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**THE COMMISSIONER'S CLEAR REFLECTION OF INCOME POWER UNDER §446(B) AND THE ABUSE OF DISCRETION STANDARD OF REVIEW: WHERE HAS THE RULE OF LAW GONE, AND CAN WE GET IT BACK?**

by

Jennifer C. Root\*

I.. INTRODUCTION

Aristotle has been credited with the beginnings of modern thought on the rule of law with his concepts of the universal rule of law and equity.<sup>1</sup> The revered philosopher saw the rule of law as the foundation to an orderly society.<sup>2</sup> He states in *Aristotle, Nicomachean Ethics* that a correctly established law promotes virtue as well as discouraging vice.<sup>3</sup> Aristotle also noted that due to the imperfections in the written law, a system of equity is necessary to supplement the application of the law to specific cases.<sup>4</sup> Thus, Aristotle illustrated the legal system's need for a balance between strict adherence to a system of written laws, and the discretionary system of individual judgement.

Eric G. Zahnd analyzes Aristotle's concept of the balance between written rules and discretion by stating: "But at some point, though admittedly not one that is always clear, the introduction of equity challenges the development and administration of an ordered system of rules, a problem of considerably greater concern today than at the time and place in which Aristotle wrote."<sup>5</sup> Accordingly,

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<sup>1</sup> Eric G. Zahnd, *The Application of Universal Laws To Particular Cases: A Defense of Equity in Aristotelianism and Anglo-American Law*, 59 LAW & CONTEMP. PROBS. 263 (1996).

<sup>2</sup>*Id.* at 266, (quoting ARISTOTLE, NICOMACHEAN ETHICS 1129019-25 (Terence Irwin trans., 1985)).

<sup>3</sup> *Id.*

<sup>4</sup> *Id.*

<sup>5</sup> *Id.* at 277 (citing *Kaiser Found. Hosps. v. Workers Compensation Appeals Bd.*, 202 Cal. Rptr. 520, 527 (Cal. Ct. App. 1984) *vacated*, 216 Cal. Rptr. 115 (Cal. 1985). See also Richard H. Fallon, Jr., "The Rule of Law" as a Concept in Constitutional Discourse, 97 COLUM. L. REV. 1, 1 (1997) ("The Rule of Law is a historic ideal, and appeals to the Rule of Law remain rhetorically powerful. Yet the precise meaning of the Rule of Law is perhaps less clear than ever before."))

judges are to be given the flexibility to use equity in particular cases where the use of a universal law is inappropriate, but the use of unfettered discretion by judges cannot be allowed.<sup>6</sup> This constant need for balance illustrates the tension that exists between the rule of law and the rule of man in a legal system. Therefore, somewhere along the continuum between the rule of law (normative written law) and the rule of man (discretion) lies the balance necessary to a legal system, and the point of balance is subject to constant change. To err too far toward the rule of law is to end with inflexibility and unjust results, and to err too far toward the rule of man is to end with inconsistency and uncertainty in results.

This article will first examine the evolution of the rule of law by examining the conceptual frameworks proposed by scholars to analyze the rule of law. The foundations of the rule of law taken from these scholars will be condensed into several principles applicable to modern tax law. These principles will then be used to illustrate how both discretion and adherence to the written law are necessary in order to promote a workable system of tax law promulgation, administration, and interpretation. The next section of this article will examine §446 of the Internal Revenue Code<sup>7</sup> and the Commissioner's clear reflection of income power contained therein. This section will illustrate the status of the clear reflection power as it is defined in the law, the judiciary, and used by the Commissioner today.

Section four will examine the judicial review of the Commissioner's determinations under §446 using the abuse of discretion standard. The fifth section will determine whether the rule of law has been unjustifiably compromised with respect to the Commissioner's clear reflection of income power. Section five will then make arguments for and propose an alternative standard of review for the Commissioner's clear reflection of income powers. Section six discusses the implications for a change in the standard of review for clear reflection of income cases and analyzes the benefits and burdens of returning power to the judicial branch. Finally, the article will conclude with thoughts on the rule of law and how it can be best served through the system of internal revenue under §446.

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<sup>6</sup> Zahnd, *supra* note 1 at 267.

<sup>7</sup> 26 U.S.C. § 446 (1994). Unless otherwise noted, all citations to code sections refer to Title 26 of the United States Code (Internal Revenue Code).

## II. THE RULE OF LAW

### A. *A Brief History of The Rule of Law*

The rule of law is an often cited and honored concept in American Jurisprudence.<sup>8</sup> The first step in understanding the rule of law is to, examine the rule of law in opposition to its contradiction the rule of man.<sup>9</sup> On the surface, the rule of law stands for the simple statement that laws must be fixed and known in advance of their application to the citizens bound by such rules.<sup>10</sup> The contrast is the situation in which governmental officials create the law as they are applying it to specific instances, also known as the rule of man.<sup>11</sup> At first glance, the rule of law appears to always be preferable to the inherent arbitrariness of the rule of man.<sup>12</sup> The assertion can even be made that respect for the rule of law is an essential and fundamental tenet of the American legal system.<sup>13</sup>

However, as Aristotle noted, the rule of law should not be taken to stand for rigidity or the elimination of all discretion in a system of laws.<sup>14</sup> Instead, both formal rules as well as limited discretion are necessary in order to have a workable balanced system of laws.<sup>15</sup> Thus, the application of rule of law principles to any system to determine when a system runs afoul of the rule of law will not end in a clear-cut conclusion except in the most extreme of instances. Instead, the violation of the rule of law will be a matter of degree where the principles of the rule of law have been too deeply sacrificed in favor of discretion. Therefore, the principles attributable to the rule of law must not be viewed as absolute requirements, but instead must be viewed in the context of a delicate balance that must be carefully cultivated and vigilently tended.

A.V. Dicey, in his treatise *The Law of the Constitution*,<sup>16</sup> sets forth three fundamental characteristics of the rule of law.<sup>17</sup> First, the rule of law is served

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<sup>8</sup> Richard A. Epstein, *Beyond the Rule of Law: Civic Virtue and Constitutional Structure*, 56 GEO. WASH. L. REV. 149, 149 (1987).

<sup>9</sup> Fallon, *supra* note 5 at 2-3.

<sup>10</sup> *Id.* at 3.

<sup>11</sup> *Id.*

<sup>12</sup> *See id.*

<sup>13</sup> *Id.*

<sup>14</sup> *See id.* at 3-4. *See also* ARISTOTLE, *supra* note 2.

<sup>15</sup> Fallon, *supra* note 5 at 3.

<sup>16</sup> A.V. DICEY, *INTRODUCTION TO THE STUDY OF THE LAW OF THE CONSTITUTION* (7<sup>th</sup> ed. 1908).

<sup>17</sup> *See* Epstein, *supra* note 8 at 151 (citing DICEY, *supra* note 16).

when there is a predominance of regular law over the discretion of individuals within the government.<sup>18</sup> This proposition stands for the general rule that man should be governed by rules and not by the judgement of a single person.<sup>19</sup> Thus, arbitrariness, prerogative, and wide discretionary authority must be minimized in order to have a legal system in conformity with the rule of law.<sup>20</sup> Second, the rule of law demands the equal treatment of those that come before the law.<sup>21</sup> This proposition stands not only for the equal treatment of similarly situated individuals by the law, but also stands for the proposition that all classes of citizens must be subject to the law.<sup>22</sup> Third, the rule of law maintains that rules are not the source of individuals' rights but instead are the consequence of individuals' rights as defined by the courts.<sup>23</sup> This proposition has been argued to stand for the principles of granting limited power to the government, the separation of powers between the branches of government, and a full utilization of judicial review.<sup>24</sup> Therefore, the rule of law is seen as a mechanism to restrain discretionary governmental action and protect citizens from the arbitrary use of overly broad governmental power.<sup>25</sup>

Unlike Dicey's constitutional and legal system oriented view on the rule of law, Freidrich Hayek takes a more pragmatic approach.<sup>26</sup> Hayek takes the three broad principles of the rule of law as articulated by Dicey and reduces them into a singular definition.<sup>27</sup> This definition lends itself more readily to modern application, and lends itself more readily to analysis of individual situations.<sup>28</sup> "The formal rules tell people in advance what action the state will take in certain types of situations, defined in general terms, without reference to time and place or particular people."<sup>29</sup> Thus, Hayek, like Dicey, believes the rule of law stands for limiting discretion in favor of formal rules providing notice to the governed, and stands for equal treatment of citizens bound by the law as well as equal subjugation

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<sup>18</sup> *Id.*

<sup>19</sup> *See id.*

<sup>20</sup> *Id.* (quoting DICEY, *supra* note 16 at 198).

<sup>21</sup> *Id.* (quoting DICEY, *supra* note 16 at 198).

<sup>22</sup> *See id.*

<sup>23</sup> Epstein, *supra* note 8 at 151.

<sup>24</sup> *See generally, id.*

<sup>25</sup> *See id.* at 152. Epstein discusses how liberty and utility can be reduced by flagrant ill-defined rules.

<sup>26</sup> *Id.* at 151. *Citing* FREIDRICH A. HAYEK, *THE ROAD TO SERFDOM* 74 (1944). Hayek uses the definition to argue against socialist planning which is in opposition to the rule of law's prohibition against discretion.

