* at 497.

<sup>309</sup> See Treas. Reg. § 1.461-1(a)(3)(1997):

The expenses, liabilities, or loss of one year generally cannot be used to reduce the income of a subsequent year. A taxpayer may not take into account in a return for a subsequent taxable year liabilities that, under the taxpayer's method of accounting, should have been taken into account in a prior taxable year.

*Id.* Under the then-applicable regulations, nonaccrual of a liability for which the all-events test was satisfied was not an option.

also allowed to choose a new method for the taxpayer that it could not have elected for itself.

Exercising clear reflection authority in this case may have corrected a perceived abuse, but that correction comes at the expense of Rule of Law values. Ford was essentially singled out for special treatment that was not prescribed by the applicable rules governing accrual methods. By the time this matter proceeded through litigation, thereby establishing the extent of the Commissioner's authority in this context, other taxpayers that took similar positions regarding the deduction of accrued liabilities may have been protected by the statute of limitations, thus ensuring inconsistent treatment among similarly situated taxpayers. In contrast, the rules enacted under section 461(h) provided systematic guidance that was likely to result in consistent treatment among taxpayers, who could then plan in reliance upon those rules.<sup>310</sup>

Clear reflection authority recognized in *Ford* has not necessarily translated into government victories in each case in which the Commissioner has challenged results produced by following existing rules. This inconsistency raises a question about when compliance with the regulations is sufficient to protect the taxpayer from clear reflection power. One approach might simply seek to dismiss *Ford* as involving extraordinary facts. For example, in one later case, the Tax Court distinguished *Ford* as a case involving "gross distortion."<sup>311</sup> However, such a distinction is unsatisfying. It leaves considerable uncertainty about the nature and extent of "distortion" that is permitted under any given method of accounting. One might consider the amount of the accrual, either in absolute terms or in relation to the taxpayer's income, as a basis for finding a distortion, but the Tax Court has elsewhere rejected disparity in results as a basis for failing to clearly reflect income.<sup>312</sup> One would expect the views of taxpayers, revenue agents, and judges to diverge with some frequency as to matters of "gross distortion."<sup>313</sup>

The Tax Court's opinion in *Ford* suggests another source of limitation on clear reflection power, to the extent that it distinguishes between

<sup>310</sup> Delays in implementing the economic performance regulations presumably resulted in some similar problems of inconsistent treatment, when evaluated on a detailed level. The magnitude of those differences, however, is likely to be less than when no particular rule existed at all.

<sup>311</sup> See *General Dynamics Corp. v. Commissioner*, 74 T.C.M. (CCH) 632, 651 (1997) ("[W]e are not confronted with the type of 'gross distortion' discussed in [*Ford*] . . .").

<sup>312</sup> See *RLC Industries, Inc. v. Commissioner*, 98 T.C. 457, 503 (1992) ("Disparity in amount is not, per se, necessarily indicative of a failure to clearly reflect income.").

<sup>313</sup> In fact, *Ford* neither involves the longest deferral, nor the greatest dollar amount of disparity. For example, in *RLC Industries*, discussed *infra* notes 338-50, the taxpayer's method produced a greater deduction and a potentially unlimited period of deferral as compared with the Commissioner's method. However, RLC's method was held to clearly reflect income.

“specifically authorized” methods and methods that are only “generally permitted.”<sup>314</sup> Regulations indicate that the Commissioner may invoke clear reflection authority if a taxpayer chooses a method that is not “specifically described” or “specifically authorized” by the Code or Regulations:

No method of accounting will be regarded as clearly reflecting income unless all items of gross profit and deductions are treated with consistency from year to year. The Commissioner may authorize a taxpayer to adopt or change to a method of accounting permitted by this chapter although the method is not specifically described in the regulations in this part if, in the opinion of the Commissioner, income is clearly reflected by the use of such method. Further, the Commissioner may authorize a taxpayer to continue the use of a method of accounting consistently used by the taxpayer, even though not specifically authorized by the regulations in this part, if, in the opinion of the Commissioner, income is clearly reflected by the use of such method.<sup>315</sup>

This language does not expressly state that clear reflection authority is limited if a method is “specifically described” or “specifically authorized.” However, the Tax Court had previously suggested such a limitation, as illustrated by the following statement:

Respondent’s broad authority to determine whether a taxpayer’s accounting method clearly reflects income is limited, in that he [or she] may not reject, as not providing a clear reflection of income, a method of accounting employed by the taxpayer which is specifically authorized in the Code or regulations and has been applied on a consistent basis.<sup>316</sup>

In *Ford*, the Tax Court took the position that authorization of “an accrual method” in section 446(c) was insufficient to invoke this limita-

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<sup>314</sup> Compare *Ford Motor Co. v. Commissioner*, 102 T.C. 87, 99 n.11 (1994) (noting that “an accrual method” under § 446(c) is not “specifically authorized”) with *Ford Motor Co.*, 102 T.C. at 99 (“The statute does not limit the Commissioner’s discretion under section 446(b) by the taxpayer’s mere compliance with the methods of accounting generally permitted under section 446(c) . . .”). Later decisions also use this distinction. See *Oakcross Vineyards, Ltd. v. Commissioner*, 72 T.C.M. (CCH) 715, 721 (1996) (citing *Ford* for the proposition that “mere compliance with a generally permitted method does not foreclose the Commissioner’s exercise of discretion pursuant to section 446(b) . . .”); *Ansley-Sheppard-Burgess, Inc. v. Commissioner*, 104 T.C. 367, 371 (1995) (to same effect).

<sup>315</sup> Treas. Reg. § 1.446-1(c)(2)(ii)(1997).

<sup>316</sup> *Hallmark Cards, Inc. v. Commissioner*, 90 T.C. 26, 31 (1988).

tion on "specifically authorized" methods. The court explained this position in a footnote:

The use of the word "an" in section 446(c)(2) suggests that more than one accrual method of accounting is permissible under sec. 446(c). Accordingly, although "an" accrual method of accounting is authorized generally by sec. 446(c), no particular method of accrual accounting is *specifically* authorized with respect to structured settlements. In this manner, it can be said that respondent has not denied petitioner the use of a specifically authorized accounting method.<sup>317</sup>

This approach toward interpreting the scope of a "specifically authorized" method appears quite restrictive. If one requires a specific reference in the Code or regulations to accrual accounting for particular types of deductions, virtually no expenses would qualify. The all-events test is oriented toward all types of liabilities, not deductions for specific categories of expenses.<sup>318</sup> Similarly, the economic performance rules that were implemented to deal with the timing issue addressed in *Ford* are generally not limited to specific types of expenditures.<sup>319</sup>

The Tax Court's opinion in *Ford* treats *Orange & Rockland Utilities, Inc. v. Commissioner*,<sup>320</sup> as the case from which the "principle that a method specifically sanctioned in the Code or regulations cannot be rejected under section 446(b)" was derived.<sup>321</sup> In *Orange & Rockland*, the taxpayer was a regulated public utility that had used the "cycle reading method" to account for accrued revenues.<sup>322</sup> Given the impracticality of reading all customers' utility meters on the last day of the year, the taxpayer had no actual measurement of revenue attributable to the period between the last meter reading date in December and year-end.<sup>323</sup> Moreover, the utility regulators did not permit the taxpayer to bill customers for utility services until the following month's cycle meter reading date.<sup>324</sup> Thus, the taxpayer had taken the position that the all-events test

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<sup>317</sup> *Ford Motor Co.*, 102 T.C. at 99 n.11 (emphasis in original).

<sup>318</sup> On the other hand, this approach could also be viewed as endorsing "the cash method" as a "specifically authorized" method, as it is delineated by "the"—a definite article. See GERTZMAN, *supra* note 211, ¶ 4.01, at S 4-2 (1998 Supp.).

<sup>319</sup> See generally GERTZMAN, *supra* note 211, at ¶ 4.04[3] ("Although intended to prevent tax abuse, Section 461(h) applies to all taxpayers using an accrual method of accounting. It is not limited in scope to particular categories of taxpayers or to particular transactions.")

<sup>320</sup> 86 T.C. 199 (1986).

<sup>321</sup> See *Ford Motor Co.*, 102 T.C. at 98.

<sup>322</sup> See *Orange & Rockland*, 86 T.C. at 200-201.

<sup>323</sup> See *id.* at 202.

<sup>324</sup> See *id.* at 202, 212.

had not been satisfied with respect to this unbilled revenue,<sup>325</sup> thereby deferring the reporting of this revenue to the following tax year.<sup>326</sup>

The taxpayer had used this "cycle reading method" consistently for over 50 years, and it was recognized as a generally accepted accounting method in the utility industry.<sup>327</sup> Neither the Code nor Regulations specifically referred to the "cycle reading method." However, the then-applicable regulations stated that: "the method used by the taxpayer in determining when income is to be accounted for will be acceptable if it accords with generally accepted accounting principles, is consistently used by the taxpayer from year to year, and is consistent with the Income Tax Regulations."<sup>328</sup> Moreover, the Service had previously ruled that the cycle reading method clearly reflected income if the taxpayer also used that method for financial reporting purposes, and the Tax Court had previously ruled that such method had clearly reflected income.<sup>329</sup>

The Commissioner's clear reflection challenge in *Orange & Rockland* was based on an assertion that the taxpayer had satisfied the all-events test with respect to the unbilled revenue, and that therefore its method (which failed to take the unbilled revenue into account until the following tax year) was properly characterized as a hybrid method that was not specifically permitted by the Code.<sup>330</sup> The Service took the position that acceptability of the hybrid method was limited to those circumstances in which the taxpayer used the same method for tax and financial reporting services.<sup>331</sup> Here, the taxpayer had changed to a different method for financial reporting purposes, which took into account estimated unbilled revenue in the current year.<sup>332</sup> Consequently, the Commissioner asserted that the taxpayer's method was not "specifically permitted" and therefore fell within his broad discretion to determine that it did not clearly reflect income in these circumstances.<sup>333</sup>

Although the Commissioner had lost a prior case raising essentially the same issue,<sup>334</sup> the Commissioner sought to distinguish that case

<sup>325</sup> See *id.* at 212.

<sup>326</sup> See *id.* at 202-03.

<sup>327</sup> See *id.* at 202, 205.

<sup>328</sup> Treas. Reg. § 1.446-1(c)(1)(ii) (1986). See *Orange & Rockland*, 86 T.C. at 209 (paraphrasing this provision). As discussed *supra* note 230, this provision was amended in 1992 by inserting the word "generally", so that the regulations now provide: "The method used by the taxpayer . . . will generally be acceptable if it accords with generally accepted accounting principles, is consistently used by the taxpayer from year to year, and is consistent with the Income Tax Regulations." T.D. 8408, 1992-1 C.B. 155, 164 (emphasis added).

<sup>329</sup> See *Orange & Rockland*, 86 T.C. at 205 (citing Rev. Rul. 72-114, 1972-1 C.B. 124).

<sup>330</sup> See *id.* at 208.

<sup>331</sup> See *id.*

<sup>332</sup> See *id.* at 203-04.

<sup>333</sup> See *id.* at 208.

<sup>334</sup> See *id.* at 206 (citing *Public Service Co. of New Hampshire v. Commissioner*, 78 T.C. 445 (1982) as "essentially identical to and indistinguishable from" the instant case).

based on the fact that he had not sought to treat the taxpayer's method as a "hybrid method of accounting not specifically permitted under section 446(c)."<sup>335</sup> The Tax Court, however, rejected that argument, finding that the taxpayer had not satisfied the all-events test, and therefore its method was a permissible accrual method that complied with the regulations.<sup>336</sup> The court stated in part:

We hold that all events which fixed petitioner's right to receive unbilled December revenue had not occurred as of December 31 of each year in issue. Consequently, the cycle meter reading method of accounting is a permissible method of accrual accounting within the meaning of section 1.446-1(c)(1)(ii), Income Tax Regs., and respondent abused his discretion by requiring petitioners to adopt a method of accounting other than the cycle meter reading method of accounting for tax purposes. Since we have determined that the cycle meter reading method is a specifically permitted accrual method of accounting within section 446(c)(2), respondent's imposition of a condition of conformity was an abuse of discretion as respondent's discretion within section 1.446-1(c)(2)(ii), Income Tax Regs., is relevant only to determine whether a method of accounting not specifically permitted clearly reflects income.<sup>337</sup>

The court in *Orange & Rockland* was not entirely clear in explaining why the "cycle meter reading" method was "specifically permitted" under section 446. This characterization could be based on the finding that the taxpayer applied an accrual method that was otherwise consistent with the applicable regulations, rather than a hybrid method.<sup>338</sup> However, such a reading is decidedly inconsistent with the Tax Court's later decision in *Ford*, which essentially rejects the possibility that "an accrual method" can be "specifically permitted":

In [*Orange & Rockland*], we held that the "cycle meter reading" method provided in the regulations and used by the taxpayer was a permissible method under section 446(c)(2). *Orange & Rockland* dealt with a specific method of accrual; it did not suggest that any method of

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<sup>335</sup> See *id.* at 207.

<sup>336</sup> See *id.* at 215.

<sup>337</sup> See *id.* at 215.

<sup>338</sup> This is undoubtedly a relevant consideration in determining whether the method is generally permitted. See *id.* at 210 ("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.").

accrual is to be protected from the Commissioner's scrutiny under section 446(b).<sup>339</sup>

Such a distinction is unsatisfying, as it is not apparent why regulatory authorization of the "cycle meter reading" method was any more specific than the "all events test" that arguably justified Ford's application of the accrual method.

Alternatively, the court may have granted protected status to the "cycle meter reading" method because the Service had previously ruled that this method had clearly reflected income; moreover, a court had previously upheld that method against a clear reflection challenge in an essentially similar case.<sup>340</sup> Neither *Orange & Rockland* nor *Ford* expressly states this rationale, although it is arguably more consistent with the restrictive view of specifically authorized methods and correspondingly greater clear reflection power contemplated in *Ford*.

To the extent that "specifically authorized" methods receive greater protection from the exercise of clear reflection power, it is important to understand how this category of methods will be defined. If the courts take a restrictive view of authorization, then the Commissioner will be free to impose additional requirements that are not provided in the regulations, thereby expanding her clear reflection authority and minimizing the protective role of compliance with rules in connection with accounting methods. Other significant cases addressing clear reflection issues in the context of specific authorization issues are discussed in the next section.