<sup>27</sup> Epstein, *supra* note 8 at 151-52.

<sup>28</sup> *See id.* at 151-52.

<sup>29</sup> HAYEK, *supra* note 26 at 74.

of those citizens to the law.<sup>30</sup> However, Hayek, unlike Dicey does not use the third requirement which is less applicable to specific instances of governmental conduct and more applicable to the structure of the government itself.<sup>31</sup>

Despite the apparent simplicity in the requirements of the rule of law as seen by Hayek and Dicey, the rule of law must also perform another function.<sup>32</sup> Thus far, the principles of the rule of law have taken on an attitude of protecting the individual from the government and having a system of fairness in the treatment of citizens before the law. Undoubtedly, this is the focus of the rule of law's main principles. However, the rule of law equation cannot balance without looking to the governing as well as the governed.<sup>33</sup> As much as the individual needs the definiteness of a written law to protect his rights, the governmental body administering the law needs definiteness in order to apply it.<sup>34</sup> To those applying the law, the rule of law requires that the rules determine the outcomes.<sup>35</sup> Thus, to fully conform to the rule of law's requirements the governing body must have prior notice of the rules to be applied, and must ensure that the results of the application of those rules flow from the rules themselves.<sup>36</sup>

In summary, the rule of law is a fluid concept and has been so since the time of Aristotle. As set in opposition to the rule of man, the rule of law is articulated as standing for clearly written rules that give notice to the governed in advance of their application. The rule of law stands against the system wherein citizens are subject to the discretion of an individual acting as judge. The rule of law takes on the principle of equality of citizens before the law, and equality of treatment of citizens by the law. The rule of law also stands for the principle that rules and governments are given life because of the rights of individuals and not the opposite.

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<sup>30</sup> *See id.*

<sup>31</sup> *See id.* *See infra* part II B 2 for a discussion of the third requirement of the rule of law.

<sup>32</sup> Fallon, *supra* note 5 at 2 (citing LON L. FULLER, *THE MORALITY OF LAW* 42-44 (rev. ed. 1964)) (arguing the regiment of public rules set in advance and adherence to some natural-law values). Also note that the requirements of the rule of law as stated by Dicey and Hayek must always be seen in light of Aristotle's balance between the rule of law and the rule of man. Discretion cannot ever be entirely eliminated. Thus, an amount of uncertainty will always pervade any discussion of the rule of law.

<sup>33</sup> *See id.* at 3, ("Within perhaps the most familiar understanding of this distinction [rule of law versus rule of man], the law-and its meaning-must be fixed and publicly known in advance of application, so that those applying the law, as much as those to whom it is applied, can be bound by it.").

<sup>34</sup> *See id.*

<sup>35</sup> *See id.* at 3-4.

<sup>36</sup> *See id.* at 3.

Analysis of the rule of law must be performed not only from the individual perspective but also from the governing body's perspective – for only through both sides can the principles of the rule of law ultimately be achieved. Finally, Aristotle's continuum must be kept in mind as the benchmark of discretion for no system can function without it – and with too much, no system can function with it.

## *B. The Rule of Law As It Applies in the Realm of Tax Law*

### 1. The Expanding Roles of Administrative Agencies

In 1913 the first modern tax law was enacted pursuant to Congress' constitutional authority to lay and collect taxes.<sup>37</sup> This early Code was only sixteen pages and by our standards today is considered to have been relatively simple in its conception.<sup>38</sup> The provisions were written in broad and general terms rather than the detailed rules that are common under the modern Code.<sup>39</sup> At the time the original Code was placed into practice, the courts were relied upon to create principles in order to deal with the problems that developed based on the indefiniteness of the statutory language.<sup>40</sup> Therefore, the Internal Revenue Code's fledgling years were marked with simplicity, broad language, and a heavy dependence upon the judiciary for interpretation.<sup>41</sup>

Since the time of the original enactment, the Code itself as well as the system of enforcement of the Code has changed radically.<sup>42</sup> First, the tax law has changed from a brief set of broadly worded statutes to volumes of specific detailed rules.<sup>43</sup> The complexity of the individual rules has increased simultaneously with

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<sup>37</sup> The Income Tax Law of 1913, Pub. L. No. 16, 38 Stat. 114, § 2 (1913). James W. Colliton, *Standard, Rules and the Decline of the Courts in the Law of Taxation*, 99 DICK. L. REV. 265, 266 (1994); U.S. CONST. amend. XVI.

<sup>38</sup> Colliton, *supra* note 37 at 265.

<sup>39</sup> *Id.* at 265-66.

<sup>40</sup> *Id.* at 266.

<sup>41</sup> *Id.*

<sup>42</sup> *Id.* at 265-69. See also Richard M. Lipton, *We Have Met The Enemy and He is Us: More Thoughts on Hyperlexis*, 47 TAX LAW. 1, 1 (1993).

<sup>43</sup> Colliton, *supra* note 37 at 265. See also Lipton, *supra* note 42 at 1 (arguing that the increase in the volumes and sources of the tax code are generally spurred on by the "incessant clamoring of tax professionals for more guidance on virtually every issue that they encounter."). Note, the Internal Revenue Code encompasses 3052 pages of the United States Code of 1994.

the elimination of broad standards.<sup>44</sup> The modern trend has been toward legislating rules that cover a long list of conceivable contingencies, which accounts for the increase in length in the Code and regulations.<sup>45</sup> Some scholars even argue that there is no incentive to refrain from this extreme elaboration present in tax legislation.<sup>46</sup> Richard M. Lipton summarizes the state of the modern Code and accompanying regulations as "particularized, elaborated and microscopic in character,"<sup>47</sup> which is the polar opposite of the original sixteen page enactment.

The second and most profound change has been among the roles of the three branches in tax promulgation, administration, and adjudication.<sup>48</sup> No longer does the legislative branch rely on the judicial branch to create principles to deal with problems that arise.<sup>49</sup> Instead the Congress simply amends the rules in order to deal with the problems themselves.<sup>50</sup> The role of the courts as a major mode of tax law development has been phased out.<sup>51</sup> Thus, the branches have experienced a major power shift away from the courts and back to Congress.<sup>52</sup> Congress has also increasingly been delegating more power to the Treasury to develop and promulgate the rules associated with the statutes that are enacted.<sup>53</sup> Therefore, the modern Code has grown in volume, detail, and complexity and its interpretation has changed from the hands of the courts to the hands of the executive branch.

The executive branch has been saddled with a large burden of rule development due to legislative delegation.<sup>54</sup> The general expansion and complexity of governmental regulation has caused the legislature to rely on outside expertise

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<sup>44</sup> Colliton, *supra* note 37 at 265-66.

<sup>45</sup> Lipton, *supra* note 42 at 2-4.

<sup>46</sup> *Id.* at 2.

<sup>47</sup> *Id.* at 3.

<sup>48</sup> Colliton, *supra* note 37 at 266.

<sup>49</sup> *Id.* at 266-67. See generally Daniel Shaviro, *Beyond Public Choice and Public Interest: A Study of the Legislative Process as Illustrated by Tax Legislation in the 1980s*, 139 U. PA. L. REV. 1 (1990).

<sup>50</sup> Colliton, *supra* note 37 at 266.

<sup>51</sup> *Id.* at 268-69.

<sup>52</sup> *Id.*

<sup>53</sup> Lipton, *supra* note 42 at 1, (citing Gordon D. Henderson, *Controlling Hyperlexis - The Most Important "Law and ..."* 43 Tax Law. 177 (1989)). See also Bayless Manning, *Hyperlexis: Our National Disease*, 71 NW. U. L. REV. 767 (1977); Peter H. Aranson et al., *A Theory of Legislative Delegation*, 68 CORNELL L. REV. 1 (1982).

<sup>54</sup> Fallon, *supra* note 5 at 3-4. See also Aranson, *supra* note 53.



in many areas of the law in which the legislature cannot itself be expert.<sup>55</sup> Congress' resource limitations make it difficult to efficiently and effectively legislate meaningful rules.<sup>56</sup> For these reasons, administrative agencies have been relied upon to take on a large amount of the responsibility for governmental regulation.<sup>57</sup> The administrative agencies are many times saddled with vague mandates from the legislature and are asked to perform duties that are a combination of rulemaking, enforcement, and adjudication.<sup>58</sup> Thus, administrative agencies have become an essential part of the complex modern legal environment<sup>59</sup> and in no other particular area of law is this more true than in the area of taxation.

## 2. Separation of Powers

The third requirement of the rule of law as set out by Dicey is the somewhat amorphous governmental structure concept that has been interpreted differently by different scholars.<sup>60</sup> In the context of our discussion of administrative agencies, several schools of thought are applicable. First, many scholars interpret the rule of law from a constitutional standpoint,<sup>61</sup> and argue that the rule of law stands for the strict separation of powers between the branches of government.<sup>62</sup> This school of thought, of which Justice Scalia counts himself, holds that the sharing of powers between the branches is absolutely prohibited by the Constitution.<sup>63</sup> Similarly, Justice Scalia also holds that the rule of law should be upheld through the use of clear legal rules, and that discretion is dangerous because it allows the individual

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<sup>55</sup> Peter Marra, *Have Administrative Agencies Abandoned Reasonability?*, 6 SETON HALL CONST. L.J. 763, 767, 770 (1996).