### 5. *Specifically Authorized Methods*

Controversies over "specifically authorized" methods have generally arisen in two different contexts. The first context, touched upon in *Ford*, involves determining the extent to which authorities containing rules of general application, such as the Code, regulations, or revenue rulings, restrict the Commissioner's clear reflection power. The second context involves the scope and effect of "authorization" through administrative approval of a taxpayer's particular method, such as when Revenue Agents approve a method, or a change in method, on audit.

#### a. Authorities of General Application

Notwithstanding the results in *Ford*, other courts have protected taxpayers from the Commissioner's clear reflection authority if the taxpayers consistently used methods complying with the Code and regulations, particularly when the Code or regulations contain some specific guidance

<sup>339</sup> *Ford Motor Co. v. Commissioner*, 102 T.C. 87, 98 (1994).

<sup>340</sup> See *Orange & Rockland*, 86 T.C. at 206.

as to the nature or application of that method. Nevertheless, courts still appear reluctant to impose rule-like constraints on the Commissioner's clear reflection authority, even in light of specific provisions authorizing the taxpayer's method.

For example, in *RLC Industries v. Commissioner*,<sup>341</sup> the Tax Court found that a taxpayer using a single "block" for all its timber holdings had complied with applicable regulations under section 611 of the Code, which provided guidelines for the composition of "blocks" for purposes of computing timber depletion.<sup>342</sup> Nevertheless, the Commissioner asserted her clear reflection power in seeking to require the taxpayer to use multiple "blocks," which produced significantly higher tax revenues for the Government.<sup>343</sup>

The court was reluctant to embark on a clear reflection analysis in this case, which it characterized as "a most unusual and somewhat circuitous situation."<sup>344</sup> As the court explained:

The regulations are unambiguous, very broad, and permissive. Yet we are asked to decide whether, in spite of compliance, petitioner's method of reporting clearly reflects income. In essence, we are asked by respondent to decide that the regulation may produce results which do not clearly reflect income. We suggest that the Secretary should seek to correct any perceived defects in the regulations under section 611 by appropriate amendment or modification.<sup>345</sup>

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<sup>341</sup> 98 T.C. 457 (1992), *aff'd*, 58 F.3d 413 (9th Cir. 1995).

<sup>342</sup> *See id.* at 487-89.

<sup>343</sup> *See id.* at 475-76, 494. During the three years at issue in this case, the taxpayer's method generated depletion deductions totaling \$34,797,000, while the Commissioner's proposed method would allow a deduction of only \$7,475,000—a difference of \$27,322,000. *See id.* This difference can be explained by the fact that the taxpayer's timber holdings had widely varying cost bases. Under the taxpayer's method, the depletion deduction was computed based on an average of all such holdings, rather than the comparatively lower cost basis of particular holdings that were harvested during the years at issue. The Commissioner's method sought to more closely match the depletion deduction to the actual cost of harvested trees. *See generally id.* at 494-95 (discussing the Commissioner's "specific tracing" approach).

<sup>344</sup> *See id.* at 489.

<sup>345</sup> *Id.* at 489-90. *See also* *Petroleum Heat and Power Co. v. United States*, 405 F.2d 1300, 1306 (Ct. Cl. 1969):

[Taxpayer] acted in complete accord with the regulations, and any dissatisfaction on the Government's part with plaintiff's treatment of income for the period in question is attributable to the lack of clarity in and omissions from the Government's own regulations. A taxpayer cannot be expected to intuit an unexpressed desire of the Internal Revenue Service that would seemingly contradict written revenue regulations which taxpayer is obliged to follow. The Commissioner is bound by its [sic] own regulations as much as is the taxpayer.



The court did not stop at that suggestion and find for the taxpayer. Instead, the court continued to analyze the application of clear reflection power:

Although we would feel justified in limiting our opinion to a finding that petitioner's compliance with the regulation should suffice, we also feel compelled to make inquiry into respondent's determination that petitioner's method does not clearly reflect income. Our compulsion is driven by pervasive authority ascribed to respondent regarding the use of accounting methods and the heavier than usual burden that is placed upon taxpayers to show that respondent has abused her discretion in these circumstances.<sup>346</sup>

The court thus considered compliance with the regulations as only "a factor which will be given appropriate weight" in the analysis.<sup>347</sup> Moreover, the court softened the *Hallmark Cards* holding that that the Commissioner is not permitted to reject a consistently applied method that complies with the Code and regulations,<sup>348</sup> substituting instead a proscription against an arbitrary change: "[i]f a taxpayer's method of accounting is specifically authorized by the Internal Revenue Code or the underlying regulations and has been applied on a consistent basis, respondent has not been allowed to arbitrarily require a change or reject the taxpayer's method."<sup>349</sup>

In evaluating whether the Commissioner had arbitrarily required a change, the court considered and rejected the Commissioner's argument that the disparity of more than \$27 million between the taxpayer's method (which computed depletion based on the average cost of all the taxpayer's timber holdings) and the Commissioner's method (which focused on particular groupings that more closely matched acquisition costs with cutting), was a sufficient basis for finding that the taxpayer's method exceeded a "reasonable allowance."<sup>350</sup> The court stated in part:

Respondent's focus is upon the disparity between the method she determined and the one used by petitioner. That focus, in the setting of this case, is an insufficient reason for the imposition of a differing method determined by respondent. The best method is not necessar-

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<sup>346</sup> *RLC Indus.*, 98 T.C. at 490.

<sup>347</sup> *Id.* at 490. In this case, that "appropriate weight" was supposed to be enhanced because of the greater deference given to legislative regulations "which have been held to have the force and effect of law." See *id.* at 493-94.

<sup>348</sup> See *Hallmark Cards v. Commissioner*, 90 T.C. 26, 31 (1988).

<sup>349</sup> *RLC Indus.*, 98 T.C. at 491-92.

<sup>350</sup> See *id.* at 494-95, 502.

ily the one which produces the most tax in a particular year.<sup>351</sup>

The court also pointed out that matching is not "an overriding rule of tax accounting," and found that the regulations were not based on a requirement of specific matching.<sup>352</sup> Further, the court noted that the taxpayer's method was consistent with GAAP and industry practices, a fact that assisted, but was not dispositive, in the court's clear reflection analysis.<sup>353</sup>

Based on these factors, the court found that the taxpayer's method clearly reflected income. However, the court went on to consider still another argument, which was based on a specific provision in the regulations under section 611 that provided in part: "[f]or good and substantial reasons satisfactory to the district director, or as required by the district director on audit, the timber or the land accounts may be readjusted by dividing individual accounts, by combining two or more accounts, or by dividing and recombining accounts."<sup>354</sup> The court's analysis of this authority was similar to that of the Commissioner's clear reflection power, as it refused to find that "[the Commissioner] has no authority to disturb accounting methods that conform with the regulations," but nevertheless concluded that the Commissioner's interference in this context was an abuse of discretion.<sup>355</sup>

On appeal to the Ninth Circuit, the Commissioner did not rely on clear reflection authority, but instead relied upon her authority in section 1.611-3(d)(5) of the regulations, which the Commissioner claimed allowed her to exercise "overriding power" in order "to achieve reasonable results."<sup>356</sup> The Ninth Circuit held that the portion of the regulation granting such power was invalid, as it constituted an inappropriate attempt to exercise judicial power, which Congress had not delegated to the Commissioner. This aspect of the case does not directly involve clear reflection authority, but it does circumscribe the Commissioner's discretionary power by ensuring that the Commissioner does not effectively become a judge in her own case through changing results that would otherwise flow from following regulations.<sup>357</sup>

<sup>351</sup> *Id.* at 502.

<sup>352</sup> *See id.* at 497.

<sup>353</sup> *See id.* at 498.

<sup>354</sup> *Id.* at 500 (quoting Treas. Reg. § 1.611-3(d)(5)).

<sup>355</sup> *See id.* at 501-02.

<sup>356</sup> *See* RLC Industries v. Commissioner, 58 F.3d 413, 417 (9th Cir. 1995).

<sup>357</sup> Query what effect this approach might have on other attempts to exercise power through "anti-abuse" rules that are rooted in interpretive regulations. *See generally* William H. Caudill, *Ninth Circuit Invalidates Anti-Abuse Rule: Is Reg. 1.701-2 Similarly Flawed?*, 83 J. TAX'N 380 (1995).

More recent cases addressing controversies over specifically authorized methods have similarly ruled for the taxpayer, while refraining from treating taxpayer compliance with regulations as a sufficient basis to resist the Commissioner's clear reflection authority. For example, in *Hospital Corporation of America v. Commissioner*,<sup>358</sup> the Tax Court rejected the Commissioner's clear reflection challenge to a hospital using a hybrid method of accounting. The hospital had used the cash method for service income, and an accrual method for inventory-related transactions.<sup>359</sup> The court found that the hybrid method was specifically authorized by the regulations, and it rejected an attempt to limit such method to taxpayers engaged in more than one business, which was not required in the regulations.<sup>360</sup>

As in *RLC Industries*, the court went on to discuss other clear reflection arguments, despite a finding of specific authorization. The court rejected the disparity between the taxpayer's method and the Commissioner's method as a sufficient basis for finding that the taxpayer's method did not clearly reflect income. Here, "any distortion of income must be examined in light of the business practice or business activities that give rise to the transaction . . . ."<sup>361</sup> In *Hospital Corporation*, the disparity between the hybrid method and an accrual method resulted from growth in the taxpayer's business, not from a change in business practices, which the court found did not justify the Commissioner's intervention.<sup>362</sup> The court also rejected the Commissioner's attempt to require the taxpayer to show a "substantial-identity-of-results" with the Commissioner's preferred accrual method in order to clearly reflect income, reaffirming that the Commissioner cannot require uniform results in the face of regulations that fail to prescribe uniform methods.<sup>363</sup>

The taxpayer also prevailed against a clear reflection challenge in *General Dynamics Corp. v. Commissioner*,<sup>364</sup> where the Commissioner contended that the deferral in connection with the taxpayer's application of the completed contract method (CCM) was "inherently too long to clearly reflect income."<sup>365</sup> The court dismissed this argument and concluded that the applicable regulations did not require the contract at issue to be severed into separate contracts with different completion dates,

<sup>358</sup> 71 T.C.M. (CCH) 2319 (1996).

<sup>359</sup> See *id.* at 2331.

<sup>360</sup> See *id.* at 2333 ("We agree with petitioner's conclusion that the regulations do not restrict the use of a hybrid method to taxpayers engaged in more than one business."). Cf. Treas. Reg. §§ 1.446-1(c)(1)(iv) – 1.446-1(d) (1997).

<sup>361</sup> *Hospital Corp. of America*, 71 T.C.M. (CCH) at 2334.

<sup>362</sup> See *id.* at 2335.

<sup>363</sup> See *id.* at 2335-36.

<sup>364</sup> 74 T.C.M. (CCH) 632 (1997).

<sup>365</sup> *Id.* at 642.

thereby limiting the deferral period.<sup>366</sup> The court also stated: "It may be that use of CCM, per se, does not clearly reflect income, but it is a method that petitioner was entitled to use for the period under consideration."<sup>367</sup> The court also noted: "In addition, we are not confronted with the type of 'gross distortion' discussed in *Ford Motor Co. . . .*"<sup>368</sup>

The above discussion of clear reflection authorities is not exhaustive,<sup>369</sup> but the cited cases illustrate that clear reflection power extends even to circumstances when the taxpayer has complied with regulations that specifically govern the method at issue. The extent that such authority is actually used to challenge methods that comply with the regulations is difficult to gauge, as accounting method issues are often settled without a trial, thus leaving no public record.<sup>370</sup> However, the above cases suggest that using clear reflection authority despite taxpayer compliance with regulations is not unprecedented and probably not uncommon.

On one hand, some aspects of these decisions appear friendly to Rule of Law values. For example, the court has suggested that the Government should change regulations when it believes their results may not clearly reflect income. Moreover, the court's clear reflection analysis also seems to rely heavily on compliance with the regulations as a factor favoring the taxpayer. The limited significance accorded to matching and disparities with the Commissioner's method imply that clear reflection power is unlikely to carry the day in most cases in which a taxpayer complies with the regulations.

On the other hand, these cases also send a message that compliance with the applicable rules does not ensure that a taxpayer has satisfied its tax obligations; clear reflection authority can still require the taxpayer to change to another method of accounting. Recognizing paramount discretionary authority that trumps taxpayer compliance with the applicable regulations undermines Rule of Law values and imposes burdens on tax-

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<sup>366</sup> See *id.* at 651.

<sup>367</sup> *Id.*

<sup>368</sup> *Id.*

<sup>369</sup> For example, controversies over application of the LIFO method in connection with so-called "bargain purchase" transactions raises similar problems in evaluating the relationship of clear reflection power and the election of the LIFO method. See Edward A. Morse, *Demystifying LIFO: Towards Simplification of Inflation-Adjusted Inventory Valuation*, 2 FLA. TAX REV. 567, 601-04 (1995).

<sup>370</sup> See I.R.S. Notice 98-31, 1998-22 I.R.B. 10, which proposes a new revenue procedure governing changes in methods of accounting. The Notice states in part: "[t]he proposed revenue procedure does not alter the authority of Appeals or counsel for the government to resolve or settle any accounting method issues." For examples of temporary settlements extending over several years, see *Hospital Corp. of America v. Commissioner*, 71 T.C.M. (CCH) 2319 (1996). In that case, IRS challenges to the taxpayer's use of the cash method began in 1972, but negotiated settlements allowed continued use of the cash method for several years, ultimately deferring litigation on this issue until the 1986 tax year. See *id.* at 2327-28. See *infra* notes 416-23 and accompanying text.

payers. By diminishing the reliability of existing rules, such authority subjects taxpayers to considerable uncertainty in the determination of their tax obligations. Such authority also tends to increase compliance costs, as compliance must be based on an analysis of particular facts and circumstances other than those identified by the applicable regulations.

b. Prior Approval or Consideration

Taxpayers have also sought to defend against the Commissioner's clear reflection power based on prior approval or consideration of a method, such as during a prior period audit. However, courts have generally refused to constrain the Commissioner's clear reflection power based on prior activities; the Service is not estopped from changing a method that fails to clearly reflect income based its current appraisal of that method.