<sup>56</sup> *Id.* at 767-68, 772-775.

<sup>57</sup> *Id.* at 767. *But see* Colliton, *supra* note 37 at 272-73.

<sup>58</sup> Fallon, *supra* note 5, at 3-4. *See also* Marra, *supra* note 55, at 769.

<sup>59</sup> *See* Marra, *supra* note 55 at 765-66, 777.

<sup>60</sup> DICEY, *supra* note 16. *See also* Paul R. Verkuil, *Separation of Powers, The Rule of Law and the Idea of Independence*, 30 WM. & MARY L. REV. 301, 307 (1989).

<sup>61</sup> Verkuil, *supra* note 60 at 307. ("Separation of powers is not mentioned in the Constitution, nor, for that matter, is the rule of law. The concern with separation of powers derives from the structure of the Constitution (which establishes three branches in articles I, II and III) and from contemporaneous political tracts like *The Federalist*.").

<sup>62</sup> *Id.* *See also* Marra, *supra* note 55 at 781-82; George Anhang, *Separation of Powers and the Rule of Law: On the Role of Judicial Restraint in "Securing the Blessings of Liberty,"* 24 AKRON L. REV. 211 (1990). (arguing that the two sides to separation of powers arguments are the "ex ante" and "ex post." Ex ante argues for strict separation of powers while ex post justifies a certain degree of interrelationship).

<sup>63</sup> Eric J. Segall, *Justice Scalia, Critical Legal Studies, and the Rule of Law*, 62 GEO. WASH. L. REV. 991, 1013-14 (1994). *See also* Morrison v. Olson, 487 U.S. 654 (1988).

making judgments to impose “value judgments instead of being forced to adhere to prior governing principles.”<sup>64</sup> Thus, when analyzing separation of powers problems, the strict separationists adopt a very rule-like approach to Dicey’s third requirement of the rule of law.<sup>65</sup>

The second set of legal scholars interpret the rule of law from the standpoint that complete separation of powers is a practical impossibility, and instead the system of checks and balances is necessary in order to fulfill the ideals of the rule of law as much as possible.<sup>66</sup> This school of thought holds that the framers of the Constitution were concerned that if they concentrated more than one of the legislative, executive, or judicial powers in one department of government, they would sacrifice liberty.<sup>67</sup> However, they also acknowledge that the framers did not create barriers to the interaction of the branches within the Constitution.<sup>68</sup> Thus, the true working of the government should be through the system of checks and balances which prevents any one branch from overpowering another.<sup>69</sup> The Supreme Court generally has followed this school of thought in most of its decisions, and has allowed Congress to delegate lawmaking tasks to administrative agencies.<sup>70</sup>

The checks and balances approach to separation of powers is arguably the most practical legal framework when analyzing the true workings of the government, but as with any balancing analysis a large degree of vagueness is inherent.<sup>71</sup> Despite the fact that this school of thought holds that an intermingling of powers is justified, it agrees that an unconstitutional exercise of federal powers is possible and will result in a violation of the separation of powers doctrine.<sup>72</sup> As

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<sup>64</sup> Segall, *supra* note 63 at 1000.

<sup>65</sup> *Id.* at 1013.

<sup>66</sup> See Marra, *supra* note 55 at 782-83. (arguing that this approach is known as the “interaction” approach to separation of powers principles, and may be seen as a more practical view).

<sup>67</sup> *Id.* at 779.

<sup>68</sup> *Id.* at 780.

<sup>69</sup> *Id.*

<sup>70</sup> *Id.* at 785-86.

<sup>71</sup> See Thomas O. Sargentich, *The Contemporary Debate About Legislative-Executive Separation of Powers*, 72 CORNELL L. REV. 430, 440 (1987). Sargentich further breaks down the checks and balances position into two classifications known as the extreme and moderate positions. For the purposes of this article the moderate approach as illustrated by Sargentich will be considered the checks and balances approach.

<sup>72</sup> M. Isabel Medina, *Judicial Review – A Nice Thing? Article III, Separation of Powers and the Illegal Immigration Reform and Immigrant Responsibility Act of 1996*, 29 CONN. L. REV.

James Madison stated: “[t]he accumulation of all powers, legislative, executive, and judiciary, in the same hands, whether of one, a few, or many, and whether hereditary, self-appointed, or elective, may justly be pronounced the very definition of tyranny.”<sup>73</sup>

However, James Madison did not seek to describe the circumstances in which a violation of the separation of powers takes place, and he did not address such violations in the context of administrative agencies in particular.<sup>74</sup> In fact, constitutional scholars such as Thomas O. Sargentich, question the vagueness of the checks and balances approach:

It seems insufficient to respond that one simply must judge whether some result would involve ‘undue’ or ‘excessive’ infringement on certain of the values at stake in the system of checks and balances. It may be, for example, that as long as there is not ‘too much’ intrusion on the role of agencies, the aims of legislative oversight, or other competing interests, centralized executive supervision is acceptable. But such a generalization begs the key questions: how much is too much, and by what measures are such things to be determined?<sup>75</sup>

Therefore, the checks and balances school of thought leaves many unanswered questions when it applies its balancing tests to separation of powers issues.<sup>76</sup>

Probably one of the most important aspects of the checks and balances school of thought is the concept of judicial review because it lends standards to the balancing which must take place when analyzing separation of powers issues.<sup>77</sup> Noting the importance of judicial review to the rule of law, Justice Brandeis states: “The supremacy of law demands that there shall be opportunity to have some court

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1525, 1546-47 (1997) (citing THE FEDERALIST NO. 47 (James Madison) (Max Beloff ed., 1987).

<sup>73</sup> THE FEDERALIST NO. 47, *supra* note 72 at 245-46.

<sup>74</sup> Medina, *supra* note 72 at 1547.

<sup>75</sup> Sargentich, *supra* note 71 at 440-41.

<sup>76</sup> *See id.* at 441.

<sup>77</sup> *See* Medina, *supra* note 72 at 1554-56.

decide whether an erroneous rule of law was applied and whether the proceeding in which facts were adjudicated was conducted regularly.”<sup>78</sup>

Judicial review has been compared to the due process clause in that it “is viewed by both litigants and the courts as the greater source of constitutional protection for the individual litigant from exercises of powers by the sovereign through administrative agencies.”<sup>79</sup> Judicial intervention and resolution of disputes is a necessary component to the concept of checks and balances in order to maintain a structural equilibrium.<sup>80</sup> Therefore, judicial review is seen as the protector of the integrity of the separation of powers between the legislative and the executive branches.<sup>81</sup>

The third set of legal theorists when looking to the rule of law and the separation of powers doctrine argue that the analysis must be focused on the concept of conflicts of interest.<sup>82</sup> These conflicts of interest can arise on three levels, between the branches themselves, between the functions within a branch, or when an individual within a branch has an interest in the outcome of a proceeding.<sup>83</sup> When conflicts of interest arise on any of these levels there is a need to strengthen the separation of powers on that level.<sup>84</sup> Thus, the conflicts of interest school of thought focuses on the practical reasons behind constitutional separation and not on “tautological expressions of branch purpose.”<sup>85</sup>

The three major schools of thought with regard to separation of powers are the strict separationists, the checks and balances theorists, and theorists that believe separation of powers should be analyzed from the standpoint of conflicts of interest. Despite the differences in view that are taken by these scholars when they analyze the separation of powers doctrine as it serves the rule of law, the role of administrative agencies poses a problem to which there are no easy answers.<sup>86</sup> From the rule of law perspective, Dicey saw the problem of comingling the three powers and functions of the government as the “insurmountable flaw of the

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<sup>78</sup> *St. Joseph Stock Yards Co. v. United States*, 298 U.S. 38, 84 (1936) (Brandeis, J., concurring).

<sup>79</sup> *Medina*, *supra* note 72 at 1554-55.

<sup>80</sup> *See Sargentich*, *supra* note 71 at 442-43 (addressing the argument that courts should not intervene and settle separation of powers issues).

<sup>81</sup> *See id.*

<sup>82</sup> *Verkuil*, *supra* note 60 at 307.

<sup>83</sup> *Id.*

<sup>84</sup> *Id.*

<sup>85</sup> *Id.* at 311.

<sup>86</sup> *Marra*, *supra* note 55 at 778, 783.

administrative state.”<sup>87</sup> Further in the view of strict separationists, “administrative agencies that combine the powers of all three branches of government violate the Constitution every time these powers are exercised.”<sup>88</sup> Nevertheless, the administrative agency is a creature that has been around since the beginning of American government,<sup>89</sup> and is not likely to be disappearing anytime soon.