*Thomas v. Commissioner*<sup>371</sup> illustrates the Tax Court's approach to prior audit activity affecting a method that failed to clearly reflect income. In *Thomas*, the Service sought to require a taxpayer to change from its method of inventory valuation, which essentially involved an arbitrary writedown to an amount that was neither cost nor market value, to the lower of cost or market method authorized by the regulations.<sup>372</sup> After finding that the taxpayer's method did not clearly reflect income, the court addressed the question of whether that method was "specifically approved" under Treas. Reg. § 1.446-1(c)(2)(ii) as a result of prior consideration and approval of that method on audit.<sup>373</sup>

In evaluating the "specific approval" issue, the court looked to its prior decision in *Pierce Ditching Co. v. Commissioner*,<sup>374</sup> which made it clear that some "positive act" was required, and that such act must go beyond approval in past audits:

The fact that respondent's agent examined petitioner's income tax returns [for prior tax years] without proposing any change in method is not, without more, such a positive act. *This is true even if respondent's agent had*

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<sup>371</sup> 92 T.C. 206 (1989).

<sup>372</sup> See *id.* at 219-20. The taxpayer was a publisher whose method immediately charged off 75 percent of the manufacturing cost of books, and then charged off the balance within two years and nine months. See *id.* at 218-19. This method accelerated the time at which the manufacturing costs were taken into account in relation to the sales, with the difference existing until the last book was sold or disposed of. See *id.* at 219. The taxpayer had failed to argue that this method was a lower of cost or market method, and even if it had, the court would have held that the taxpayer failed to prove that the value was less than cost. See *id.* at 220 n.11. The cumulative difference in value between the taxpayer's method and the lower of cost or market method, authorized by Treas. Reg. §§ 1.471-2(c) and 1.471-4, was more than \$4.6 million. See *id.* at 220-21.

<sup>373</sup> See *id.* at 221-22.

<sup>374</sup> 73 T.C. 301 (1979).

*been made aware of, or even approved, petitioner's erroneous method.*<sup>375</sup>

Thus, no matter how specific their consideration of the taxpayer's method, apparently neither Revenue Agents nor the District Director may constrain the Commissioner's clear reflection power from correcting a past erroneous determination.

Furthermore, the court stated that even the District Director's specific approval of the taxpayer's method would not be sufficient:

In the instant case, petitioner's method of accounting does not clearly reflect income. If under section 1.446-2(c)(ii), Income Tax Regs., respondent approved this erroneous method of accounting, we do not believe that his 'hands are tied and he is required to perpetuate error.' *Klein Chocolate Co. v. Commissioner*, 36 T.C. at 147. To bar respondent from changing an erroneous method of accounting, which he approved would allow petitioners to continue distorting their income in future taxable years. Section 446(b) and the regulations thereunder are intended to give respondent broad power to ensure that a taxpayer's method of accounting clearly reflects income. To hold that respondent is prohibited from requiring a taxpayer to change from an erroneously approved accounting method to an accounting method which clearly reflects income would defeat the purpose and importance of the statutes' requirement, in section 446(b), that the method of accounting 'clearly reflect income'. See *Thor Power Tool Co. v. Commissioner*, 439 U.S. at 538-43.<sup>376</sup>

Moreover, the court refused to recognize any detrimental reliance on part of the taxpayer, which might have formed the basis for estoppel in other contexts. Although the court noted that the taxpayer's consistent use of the method and the Commissioner's failure to require changes on audit are factors that may be considered in evaluating whether a method does clearly reflect income, they do not prevent the Commissioner from correcting past errors.<sup>377</sup> Here, where the taxpayer's writedown method did not clearly reflect income, the court was unsympathetic toward an equitable claim of estoppel based the "detriment" of paying additional taxes.<sup>378</sup> As the court pointed out, the taxpayer received an interest-free

<sup>375</sup> *Id.* at 306 (emphasis added).

<sup>376</sup> *Thomas*, 92 T.C. at 225 (citations in original).

<sup>377</sup> See *id.* at 225-27. See also *Public Service Co. of New Hampshire v. Commissioner*, 78 T.C. 445, 456 (1982) (consideration on audit, coupled with nearly 40 years of no proposed adjustments, considered as factor in clear reflection analysis).

<sup>378</sup> See *Thomas*, 92 T.C. at 227.

loan from the government on its deferred tax liabilities,<sup>379</sup> and there was no legal entitlement to continue that "windfall" indefinitely.<sup>380</sup>

Although *Thomas* suggests that a court may take into account prior approval and consistent application as factors in determining whether a method clearly reflects income, these factors appeared to have no bearing on the court's analysis. The method at issue in *Thomas* did not comply with the regulations,<sup>381</sup> and it produced results that varied substantially with a method that did comply with the regulations.<sup>382</sup> Although a taxpayer's consistent application of a method helps to demonstrate the absence of manipulation, which is an important aspect of clear reflection analysis,<sup>383</sup> the independent value of tacit, or even explicit, approval by the Service is unclear, particularly in light of the court's unwillingness to constrain the Commissioner from correcting prior errors.

*Thomas* also does not indicate what, if any, further "positive acts" besides merely reviewing a method on audit might be sufficient to constrain the Commissioner's clear reflection power. Some earlier cases suggest the possibility that approval of a taxpayer's change in method of accounting or initial adoption of a method might, in particular circumstances, be effective to constrain the Commissioner from proposing an adjustment to that method.<sup>384</sup> However, these cases do not involve circumstances in which clear reflection of income is seriously in doubt during the years at issue; even here it appears that clear reflection power could be invoked despite prior permission to change to or adopt a new method.

One of these earlier cases was *Maloney v. Hammond*,<sup>385</sup> in which the Service challenged the taxpayer's use of an accrual method to account for certain contracting work. The revenue agent had "felt there was a distortion of income present" under the taxpayer's method.<sup>386</sup> However, due to the agent's belief that a "prohibitive amount of time" would be required to compute income using "a true accrual basis," he

<sup>379</sup> See *id.* at 219, 227.

<sup>380</sup> See *id.* at 227.

<sup>381</sup> As noted above, this inventory was not valued at cost, and the taxpayer did not attempt to prove that it was valued at market under the lower of cost or market method authorized in Treas. Reg. § 1.471-2(d) and Treas. Reg. § 1.471-4. See *id.* at 220 n.11. Moreover, it should be noted that the Commissioner could have required the taxpayer to show that its method conforms with the "best accounting practice in the trade or business" under section 471, which was doubtful in this case. However, the Commissioner had raised only clear reflection power under section 446(b).

<sup>382</sup> See *Thomas*, 92 T.C. at 219 (noting \$4.6 million cumulative difference in inventory valuation).

<sup>383</sup> See, e.g., *Klein Chocolate, Inc. v. Commissioner*, 36 T.C. 142, 147 (1961) (discussing the importance of consistency).

<sup>384</sup> See *infra* notes 385-415 and accompanying text.

<sup>385</sup> 176 F.2d 780 (9th Cir. 1949), *aff'd* 80 F. Supp. 212 (D. Ore. 1948).

<sup>386</sup> *Id.* at 781.

proposed adjustments using a different method, which he believed "would fairly reflect the income of the years under consideration."<sup>387</sup> Although the agent's method was not provided for in either the Code or regulations, the Commissioner claimed that the authority to impose such a method was within his clear reflection power.<sup>388</sup>

The Ninth Circuit affirmed the trial court's decision in favor of the taxpayer, based in part on the fact that the Commissioner had previously authorized the taxpayer to use the accrual method.<sup>389</sup> The Ninth Circuit also pointed to the fact that the Commissioner had audited the taxpayer's returns twice during the previous four taxable years, while failing to challenge the accrual method, as a "circumstance which may be considered in determining the validity of the Commissioner's subsequent determination."<sup>390</sup> However, the Commissioner's failure to show that the accrual method had been used incorrectly, or that the books were not "fairly and honestly kept and maintained,"<sup>391</sup> was also undoubtedly important to the court's analysis.<sup>392</sup>

*Geometric Stamping Company v. Commissioner*,<sup>393</sup> involved a taxpayer that changed its own method of inventory costing beginning in its 1946 tax year from an "absorption" method, which included indirect costs, to a "direct costing" method, which did not include such costs.<sup>394</sup>

<sup>387</sup> *Id.*

<sup>388</sup> *See id.*

<sup>389</sup> *See id.* at 780. By way of background, the taxpayer had previously carried on his contracting business through a corporation, which used the percentage of completion method. This corporation was dissolved in 1937. According to the trial court: "[i]n 1938, [the taxpayer] applied to the Commissioner of Internal Revenue for permission to adopt individually the accrual method of accounting," with the exception of one project which was to be continued on the percentage of completion method. *See Maloney*, 80 F. Supp. at 215. The Commissioner granted this permission. *Id.* However, under present law such permission would not be required, as the taxpayer could adopt its initial method without consent. *See generally GERTZMAN, supra* note 211, at ¶ 2.03. It should be noted that in 1942, the taxpayer began to operate this business in partnership with his son. *See Maloney*, 80 F. Supp. at 214. Although the partnership also adopted the accrual method, *see id.* at 215, neither court addressed why prior approval to the taxpayer should also be attributed to the partnership.

<sup>390</sup> *Maloney*, 176 F.2d at 782.

<sup>391</sup> *Id.* at 781-82.

<sup>392</sup> *See id.* It should be noted that a "fairly or honestly" standard applied in the Ninth Circuit to evaluate clear reflection of income. *See Osterloh v. Lucas*, 37 F.2d 277 (9th Cir. 1930). An alternative standard, announced in *Caldwell v. Commissioner*, 202 F.2d 112, 115 (2d Cir. 1943), focuses on whether income is reflected with "as much accuracy as standard methods of accounting practice permit." For a discussion of these standards and their interrelationships, see GERTZMAN, *supra* note 211, at ¶ 2.02[j].

<sup>393</sup> 26 T.C. 301 (1956).

<sup>394</sup> *See id.* at 301-02. Under a direct costing method, "direct production costs and variable indirect production costs are includible in costs allocable to inventory, [but] all fixed indirect production costs are deductible as period expenses." *See* 1 LESLIE J. SCHNEIDER, FEDERAL INCOME TAXATION OF INVENTORIES § 4.01[1], at 4-5 (1998). A "full absorption method" includes all direct production costs and all indirect production costs as inventoriable costs. *See id.* According to Schneider, "Historically, there was considerable uncertainty over the proper



The Service discovered the change on audit, and proposed adjustments to return the taxpayer to the absorption method.<sup>395</sup> While negotiations were pending over proposed adjustments for the 1946-47 years, the revenue agent issued his report for 1948, which showed an overassessment of \$11,757.38 based on the absorption method.<sup>396</sup>

Prior to trial, the taxpayer and the Service then settled the dispute over the 1946-47 tax years, with the Service conceding that the taxpayer could use the direct costing method as reported in its return.<sup>397</sup> However, the Service recomputed the overassessment for the 1948 tax year to only \$349.27, based on allowing the direct costing method.<sup>398</sup> The taxpayer did not challenge this determination, but accepted a refund based on this reduced overassessment for 1948.<sup>399</sup>

When the Service again challenged the taxpayer's method in the 1950 tax year, the Tax Court held for the taxpayer based on the Service's "tacit approval" of the taxpayer's method in 1948. In these circumstances, acceptance of the taxpayer's method on audit was deemed to be "the equivalent and have the effect of a formal request on the part of petitioner to change its method of reporting and a formal approval by the Commissioner of that change."<sup>400</sup> Although the Court found that the significance of the negotiated settlement in 1946-47 was not "clear cut,"<sup>401</sup> the acquiescence to the taxpayer's method in 1948 (which incidentally had the effect of substantially reducing the taxpayer's refund) was effective to approve the new method.<sup>402</sup>

Although *Geometric Stamping* resulted in a taxpayer victory, it cannot be read as cutting off a clear reflection inquiry when a request for a change in method is granted. First, the court suggests only that "respondent ought to take account of the extent to which a taxpayer's conduct conforms to respondent's own requirements."<sup>403</sup> This is consistent with treating prior approval as a factor, but not a determinative factor, in clear reflection analysis. Second, it is significant that the court found it "noteworthy that respondent never contests the propriety of the direct costing

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method of costing goods that are produced by the taxpayer, although the full absorption method had generally been preferred by the Service." *Id.* at 4-6. Currently, extensive and detailed "uniform capitalization" rules govern inventory costing. See generally I.R.C. § 263A and regulations thereunder.

<sup>395</sup> See *Geometric Stamping*, 26 T.C. at 302.

<sup>396</sup> See *id.*

<sup>397</sup> See *id.* at 303, 305.

<sup>398</sup> See *id.* at 303.

<sup>399</sup> See *id.*

<sup>400</sup> *Id.* at 304-05.

<sup>401</sup> *Id.* at 305.

<sup>402</sup> See *id.*

<sup>403</sup> *Id.* at 304.

method."<sup>404</sup> Apparently, the Commissioner's challenge in this case was based on a theory either that the taxpayer's change in method was unauthorized, or that it did not conform to the method used for the taxpayer's books.<sup>405</sup> Thus, if the Commissioner had questioned whether the taxpayer's method clearly reflected income, it is doubtful that the taxpayer would have fared as well.<sup>406</sup>

In *Klein Chocolate, Inc. v. Commissioner*,<sup>407</sup> the Tax Court sought to determine whether the principle of "tacit approval" recognized in *Geometric Stamping* should be applied to a taxpayer's adoption of a single pool in applying the LIFO method to its inventory. The taxpayer had properly adopted the LIFO method for the 1942 tax year, and it used a single pool for its inventory items.<sup>408</sup> At this time, there were no detailed regulations governing pooling in LIFO inventories. Detailed regulations as to "natural business unit" pooling, which the taxpayer alleged supported its pooling practice, were later promulgated in 1961, but the court rejected any reference to these regulations for earlier taxable years.<sup>409</sup>

With regard to the 1942-44 tax years, the court found that the Revenue Agent's report stated that taxpayers use of LIFO had been "thoroughly examined" and recommended that the taxpayer's method be "accepted" for the years at issue.<sup>410</sup> Accordingly, those tax years were closed.<sup>411</sup> In the 1946-47 tax years, the Commissioner proposed an adjustment to change the taxpayer from a single pool to ten separate pools, which increased taxable income.<sup>412</sup> However, the court rejected this adjustment, treating the prior examination and approval of the single pool as being "as definite and as effective under the statute as if approval had

<sup>404</sup> *Id.* at 305.