### 3. The Need for Certainty – The Taxpayer’s Perspective

The modern system of taxation when analyzed from Dicey’s first component of the rule of law appears to be passing with flying colors.<sup>90</sup> Recall that Dicey’s paramount ideal of the rule of law is the supremacy of the written rule over the discretion of individuals.<sup>91</sup> The amount of tax statutes, regulations, and other guidance has grown at exponential rates since 1913 in order to achieve the utmost definiteness in the written rule.<sup>92</sup> Many have argued that taxation is an over-legislated area of the law, or suffering from a disease called “hyperlexis.”<sup>93</sup> According to Bayless Manning, hyperlexis is a “pathological condition caused by an overactive law-making gland.”<sup>94</sup> Thus, when we look to Dicey’s first requirement of the rule of law that rules must take precedence over the use of arbitrary discretion, we see that with so many rules it appears unlikely that any discretion has been left in the system at all.<sup>95</sup>

Taxpayers are generally in favor of a strong rule-based system in which they are able to rely on the notice they have been given about how their affairs will be taxed.<sup>96</sup> In fact, tax considerations can strongly influence the decisions that taxpayers will make with regard to their economic activities.<sup>97</sup> For example, a taxpayer faced with two alternative ways he can invest his income will look to the tax consequences of each option before making a choice.<sup>98</sup> One alternative will

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<sup>87</sup> Verkuil, *supra* note 60 at 307 (citing DICEY, *supra* note 16 at 183-205).

<sup>88</sup> Marra, *supra* note 55 at 789.

<sup>89</sup> *Id.* at 768.

<sup>90</sup> See Epstein, *supra* note 8 at 151 (citing DICEY, *supra* note 16).

<sup>91</sup> DICEY, *supra* note 16.

<sup>92</sup> Colliton, *supra* note 37 at 265-66.

<sup>93</sup> Lipton, *supra* note 42 at 1-2. See also Henderson, *supra* note 53, for a discussion of how too much guidance can actually cause ambiguity and confusion.

<sup>94</sup> Manning, *supra* note 53 at 767.

<sup>95</sup> See Colliton, *supra* note 37 at 266.

<sup>96</sup> See Linda A. Schwartzstein, *Smoke and Mirrors: Tax Legislation, Uncertainty and Entrepreneurship*, 6 CORNELL J.L. & PUB. POL’Y 61, 62 (1996).

<sup>97</sup> See *id.*

<sup>98</sup> See *id.*

defer the taxpayer's tax on his earnings so long as the taxpayer does not touch the investment because the tax law seeks to create an incentive for taxpayers to save for retirement. The second option requires the taxpayer to pay tax on his earnings on his investment every year and has no restrictions on when the taxpayer can remove the money. The taxpayer may well decide that he would like to take advantage of the tax deferral and invest for retirement. This type of decision making occurs frequently in reliance upon incentive provisions of the Code for a wide variety of taxpayers from individuals to businesses.<sup>99</sup>

The government is also well aware of the reliance that taxpayers place on the Internal Revenue Code.<sup>100</sup> In fact, tax legislation itself seeks to influence taxpayer decision-making, and direct behavior into realms that are considered socially good.<sup>101</sup> Tax incentives have been written into the Code in order to further the government's goals.<sup>102</sup> For example, the Code places incentives for behavior changes in order to motivate taxpayers to save more, spend more, or invest in certain ways that the government considers beneficial to the economy.<sup>103</sup> The reward to the taxpayer is a decrease in taxes due, or an increase in a refund due to the taxpayer,<sup>104</sup> The cash reward to taxpayers provides the incentive that motivates the taxpayer to change his behavior,<sup>105</sup> and for the most part the incentive system has been successful at motivating taxpayer behavioral changes. Thus, under Aristotle's theory that effective lawmaking should promote virtuous activity as well as discouraging vice, the Code and regulations have excelled.<sup>106</sup>

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<sup>99</sup> *Id.* ("The Internal Revenue Code has, in recent years, become the antithesis of a stable societal institution. Instead, its constant state of flux has created many impediments to entrepreneurship."). Note the discussion of the need for stable institutions in order to facilitate entrepreneurial decision making.

<sup>100</sup> See Joshua D. Rosenberg, *Tax Avoidance and Income Measurement*, 87 MICH. L. REV. 365, 374 (1988).

<sup>101</sup> *Id.*

<sup>102</sup> *Id.*

<sup>103</sup> *Id.*

<sup>104</sup> *Id.*

<sup>105</sup> *Id.* at 374. Note that the ability of the government to gauge the extent to which a taxpayer has changed his behavior in response to incentives in the tax code is impossible. *Id.*

<sup>106</sup> See Rosenberg, *supra* note 100 at 374, 382. Note that the tax system is also seen as having taxpayer disincentives as the production of income is generally taxable and in some cases can take away the economic incentive to participating in some economic activities. *Id.*

The legislative and executive branches are not alone in acknowledging taxpayer reliance.<sup>107</sup> In *Commissioner v. Newman*,<sup>108</sup> the Court stated in its often cited words:

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>109</sup>

With this statement the government acknowledges that taxpayer reliance on rules is commonplace and possibly even encouraged, and further does not judge such behavior as anything other than morally proper.<sup>110</sup> In fact, courts have held that the taxpayer need for reliance is so great that having a rule that is settled and followed by taxpayers is sometimes more important than having a correct rule.<sup>111</sup> Thus, given that the government actually seeks to promote reliance and influence taxpayer behavior, it can be argued that the government has created a "right to rely" by taxpayers on tax guidance.<sup>112</sup>

With respect to the rule of law, taxpayer reliance is a function of the notice that rules provide. A strict rule of law proponent argues that the rule of law requires that rules provide notice so that people can govern their affairs.<sup>113</sup> Furthermore, "...they can do so only if laws are understandable, predictable, and fairly enforced."<sup>114</sup> Taxpayers require clear rules and notice of those rules so that they can effectively plan their affairs in accordance with the rules.<sup>115</sup> The government also seeks taxpayer reliance because it uses tax policy as an instrument to influence

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<sup>107</sup> See *Commissioner v. Newman*, 159 F.2d 848 (2<sup>nd</sup> Cir. 1947).

<sup>108</sup> *Id.*

<sup>109</sup> *Id.* at 850-51 (Hand, dissenting).

<sup>110</sup> See *id.*

<sup>111</sup> *Pacific First Fed. Sav. Bank v. Commissioner*, 961 F.2d 800, 803 (9<sup>th</sup> Cir. 1992).

<sup>112</sup> *United States v. Carlton*, 512 U.S. 26, 33 (1994). ("Tax legislation is not a promise, and a taxpayer has no vested right in the Internal Revenue Code."). Despite the fact that an argument from the rule of law perspective can be made that taxpayer reliance is a right, the Supreme Court has refused to find a constitutional violation of due process based on taxpayer reliance on the Code.

<sup>113</sup> Segall, *supra* note 63 at 996.

<sup>114</sup> *Id.*

<sup>115</sup> See *id.*

behavior toward desired social goals, this is evident from the legislative intent behind tax legislation.<sup>116</sup> Thus, adequate notice is necessary to influence taxpayer behavior in order to achieve the government's goals.<sup>117</sup> From the taxpayer and governmental perspective clear tax guidance is necessary to further effective policy and to promote the rule of law.<sup>118</sup>

#### 4. The Need for Discretion – The Rule Maker's Perspective

##### a. The Enacting of Anti-Abuse Rules

Although it appears that the realm of tax rulemaking has left the rule of man completely in favor of the rule of law, some discretion and flexibility are still necessary for a workable system of tax law promulgation, administration, and interpretation.<sup>119</sup> As taxation is one of the most complex and broad reaching areas of the law, the impossibility of legislating for all contingencies is accepted as part of the status quo.<sup>120</sup> Taxation that seeks to influence behavior toward social policy must also take into account the fact that taxpayer behavior can sometimes be influenced beyond the intent of legislation, and circumvent the purposes behind the laws.<sup>121</sup> Further, due to the nature of taxpayers in seeking to reduce their liability, legislators have instituted anti-abuse laws that try to prevent this circumvention of the purposes behind taxation.<sup>122</sup> These anti-abuse laws have a large degree of

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<sup>116</sup> Rosenberg, *supra* note 100, at 374.

<sup>117</sup> *See id.* at 68.

<sup>118</sup> *See id.* at 68-69. Note, Schwartzstein argues that the rule of law has been violated by the constant changes in the tax laws which hinder taxpayer notice and reliance on tax law. *Id.* (quoting Sheldon D. Pollack, *Tax Reform: The 1980's in Perspective*, 46 TAX L. REV. 489, 529 (1991) "The result is tax 'laws,' such as the passive activity loss rules, that defy the very notion of 'rule by law.' These are not laws in the traditional sense that the citizenry can take notice of, and accordingly plan their actions. Quite the contrary, it is unclear what activity or behavior is forbidden...and what is sanctioned...-the very essence of the rule of law. In many ways, it appears as if the ideal of the rule of law, a principal central to our liberal political culture, has been largely abandoned in the realm of tax law.").

<sup>119</sup> *See* James A. Gouwar, *The Proposed Partnership Anti-Abuse Regulation: Treasury Oversteps Its Authority*, 11 J. PARTNERSHIP TAX 'N 287, 289 (1995). *See generally* Debroah A. Geier, *Interpreting Tax Legislation: The Role of Purpose*, 2 FLA. TAX REV. 492 (1995).

<sup>120</sup> Gouwar, *supra* note 119 at 287-88; Daniel Halperin, *Are Anti-Abuse Rules Appropriate?*, 48 TAX LAW. 807, 808 (1995).

<sup>121</sup> *See* Gouwar, *supra* note 119 at 287-88. *See also* Halperin, *supra* note 120 at 808.

<sup>122</sup> Stuart L. Rosow, *The Taxation of Economic Reality The Role of Anti-Abuse Rules in Tax Administration*, 416 PLI/TAX 493, 497 (1998). *See also* Hoffman Fuller, *The Intent To*



discretion built in to their written law so that unintended taxpayer behavior can be curtailed.<sup>123</sup> Thus, the system of taxation, despite its rule-based nature, has recognized the need for governmental discretion and has written such necessary discretion into tax legislation.<sup>124</sup>

Tax law promotes behavior that will aggressively seek to reduce income taxes.<sup>125</sup> The system, it has been argued, is the source of the aggressive actions of taxpayers for several reasons.<sup>126</sup> First, the system is a system of self-assessment.<sup>127</sup> In self-assessment systems, the taxpayers are more likely to take chances and aggressive positions on certain items due to the fact that the chances of audit are relatively small.<sup>128</sup> Second, the system has an adversarial resolution of disputes, which encourages settlement by the government due to a lack of resources or will to prosecute the matter fully.<sup>129</sup> Finally, tax practitioners are sometimes seen as the impetus behind tax schemes or arrangements that push the envelope on tax reduction.<sup>130</sup> Such arrangements, although sometimes technically correct or acceptable results of the statutes and regulations, are not the intended results of the legislation.<sup>131</sup> Thus, the nature of the system is seen as the true cause of taxpayer behavior which seeks to aggressively reduce taxes, sometimes to the point of "abusing" the rules.<sup>132</sup>

Anti-abuse laws have been written in order to combat the inventiveness of taxpayers who seek to aggressively reduce their income taxes.<sup>133</sup> Most commonly, anti-abuse rules come in the form of a specific statutory enactment.<sup>134</sup> This type of anti-abuse rule is written when a particular abuse has been identified and the

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*Avoid Tax*, 70 TUL. L. REV. 2103 (1996).

<sup>123</sup> Rosow, *supra* note 122 at 497-99.

<sup>124</sup> *Id.* See also Halperin, *supra* note 120 at 812, 815-16.

<sup>125</sup> Rosow, *supra* note 122 at 497.

<sup>126</sup> *Id.* See generally Fuller, *supra* note 122.

<sup>127</sup> Rosow, *supra* note 122 at 497.

<sup>128</sup> *Id.* See also David P. Korteling, *Let me Tell you how it will be; Here's one for you, Nineteen for me: Modifying the Internal Revenue Service's Approach to Resolving Tax Disputes*, 7 ADMIN. L.J. AM. U. 659 (1994).

<sup>129</sup> Rosow, *supra* note 122 at 497.

<sup>130</sup> *Id.* at 497-98.

<sup>131</sup> *Id.* at 498. See also Sheldon I. Banoff, *The Use And Misuse of Anti-Abuse Rules*, 48 TAX LAW. 827, 835-36 (1995).

<sup>132</sup> Rosow, *supra* note 122 at 497. Note Rosow does not attempt to define what taxpayer actions constitute "abuse," but that inevitably abuses do occur.

<sup>133</sup> *Id.* at 497.

<sup>134</sup> *Id.* at 501. See generally Banoff, *supra* note 131 at 827-28.

enactment's purpose is to rectify the situation.<sup>135</sup> Other more general statutory anti-abuse rules have been written to espouse a specific statutory intent or purpose behind a provision, so that general abuses which do not conform to the legislative intent can be prevented.<sup>136</sup> Finally, judicially created anti-abuse rules generally are used by the courts in a broad and principle oriented approach to a taxpayer action.<sup>137</sup> All three types of anti-abuse rules have been utilized to prevent the inventive taxpayer from circumventing the government's intent behind tax rules.<sup>138</sup>

Despite the ease of categorizing anti-abuse rules, defining anti-abuse rules can be difficult.<sup>139</sup> Frank V. Battle Jr. defines anti-abuse rules by stating:

In its purist form, an anti-abuse rule is a rule designed to prevent a taxpayer from achieving a result which is inconsistent with a dominant policy of the law by altering the tax consequences which would otherwise have flowed from a transaction, to others more consistent with that policy.<sup>140</sup>

However, other definitions of anti-abuse rules take a more policy oriented approach.<sup>141</sup> Pamela Olson states: "anti-abuse provisions are necessary to encourage the exercise of sound judgment...., rather than the mechanical application of complex and detailed rules which may lead to results not anticipated and not consistent with statutory intent."<sup>142</sup> Thus, the definitions of anti-abuse rules are somewhat based on the purpose or intent with which anti-abuse rules are enacted.<sup>143</sup> Therefore, to adequately understand how the anti-abuse rule should be viewed with respect to the rule of law, a person must look toward the reason for the

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<sup>135</sup> Stuart L. Rosow, *The Taxation of Economic Reality: The Role of Anti-Abuse Rules in Tax Administration*, 431 PLI/TAX 1215, 1219 (1998).

<sup>136</sup> *Id.*

<sup>137</sup> *Id.*

<sup>138</sup> *Id.* See also Banoff, *supra* note 131 at 827-28.

<sup>139</sup> Rosow, *supra* note 122 at 499-500.

<sup>140</sup> Frank V. Battle, Jr., *The Appropriateness of Anti-Abuse Rules in the U.S. Income Tax Systems*, 48 TAX LAW. 801, 802 (1995).

<sup>141</sup> Rosow, *supra* note 122 at 499-500.

<sup>142</sup> See Pamela Olson, *Some Thoughts on Anti-Abuse Rules*, 48 TAX LAW. 817, 817 (1995).

<sup>143</sup> Rosow, *supra* note 122 at 499-500.

anti-abuse rule's enactment, and to the goals that it was meant to achieve or the functions it was meant to perform.<sup>144</sup>

Just as several different types of anti-abuse rules exist, there are many different reasons for their enactment.<sup>145</sup> First, as articulated previously, anti-abuse rules are enacted to correct perceived abusive transactions.<sup>146</sup> Second, anti-abuse rules have the purpose of illustrating statutory policy or explaining legislative intent behind tax provisions.<sup>147</sup> Third, anti-abuse rules satisfy the taxpayer's and practitioner's desire for more guidance on the tax laws and their intended operation.<sup>148</sup> Fourth, the protection of the government fisc is an important goal of anti-abuse rules.<sup>149</sup> Anti-abuse rules protect the fisc in two main ways, first by generally deterring transactions that will deplete the government's funds coming in, and second by providing solutions to revenue losses from misuse of provisions.<sup>150</sup> Fifth, anti-abuse rules are seen as the promoters of fairness because they place taxpayers who seek out tax advisors and taxpayers who do not on the same plateau.<sup>151</sup> Sixth, anti-abuse rules are supposed to promote simplification of the complexity contained in the Code.<sup>152</sup> General principles allow Congress and the Treasury the flexibility to promulgate shorter more concise rules.<sup>153</sup> Finally, anti-abuse rules are intended to act as a deterrent or warning to taxpayers who are considering playing the audit "gamble."<sup>154</sup> Anti-abuse rules have been enacted to serve many specific purposes, arguably their greatest overall function is to return some amount of discretion back to the rule-based system of taxation.<sup>155</sup>

Anti-abuse rules appear to be the solution to the problem of overly aggressive taxpayers abusing the system,<sup>156</sup> because the rules replace some of the discretion back into the tax system that has been eliminated by over-legislation. In fact the trend in tax rule promulgation has been toward placing general anti-abuse

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<sup>144</sup> See Rosow, *supra* note 135 at 1220-21 (discussing purposes of anti-abuse rules). See also Banoff, *supra* note 131 at 827-28 (discussing purposes and characteristics of anti-abuse rules).

<sup>145</sup> Rosow, *supra* note 135 at 1244.

<sup>146</sup> *Id.* See also Banoff, *supra* note 131 at 828.

<sup>147</sup> Rosow, *supra* note 135 at 1244. See also Banoff, *supra* note 131 at 830.

<sup>148</sup> Rosow, *supra* note 135 at 1244.

<sup>149</sup> *Id.*

<sup>150</sup> *Id.* See also Banoff, *supra* note 131 at 831-32.

<sup>151</sup> Rosow, *supra* note 135 at 1244.

<sup>152</sup> *Id.*

<sup>153</sup> *Id.* See also Banoff, *supra* note 131 at 830-31.

<sup>154</sup> Rosow, *supra* note 135 at 1244. See also Banoff, *supra* note 131 at 831-32.

<sup>155</sup> See Rosow, *supra* note 135, at 1245.