<sup>405</sup> *See id.* at 305-06.

<sup>406</sup> By the time of trial, the taxpayer was able to show results from ten years of applying the direct method (i.e., through the 1955 tax year). The direct method produced greater taxable income in five of the years, but less in the other five. *See id.* at 305. As the court observed: "[t]he consistency required of taxpayers in reporting their income and the uniformity shown by petitioner consequently results, as is so often the case, in the long-range consequences being no different under one system than under the other. This is at once the theoretical reason and the practical demonstration of the superior significance of consistency where permissible alternatives are involved." *See id.* Thus, the court did not consider direct costing to be an "impermissible" method at this time. However, later decisions reached that conclusion and full absorption costing was eventually required. *See generally* SCHNEIDER, *supra* note 393, at § 4.01.

<sup>407</sup> 36 T.C. 142 (1961), *acq. in result*, 1961-2 C.B. 4.

<sup>408</sup> *See id.* at 146-47. Taxpayers adopt the LIFO method by filing Form 970, and unlike most changes in methods of accounting, such adoption does not require the Commissioner's prior approval. *See generally* SCHNEIDER, *supra* note 393, at § 10.02[1]; GERTZMAN, *supra* note 211, at ¶ 7.03[1].

<sup>409</sup> *See Klein Chocolate*, 36 T.C. at 148 (citing T.D. 6539, 1961-10 C.B. 167).

<sup>410</sup> *See id.* at 144.

<sup>411</sup> *See id.*

<sup>412</sup> *See id.* at 147.

been made on application prior to the use of such method of inventory in any return."<sup>413</sup>

The significance of the resulting approval and constraint appears limited, however, as the court made it clear that this decision did not mean that "if the consistent and continued use of a method thus approved is later shown to result in a distortion of income or it is improperly practiced the respondent's hands are tied and he is required to perpetuate error."<sup>414</sup> Here, the Commissioner had made no such claim, and he was forced to respect the taxpayer's consistent use of its method.<sup>415</sup>

Thus, cases such as *Maloney v. Hammond*, *Geometric Stamping*, and *Klein Chocolate* ultimately offer little protection for taxpayers seeking refuge from the Commissioner's clear reflection power. Even specific authorization of a method for a particular taxpayer does not ensure that such method will clearly reflect income. On one hand, it is doubtful that clear reflection power could be used solely because the Service finds another method that produces higher taxable income. As the Ninth Circuit stated in *Maloney v. Hammond*:

If [the Commissioner's] position is that, having granted permission to a taxpayer to use a certain method of accounting and the taxpayer having in good faith followed the allowed method, the Commissioner may subsequently determine that some other method would be more advantageous to the government in the amount of taxes to be collected and substitute the second method for the first, we say the Commissioner has no such right. To do so would be most unfair to the taxpayer.<sup>416</sup>

On the other hand, taxpayers should not take too much comfort from this pronouncement. Without adequate development of the parameters of clear reflection of income, it is difficult to ascertain when the above limitation has been exceeded. Revenue concerns undoubtedly inform the Commissioner's decisions to challenge methods of accounting, and to the extent that clear reflection power extends to specifically authorized methods, one is hard pressed to find a justification that is not revenue-based to sustain such a challenge.

Moreover, as noted above, sustaining a clear reflection challenge is not accomplished without significant cost. A recent case involving clear

<sup>413</sup> See *id.* at 147-48.

<sup>414</sup> *Id.* at 147. *Thomas* specifically notes this point. See *supra* note 376.

<sup>415</sup> See *Klein Chocolate*, 36 at T.C. 147-48. Although consistency is emphasized in regulations under section 471, it is quite clear that consistent use does not preclude the Commissioner from adjusting a method that does not clearly reflect income. See SCHNEIDER, *supra* note 393, at § 3.04.

<sup>416</sup> *Maloney v. Hammond*, 176 F. 2d 780, 781 (9th Cir. 1949).

reflection issues illustrates that clear reflection controversies can be drawn-out affairs. In *Hospital Corporation of America*,<sup>417</sup> the taxpayer was initially using the cash method for most of its hospitals and subsidiaries.<sup>418</sup> In its 1972-73 tax year, the Service sought to change the taxpayer to an accrual method, but a settlement was negotiated to allow the taxpayer to use a hybrid method.<sup>419</sup> The hybrid method was then accepted in subsequent audit cycles covering the tax years 1974-1978.<sup>420</sup> However, in the examination of the 1979-80 tax years, the Service once again challenged the hybrid method, seeking a change to the accrual method.<sup>421</sup> This issue was resolved at Appeals by permitting the hybrid method, with some modifications.<sup>422</sup> However, the Service renewed its clear reflection challenge to the hybrid method in the 1981-1986 tax years,<sup>423</sup> which was ultimately resolved by a judicial determination that the method clearly reflected income.<sup>424</sup>

The fact that the accrual method would increase taxable income by more than \$588 million<sup>425</sup> undoubtedly affected the Commissioner's decision to pursue this issue.<sup>426</sup> By 1987, section 448 required the taxpayer to change to an accrual method, so that the revenue effects from a future tax year were not at issue.<sup>427</sup> These multiple challenges of the same method throughout an extended period illustrate the costs of using clear reflection power, as opposed to a clear rule.

Here, Congress ultimately provided a rule-based solution to the perceived problem of deferred tax revenues arising from the cash method, but disputes in the intervening period consumed significant resources for rather speculative benefits. As the court pointed out, the cash method enjoyed "overwhelming acceptance" in the health care industry.<sup>428</sup> If the Service obtained a favorable decision, it is unlikely that the decision would provide an industry-wide solution nearly ten years after the last potential open tax year. By this time, many taxpayers in the industry are likely to have the protection of the statute of limitations. This practice

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<sup>417</sup> 71 T.C.M. (CCH) 2319 (1996).

<sup>418</sup> *See id.* at 2326-27.

<sup>419</sup> *See id.* at 2327.

<sup>420</sup> *See id.* at 2328-29.

<sup>421</sup> *See id.* at 2329.

<sup>422</sup> *See id.*

<sup>423</sup> *See id.* at 2329-30

<sup>424</sup> *See id.* at 2336-37. It should be noted that the Tax Court here did not reach the issue of whether the Commissioner had changed the taxpayer's method. *See id.* at 2332. However, it did consider the Service's acquiescence in the hybrid issue, while "not binding" on the Commissioner, as "a factor in the [taxpayer's] favor." *Id.* at 2334 (citing *Klein Chocolate and Geometric Stamping*).

<sup>425</sup> *See id.*

<sup>426</sup> *See id.* (arguing based on "disparity" between methods).

<sup>427</sup> *See id.* at 2332 n.20.

<sup>428</sup> *See id.* at 2330.

ensures that similarly situated taxpayers will bear unequal burdens, both in terms of taxes paid and the cost to determine that tax liability.

#### IV. CONCLUDING THOUGHTS ON THE RULE OF LAW AND CLEAR REFLECTION AUTHORITY

The Rule of Law ideal is often compromised in Federal tax law, at least when the Rule of Law is understood in relation to the protective, constraining function of rules. Taxpayers must not only contend with problems of linguistic indeterminacy, which might be viewed as a necessary byproduct of good faith rulemaking efforts, but also with avoidable forms of discretion. Avoidable discretion is traceable to more radical forms of purposivism, as well as discretion that is a product of legislative choice, as exemplified by the Commissioner's clear reflection authority.

Choosing discretion is troublesome under the Rule of Law ideal. Rather than providing notice of legal obligations in advance of their application, discretion-based provisions only provide notice of risk or uncertainty. Some notice is probably better than none, as the impact of coercive government power is perhaps not completely unexpected. However, a discretionary approach may be unsatisfactory if rules could be fashioned to limit or reduce that uncertainty. Significant normative judgments are at stake in choosing discretion, and reevaluation of these judgments is necessary in light of the importance of the Rule of Law in our legal system.

Congress' grant of discretionary authority to the Commissioner under section 446(b) has proven troublesome for the certainty and predictability of tax law, as the phrase "clearly reflect income" does not provide an adequate textual basis to constrain that authority. In seeking parameters for constraint, courts have sometimes resorted to principles that are patently tautological. For example in *Hospital Corp.*, the court stated that "where a taxpayer's method of accounting does clearly reflect income, [the Commissioner] cannot require the taxpayer to change to a different method even if the Commissioner's method more clearly reflects income."<sup>429</sup> Attempts to identify other principles, such as matching, conformity to GAAP, or compliance with industry practices, have hardly resulted in rule-like clarity. Moreover, findings of "abuse" or "distortion" are conclusions, not rationales, and these conclusions must be made in relation to some benchmark for income, which is sorely lacking apart from parameters derived from the Code and Regulations.

Some commentators have suggested that uncertainty generated by discretion may be beneficial, to the extent of an *in terrorem* effect in

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<sup>429</sup> See, e.g., *Ford Motor Company v. Commissioner*, 71 F.3d 209, 213 (6th Cir. 1995).

detering "abusive" transactions.<sup>430</sup> However, this presupposes that taxpayers can intuitively know when a transaction has somehow crossed the line into the realm of the "abusive."<sup>431</sup> It also presupposes that Revenue Agents can appropriately apply discretionary doctrines, thereby avoiding the imposition of enforcement costs on "innocent" taxpayers.<sup>432</sup>

Whatever the merit of deterrent effects of anti-abuse doctrines in other transactional contexts, an *in terrorem* effect is not essential to ensure that taxpayers adopt appropriate tax accounting methods. Allowing the Commissioner to exercise dynamic rule-revision power may help boost tax collections, but rulemaking can also protect the public fisc without the selective, *ad hoc* impact of discretionary justice. Broadly-based discretion threatens the administrability of the tax system, particularly when vague notions of purpose are allowed to override the result of following otherwise applicable rules.<sup>433</sup> The equitable merits of discretion in this context are dubious, given its selective application and the attendant costs imposed on those targeted by such authority.

Efforts to restore Rule of Law values in this area should begin by eliminating the Commissioner's authority to challenge methods of accounting that otherwise conform to the requirements of the Code and regulations. Dynamic rule-revision power is particularly offensive to Rule of Law values, and both taxpayer rights and goals of efficient tax administration are threatened when rules are abandoned in favor of a

<sup>430</sup> See Daniel Halperin, *Are Anti-Abuse Rules Appropriate?*, 48 *TAX LAW.* 807, 809 (1995).

<sup>431</sup> See *id.* at 809:

I believe that sophisticated practitioners are undoubtedly aware when a transaction is structured to achieve a tax result inconsistent with its economic substance. In fact, it is often harder to determine whether or not a given transaction will actually achieve an apparent tax result which seems too good to be true, than it is to discern what would be required to properly measure income consistent with the intent behind the rule.

*Id.* As a basis for this latter statement, Professor Halperin notes: "It has been suggested to me that this capacity is not widely disseminated, but I wonder if it is any rarer than the ability to construct the kind of perceived abusive schemes under review." *Id.* at 809 n.12.

<sup>432</sup> See *id.* at 808. Professor Halperin points out that procedural safeguards for implementation of the partnership anti-abuse rules limit this risk. A procedural safeguard, such as requiring National Office approval as a prerequisite for clear reflection challenges might limit the abuse of clear reflection power, although it would not ensure that a purposive approach was invoked appropriately.

<sup>433</sup> See *id.* at 811:

[W]e sometimes deliberately decide not to attempt to achieve consistency with 'purpose' in every situation. The tax law will always be an uneasy compromise between efforts to achieve equity and limit efficiency losses at a reasonable level of complexity. In the end, the Code must be administrable. Thus, perhaps primarily with respect to broad-based rules affecting ordinary taxpayers, Congress (or the Service) must sometimes opt for a bright line in order to achieve this goal. In those situations we do not want to apply an overriding purpose.

case-by-case determination of tax liability. Structural principles of tax law that may be identified and applied by courts hardly provide certainty and predictability as to when rules should be abandoned. Rule-based reliance is more likely to ensure that all taxpayers are treated similarly, and it avoids the costs associated with an attempt to achieve substantive justice in each case.

When tax accounting rules fail to authorize or prohibit particular methods of accounting, there may still be room for the Commissioner's discretion. However, this discretion should be constrained by parameters that are accessible to taxpayers and Revenue Agents. Generally accepted accounting principles (GAAP) would appear to provide a logical benchmark for evaluating whether accrual methods that are neither proscribed nor specifically authorized by the Code or regulations should be deemed to clearly reflect income.

Current regulations look to compliance with GAAP as a general indicator of clear reflection of income. Section 1.446-1(a)(2) of the regulations states in part: "A method of accounting which reflects the consistent application of generally accepted accounting principles in a particular trade or business in accordance with accepted conditions or practices in that trade or business will *ordinarily* be regarded as clearly reflecting income, provided all items of gross income and expense are treated consistently from year to year."<sup>434</sup> Elevating compliance with GAAP to conclusive status in clear reflection analysis would provide an objective basis for constraint, thereby restoring Rule of Law values in this context.

Although the Supreme Court has emphasized that financial accounting and tax accounting have competing goals and interests,<sup>435</sup> those differences would not necessarily interfere with the use of GAAP for the limited purpose of providing an external benchmark for constraining dis-

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<sup>434</sup> Treas. Reg. § 1.446-1(a)(2) (emphasis added).

<sup>435</sup> See *Thor Power Tool Co.*, 439 U.S. 522 (1978):

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. Consistently with its goals and responsibilities, financial accounting has as its foundation the principle of conservatism, with its corollary that "possible errors in measurement [should] be in the direction of understatement rather than overstatement of net income and net assets." In view of the Treasury's markedly different goals and responsibilities understatement of income is not destined to be its guiding light. Given this diversity, even contrariety, of objectives, any presumptive equivalency between tax and financial accounting would be unacceptable.

*Id.* at 542-43 (footnote omitted).

cretion when the Code or regulations are otherwise silent.<sup>436</sup> If Congress or the Treasury determines that the interests of tax accounting require a different approach than allowed by GAAP, those interests can be addressed through rulemaking, which will ensure industry-wide effects in lieu of particularized decisionmaking. Here, the "rough justice" of a rule has much to offer as compared with the uncertainty of discretion, which has flowed from the Commissioner's clear reflection power.

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<sup>436</sup> It should be noted that *Thor Power* involved a method that did not comply with the regulations; allowing GAAP to control in those situations would have created problems that are quite different from those considered here.