<sup>156</sup> Rosow, *supra* note 122 at 498-99. See also Banoff, *supra* note 131 at 831-33.

rules into statutes, and where there are not statutes, into the regulations proposed by the Treasury.<sup>157</sup> However, anti-abuse rules do pose problems from a rule of law standpoint.<sup>158</sup> First, the generality of anti-abuse rules which grant discretion to the Service can lead to the Service abusing its power over taxpayers.<sup>159</sup> In some situations the Service has used the power granted to them under anti-abuse rules to try to override precedents that have been long established.<sup>160</sup> Second, most anti-abuse rules remove predictability so that taxpayers cannot make decisions and act with certainty.<sup>161</sup> This lack of certainty and negative impact on decision making stems from the fact that taxpayers have no knowledge as to what the tax consequences of their actions will be.<sup>162</sup> Finally, from a pragmatic standpoint, anti-abuse rules can lead to the unnecessary interference by the Service in transactions that are legitimate.<sup>163</sup> It is just such harassment of the individual by the government that the rule of law seeks to prevent.<sup>164</sup> Therefore, anti-abuse rules, although a necessary mode of returning discretion to the system of taxation, do pose problems from the rule of law perspective.<sup>165</sup>

In summary, discretion is necessary to any system of law as Aristotle noted.<sup>166</sup> The government has tried to restore a level of discretion back into the tax system through the enactment or judicial creation of anti-abuse rules.<sup>167</sup> These rules have been necessary because taxpayers aggressively seek to reduce their taxes to the point of abusing the system and circumventing the legislative intent behind tax rules.<sup>168</sup> Further, anti-abuse rules and the discretion they provide are necessary because the legislature is incapable of creating a rule for every conceivable contingency or transaction.<sup>169</sup> However, from the rule of law standpoint, the creation of and the use of anti-abuse rules is not without flaws.<sup>170</sup> The problems

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<sup>157</sup> Rosow, *supra* note 122 at 499. *See also* Banoff, *supra* note 131 at 827.

<sup>158</sup> *See* Rosow, *supra* note 122 at 498.

<sup>159</sup> *See* Gouwar, *supra* note 119 at 292. *See also* Banoff, *supra* note 131 at 835.

<sup>160</sup> Gouwar, *supra* note 119 at 292. *See also* Banoff, *supra* note 131 at 837; Frank Lyon Co. v. United States, 435 U.S. 561 (1978); Newman v. Commissioner, 902 F.2d 159 (2d Cir. 1990); Uniroyal Inc. v. Commissioner, 65 T.C.M. (CCH) 2690 (1993).

<sup>161</sup> Gouwar, *supra* note 119 at 292. *See also* Banoff, *supra* note 131 at 835-36.

<sup>162</sup> Gouwar, *supra* note 119 at 292. *See also* Halperin, *supra* note 120 at 809.

<sup>163</sup> Rosow, *supra* note 135 at 1245. *See also* Halperin, *supra* note 120 at 808-09.

<sup>164</sup> *See* Rosow, *supra* note 135 at 1245-46.

<sup>165</sup> *See id.* *See generally* Banoff, *supra* note 131.

<sup>166</sup> ARISTOTLE, *supra* note 2.

<sup>167</sup> *See* Rosow, *supra* note 122 at 499-500.

<sup>168</sup> *Id.* at 497.

<sup>169</sup> *See* Halperin, *supra* note 120 at 808.

<sup>170</sup> *See id.* at 292.

arise when the discretionary power granted to the Service is abused.<sup>171</sup> Instead of using the anti-abuse rule to further one of the seven goals listed above, the Service uses the discretionary power to rewrite laws and precedents, or interfere with legitimate transactions.<sup>172</sup> Finally, the anti-abuse rule is problematic because it reduces taxpayer certainty as to how his affairs and transactions will be taxed.<sup>173</sup> Despite the problems that anti-abuse rules foster, most practitioners as well as lawmakers would agree that anti-abuse rules are necessary to the system of taxation.<sup>174</sup> Therefore, the anti-abuse rule, although subject to criticism from a rule of law standpoint, will not likely disappear from the system of taxation despite its problems.<sup>175</sup>

#### b. Retroactive Legislation

The tax system also restores discretion with the use of retroactivity in its legislative enactments.<sup>176</sup> This return of discretion through retroactivity is utilized by both the Congress and the Internal Revenue Service when they promulgate rules.<sup>177</sup> The Supreme Court has stated that due process is not necessarily offended by the enactment of retroactive legislation.<sup>178</sup> This reasoning holds that the system of taxation, unlike other areas of the law, is a system of apportionment of the burden of supporting the government and not a penalty or a contractual liability.<sup>179</sup> Further, no citizen is allowed to escape their civic burden of supporting the government, as they are privileged by the benefits of the government by virtue of their citizenship.<sup>180</sup> Therefore, imposing a taxing statute retroactively does not

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<sup>171</sup> *Id.* See generally Banoff, *supra* note 131.

<sup>172</sup> Rosow, *supra* note 135 at 1245. See also Banoff, *supra* note 131 at 836-37.

<sup>173</sup> Gouwar, *supra* note 119 at 292. See also Banoff, *supra* note 131 at 835.

<sup>174</sup> Rosow, *supra* note 122 at 499. See also Halperin, *supra* note 120 at 812.

<sup>175</sup> Rosow, *supra* note 122 at 499 (discussing increase in use of anti-abuse rules). See also Banoff, *supra* note 131 at 828-34 (discussing why the rules are increasingly utilized and the justifications for such rules).

<sup>176</sup> See generally Stephen R. Munzer, *A Theory of Retroactive Legislation*, 61 TEX. L. REV. 425 (1982).

<sup>177</sup> Benjamin J. Cohen & Catherine A. Harrington, *Is The Internal Revenue Service Bound by its Own Regulations and Rulings?* 51 TAX LAW. 675, 675 (1998), citing *Manhattan Gen. Equip. Co. v. Commissioner*, 297 U.S. 129 (1936).

<sup>178</sup> *Welch v. Henry*, 305 U.S. 134, 146-147 (1938). See also *United States v. Carlton*, 512 U.S. 26 (1994) (describing a specific instance in which a taxpayer was caught in the web of retroactive legislation when he had previously relied on a rule).

<sup>179</sup> *Welch* 305 U.S. at 146.

<sup>180</sup> *Id.* at 147.

necessarily offend due process, and no unconditional "right" to rely on tax legislation has been recognized by the Supreme Court.<sup>181</sup>

Retroactive legislation is enacted for a variety of reasons in the law of taxation, and for the most part the government does what it can to mitigate the effects of retroactivity.<sup>182</sup> Most often retroactive legislation is written to correct mistakes or errors in the function of tax provisions and is therefore justified.<sup>183</sup> The government's efforts to mitigate the hardship caused to taxpayers by changing a law on which they have previously relied are noteworthy.<sup>184</sup> For example, at one time the dividends paid on shares of stock in the form of stock were not taxable but cash dividends paid were.<sup>185</sup> Taxpayers tended to arrange their investments in reliance on the tax law, and purchase stock that paid dividends in stock rather than cash to avoid taxation.<sup>186</sup> Congress decided to correct this error, or loophole, in the Code and used a retroactive provision to do so.<sup>187</sup> Instead of making the rule harshly retroactive, Congress enacted a twenty-one year phase out period so that taxpayers would not be saddled with a large tax burden or forced to change their investments suddenly.<sup>188</sup> Thus, the government seeks to impose upon itself a limitation on the use of retroactivity and when retroactivity is necessary, it generally will try to protect the interests of those who have relied upon the old tax law to their detriment under the new law.<sup>189</sup>

Despite its constitutionality and despite Congress' efforts to minimize the negative effects on the taxpayer, retroactive legislation can create problems from a rule of law standpoint.<sup>190</sup> Generally, the rule of law value of fairness is compromised when the laws are changed after they have been relied upon.<sup>191</sup> As Steven R. Munzer states:

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<sup>181</sup> *See id.* at 146-47.

<sup>182</sup> Munzer, *supra* note 176 at 449. *See also* Cohen & Harrington, *supra* note 177, *citing* Manhattan Gen. Equip. Co. v. Commissioner, 297 U.S. 129 (1936).

<sup>183</sup> *See* Munzer, *supra* note 176 at 450.

<sup>184</sup> *See id.* at 449.

<sup>185</sup> Tax Reform Act of 1969, Pub. L. No. 91-172, 83 Stat. 487, § 421(a) (1969) (codified in scattered sections of 26 U.S.C.).

<sup>186</sup> Munzer, *supra* note 176 at 449.

<sup>187</sup> *Id.*

<sup>188</sup> *See id.*

<sup>189</sup> *See id.* at 448-50. The author uses the term entrenching to show how Congress tends to protect the property interests of taxpayers when enacting retroactive legislation.

<sup>190</sup> Munzer, *supra* note 176 at 425.

<sup>191</sup> *See id.*

The central purpose of law is to guide behavior. When legislatures create rules, a person properly forms expectations about how the legal system will respond to his actions. Retroactive laws frustrate the central purpose of law by disrupting expectations and actions taken in reliance on them. This disruption is always costly and rarely defensible.<sup>192</sup>

Thus, retroactivity has generally been frowned upon because it is an unfair legislative act that defeats taxpayer expectations.<sup>193</sup> The rule of law value of giving citizens notice from rules that are fixed and publicly known in advance is also compromised.<sup>194</sup> This violation of rule of law principles hinders the ability of a taxpayer to plan his activities according to the rules that govern his behavior.<sup>195</sup> Therefore, retroactive laws in taxation are difficult to reconcile from a rule of law standpoint, and can be hard to justify despite the lack of a judicially acknowledged right to rely.<sup>196</sup>

Retroactive legislation is problematic when analyzing it in light of rule of law principles because it seeks to change the rules that govern behavior either during or after the behavior has taken place.<sup>197</sup> Given that the rule of law stands for the stability of societal institutions that govern citizen behavior, these changes are a direct violation of the rule of law.<sup>198</sup> However, because Congress chooses to use retroactive legislation sparingly, and generally when it does so, it tries to protect the interests of those who will be affected, retroactive legislation is generally permitted.<sup>199</sup> Further, due to the fact that the Supreme Court has held that the Code does not grant the right to rely, no constitutional violation necessarily occurs

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<sup>192</sup> *Id.* at 426-27. See also Cohen & Harrington, *supra* note 177 at 675 (arguing that the Taxpayer Bill of Rights 2 may also frown upon retroactive legislation and discourage its use).

<sup>193</sup> Munzer, *supra* note 176 at 426-27.

<sup>194</sup> *Id.*

<sup>195</sup> *Id.* See also Cohen & Harrington, *supra* note 177 at 678-79 (arguing that retroactivity is an abuse of discretion).

<sup>196</sup> Munzer, *supra* note 176 at 426-27.

<sup>197</sup> See *id.* at 425.

<sup>198</sup> See Schwartzstein, *supra* note 96 at 76 and *supra* Section II.A.

<sup>199</sup> Munzer, *supra* note 176 at 448-50.

either.<sup>200</sup> Therefore, retroactive tax legislation has governmental support and in many instances is considered a justified violation of the rule of law.<sup>201</sup>

### C. Summary of The Rule of Law in the Tax Realm

The rule of law is a fluid conceptual framework that provides guidance as to how a workable system of laws should function. As Aristotle noted, both a system of written laws and a system of equity or discretion are necessary in order to fulfill the principles of the rule of law and have an effective government.<sup>202</sup> The rule of man and the rule of law must always be balanced against each other, and the balance should be maintained with an eye toward the principles A. V. Dicey illustrated.<sup>203</sup> Furthermore, the rule of law is necessary from both the standpoint of the government that is applying the law and from the standpoint of the citizens bound by it.<sup>204</sup> From constitutional scholars we glean three separate requirements of the rule of law, the first requirement is that a system of written laws should predominate over a system of individual discretion.<sup>205</sup> Second, equality must be maintained so that all citizens are subject to the law, and all similarly situated citizens are treated equally by it.<sup>206</sup> Finally, the government must have limited powers, adhere to separation of powers principles, and be subject to adequate judicial review.<sup>207</sup>

The rule of law as it applies to the system of taxation has many implications. The law of taxation has radically changed since its early years when it was a simple system of broadly worded rules that relied on the judicial system to interpret and clarify the system.<sup>208</sup> The role of the Internal Revenue Service administrative agency has expanded.<sup>209</sup> The administrative agency has promulgated rules that Congress does not have the expertise to legislate itself, and has done so more effectively and efficiently.<sup>210</sup> However, the rise of the use of the administrative agency poses special separation of powers problems.<sup>211</sup> Most often

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<sup>200</sup> See Welch 305 U.S. at 146-147.

<sup>201</sup> Munzer, *supra* note 176 at 448-50.

<sup>202</sup> ARISTOTLE, *supra* note 2.

<sup>203</sup> Epstein, *supra* note 8 at 151. (citing DICEY, *supra* note 16).

<sup>204</sup> See Fallon, *supra* note 5 at 3.

<sup>205</sup> Epstein, *supra* note 8 at 151. (citing DICEY, *supra* note 16).

<sup>206</sup> See *id.*

<sup>207</sup> See *supra* Section II.B.2.

<sup>208</sup> See Colliton, *supra* note 37 at 265-67.

<sup>209</sup> Marra, *supra* note 55 at 767.

<sup>210</sup> *Id.* at 777.

<sup>211</sup> Verkuil, *supra* note 60 at 307.



these problems are analyzed from the standpoint that the government should function with a system of checks and balances to prevent the concentration of power in any one area.<sup>212</sup> This school of thought recognizes the necessity of the administrative agency to the system of tax law, but will find a constitutional violation when the agency is guilty of “undue” or “excessive” use of power.<sup>213</sup> Furthermore, the concept of judicial review is seen as the restraining hand on agency power when the legislative and executive branches do not maintain some degree of separation of powers.<sup>214</sup>

The rule of law also seeks to maintain a balanced system with some discretion intermingled in a system comprised of primarily rule-based laws. In this regard we must look to the two competing forces on the continuum. First, the taxpayer prefers a system of definite written rules upon which he can rely in making his decisions.<sup>215</sup> The government also appears to favor such concreteness because taxpayer reliance on incentives is the best way to further the social policy goals of the government.<sup>216</sup> The courts have further acknowledged taxpayer reliance on tax law is an important aspect to the function of the tax system, and have stopped just short of proclaiming that taxpayers have a right to rely on tax guidance.<sup>217</sup>

The other side of the coin is the need for discretion. Most often the government is the biggest proponent of adding more discretion into the system so that it will be given a tool to combat unanticipated taxpayer behavior without resorting to congressional enactments every time a problem arises.<sup>218</sup> The government has enacted anti-abuse rules in several different ways.<sup>219</sup> Most obviously opposed to rule of law values, is the broadly worded statutory enactment that codifies legislative intent and purpose behind a statute.<sup>220</sup> These anti-abuse rules place a great deal of discretion back into the government’s hands and consequently reduce taxpayer certainty and ability to rely on the written statute.<sup>221</sup> Finally, the use of retroactive legislation also returns a certain amount of discretion back to the government.<sup>222</sup> Despite the fact that retroactive legislation does not

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<sup>212</sup> Marra, *supra* note 55 at 779-85.

<sup>213</sup> See Sargentich, *supra* note 71 at 440-41.

<sup>214</sup> See Medina, *supra* note 72 at 1554-55.

<sup>215</sup> See Schwartzstein, *supra* note 96 at 62.

<sup>216</sup> See Rosenberg, *supra* note 100 at 374.

<sup>217</sup> See *Commissioner v. Newman*, 159 F.2d 848, 850-51 (2d Cir. 1947) (Hand, dissenting).

<sup>218</sup> See Rosow, *supra* note 122 at 527-31.

<sup>219</sup> *Id.* at 501.

<sup>220</sup> See *Id.* at 498-99, 528.

<sup>221</sup> Gouwar, *supra* note 119 at 292.

<sup>222</sup> See generally Munzer, *supra* note 176.

offend due process, it undeniably offends the rule of law regardless of the justification behind such an enactment.<sup>223</sup>

The rule of law has many implications when it is applied to the realm of tax law. The task now is to determine if, given these values in our governmental system, the rule of law has been compromised too much to the discretion of the rule of man so that the system is invalid in the eyes of the rule of law. Although even the most renowned scholars have difficulty in determining when the rule of law has been overly offended, some guidance can be found. The discussion must move on to the more specific analysis of §446, and the Commissioner's clear reflection of income powers.

### III. §446 – THE COMMISSIONER'S CLEAR REFLECTION OF INCOME POWER

#### A. §446 – *The General Rule for Methods of Accounting and its Exception*

Section 446 of the Internal Revenue Code was enacted to give guidance to taxpayers as to what type of accounting method is acceptable for computing taxable income.<sup>224</sup> “Although a number of code provisions form the skeletal framework of tax accounting, the backbone of this statutory scheme is indisputably section 446.”<sup>225</sup> Thus, §446 is considered to be the fundamental provision that gives guidance to taxpayers about methods of accounting.<sup>226</sup> Generally, the provision holds that the method acceptable is the method used by the taxpayer in keeping his books.<sup>227</sup> The provision also lists specific acceptable methods, which include the cash receipts and disbursements method, the accrual method, or a hybrid method so long as it has been permitted by the Code or the Secretary.<sup>228</sup> Further, the provision provides that a taxpayer, who has used a specific method of accounting and wishes to changes his method, must obtain the consent of the Secretary before he

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<sup>223</sup> *Id.*

<sup>224</sup> I.R.C. § 446 (1994). Note that the term method of accounting is used to describe both an overall method for accounting for revenues and expenses as well as methods that are used to apply to single items of revenue or expense, Treas. Reg. § 1.446-1(a)(1) (as amended in 1999).

<sup>225</sup> Francis M. Allegra, *Section 482: Mapping the Contours of the Abuse of Discretion Standard of Judicial Review*, 13 VA. TAX REV. 423, 475 (1994).

<sup>226</sup> *Id.*

<sup>227</sup> § 446(a).

<sup>228</sup> § 446(c).

determines his taxable income using the new method.<sup>229</sup> If a taxpayer does not obtain such consent, he could be subject to penalties or additional taxes.<sup>230</sup>

Section 446 also contains a broadly worded statutory anti-abuse rule, which states the policy behind the provision.<sup>231</sup> This anti-abuse rule takes the form of an exception to the general rule that a taxpayer may use an accounting method for the computation of taxable income that is used ordinarily in computing the taxpayers books.<sup>232</sup> The exception 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>233</sup> The statute is silent as to the definition of what "clearly reflect income" means and only gives the language itself as guidance.<sup>234</sup> The language tends to grant two separate powers to the Secretary.<sup>235</sup> First, the Secretary has the power to determine whether a taxpayer's method of determining taxable income is accurate.<sup>236</sup> Second, the Secretary has the power to choose an alternative method of accounting for the taxpayer that, in his opinion, does clearly reflect taxable income.<sup>237</sup> Thus, the Secretary has the power to determine if a violation of the statute has taken place and the power to remedy the violation by requiring a taxpayer to recompute his income under a new method.<sup>238</sup>

The concept of a "clear reflection of income" does not have a definition in the Code and also does not have a definition in the regulations that accompany §446.<sup>239</sup> However, some guidance can be gleaned from the regulations.<sup>240</sup> Regulation 1.446-1(a)(2) states in part that no uniform method of accounting will be the correct method for all taxpayers and thus, some leeway is given to the taxpayer to pick a method that will work for his business and industry.<sup>241</sup> The Regulation states:

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<sup>229</sup> § 446(e).

<sup>230</sup> § 446(f). Note: Although an interesting topic, the procedures and implications of a change in accounting methods under § 446 is not the focus of this article.

<sup>231</sup> § 446(b).

<sup>232</sup> § 446(a) & (b).

<sup>233</sup> § 446(b).

<sup>234</sup> *See id.*

<sup>235</sup> *See id.*

<sup>236</sup> *See id.*

<sup>237</sup> *See id.*

<sup>238</sup> *See id.*

<sup>239</sup> Allegra, *supra* note 225 at 475-76.

<sup>240</sup> *See* Treas. Reg. § 1.446-1(a)(2) (as amended in 1997).

<sup>241</sup> *Id.*

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>242</sup>

Thus, a taxpayer who computes his income based on generally accepted accounting principles, or "G.A.A.P.," has a fighting chance for clearly reflecting his income, but cannot rely on that factor alone to demonstrate compliance.<sup>243</sup> The Regulation, rather than creating a safeharbor for taxpayers, gives the taxpayer guidance as to one of the factors that the Secretary uses in his analysis to determine whether an accounting method clearly reflects the taxpayer's income.<sup>244</sup>

The Code and Regulation create ambiguity for the taxpayer who wishes to know whether his accounting method clearly reflects his income.<sup>245</sup> This ambiguity is directly caused by the statutory language of the anti-abuse rule that seeks to grant discretionary power to the Secretary.<sup>246</sup> Section 446 is discretion-conferring because it relies upon the opinion of a person to make the determination, a rule of man judgment.<sup>247</sup> The regulations provide little guidance as well because they seek to protect the reserved discretion given to the Secretary and only give taxpayers one factor that will guide the decision as to whether the method of accounting they have selected will clearly reflect income.<sup>248</sup> Therefore, the taxpayer must turn to the courts for guidance as to how §446 will function and in order to find a definition for the language "clearly reflect income."<sup>249</sup>

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<sup>242</sup> *Id.*

<sup>243</sup> *Clement v. United States*, 580 F.2d 422, 430 (Ct. Cl. 1978).

<sup>244</sup> *See* Treas. Reg. § 1.446-1(a)(2) (1999).

<sup>245</sup> *See Allegra, supra* note 225 at 475-76.

<sup>246</sup> *See* § 446(b).

<sup>247</sup> *See* Treas. Reg. § 1.446-1(a)(2) (1999).

<sup>248</sup> *See id.*

<sup>249</sup> *Rosow, supra* note 122 at 509-10.

### B. Judicially Developed Guidance

The Service and courts have focused on a number of factors when making a determination as to whether a taxpayer has clearly reflected his income.<sup>250</sup> As stated in the regulations, one of the biggest factors is whether the taxpayer has used a method of accounting that is in accordance with G.A.A.P.<sup>251</sup> Although compliance is not in and of itself considered determinative, a taxpayer who conforms to G.A.A.P. will have a greater chance of clearly reflecting his income.<sup>252</sup> Another factor to be considered is whether the taxpayer's accounting method is reflective of industry practice in general.<sup>253</sup> A taxpayer who uses the same system of accounting as the majority of taxpayers in his industry will be more likely to clearly reflect income than a taxpayer using a novel method or one that does not have wide support for its use.<sup>254</sup>

Another factor is based on the consistency of the taxpayer's use of this accounting method.<sup>255</sup> As the Regulation states, consistency in the application will strengthen a taxpayer's likelihood of having a method that clearly reflects income.<sup>256</sup> The Internal Revenue Service's reaction to a method of accounting is also a factor used by the courts in determining clear reflection.<sup>257</sup> If a taxpayer uses a method that has received prior favorable treatment by the Service, then courts will more likely find clear reflection than if the taxpayer used a method that the Service did not give favorable consideration.<sup>258</sup> Finally, another factor to consider is whether a method has enjoyed an absence of challenge by the Service for a long period of time.<sup>259</sup> The method is more likely to clearly reflect income if it has not been challenged by the Service.<sup>260</sup> These factors must be weighed in view of each other as no one factor will be determinative in all cases, and a different combination of factors will be important depending on the facts and circumstances of the situation. Therefore, the discretion conferred by Congress in §446 is protected by the Treasury and the courts, and a facts and circumstances analysis is necessary in all clear reflection of income cases.

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<sup>250</sup> Rosow, *supra* note 135 at 1227-28.

<sup>251</sup> Garth v. Commissioner, 56 T.C. 610, 619 (1971).

<sup>252</sup> *Id.* at 619-23.

<sup>253</sup> Public Service Co. v. Commissioner, 78 T.C. 445, 456 (1982).

<sup>254</sup> See Rosow, *supra* note 135 at 1227.

<sup>255</sup> Fort Howard Paper Co. v. Commissioner, 49 T.C. 275, 286-87 (1967).

<sup>256</sup> See *id.*

<sup>257</sup> Pierce Ditching Co. v. Commissioner, 73 T.C. 301, 306 (1979).

<sup>258</sup> *Id.*

<sup>259</sup> Public Service Co. v. Commissioner, 78 T.C. 445, 456 (1982).

<sup>260</sup> See *id.*

## IV. THE ABUSE OF DISCRETION STANDARD OF REVIEW

A. *The Source & Definition of The Abuse of Discretion Standard of Review*

In 1946, Congress enacted the Administrative Procedure Act, or "A.P.A.," in order to place a check on the power of administrative agencies.<sup>261</sup> The A.P.A. designed a provision that gives courts a standard for reviewing the determinations of agencies.<sup>262</sup> The stated purpose behind the A.P.A.'s provision was "to restate the law of judicial review."<sup>263</sup> Thus, some definitional guidance about the standard can be gained from looking to the statute.<sup>264</sup> Further, non-tax administrative agency decisions made by the Supreme Court can shed some light on the standard of review.<sup>265</sup> Comparing the abuse of discretion standard to other standards of review will also prove helpful in understanding how the standard is used by the courts. Thus, the A.P.A. and some related case law will help to define the abuse of discretion standard of review before we foray into its taxation application.

The Administrative Procedure Act §706(2)(A)<sup>266</sup> states the standard of review for courts when reviewing an agency determination:

To the extent necessary to decision and when presented, the reviewing court shall decide all relevant questions of law, interpret constitutional and statutory provisions, and determine the meaning or applicability of the terms of an agency action. The reviewing court shall . . . (2) hold unlawful and set aside agency action, findings, and conclusions found to be (A) arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law; . . . (E) unsupported by substantial evidence in a case subject to sections 556 and 557 of this title or otherwise reviewed on

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<sup>261</sup> *Currently* 5 U.S.C. § 551-§ 559, § 701-§ 706, § 1305, § 3105, § 3344, § 4301, § 5335, § 5372, § 7521 (1994).

<sup>262</sup> *Id.*

<sup>263</sup> U.S. DEP'T OF JUSTICE, ATTORNEY GENERAL'S MANUAL ON THE ADMINISTRATIVE PROCEDURE ACT 9 (1973).

<sup>264</sup> Allegra, *supra* note 225 at 456-57. "Judges writing tax opinions characteristically expend few words (often the same ones) describing the mechanics of abuse of discretion review." *Id.* at 473.

<sup>265</sup> *Id.* at 458-60.

<sup>266</sup> 5 U.S.C. § 706(2)(A) (1994).

the record of an agency hearing provided by statute; or (F) unwarranted by the facts to the extent that the facts are subject to trial de novo by the reviewing court.<sup>267</sup>

The stated intention of this language was to reiterate the general notion of judicial review.<sup>268</sup> The legislative history states further that this statement of judicial review was not meant to change the way courts have always adjudicated such cases.<sup>269</sup> In fact the legislative history states in part that under the notion of judicial review, courts with proper jurisdiction have always had the power to overturn cases that were not in accordance with the law, arbitrary or capricious, or an abuse of discretion.<sup>270</sup> Therefore, the A.P.A. simply codified what the legislature considered to be a general notion of judicial review.<sup>271</sup>

The Supreme Court in dealing with the A.P.A. standard has articulated that the courts cannot substitute their judgment for that of the agency making the determination.<sup>272</sup> In fact, the courts' primary function is to evaluate the choice of the administrative agency looking to all the relevant facts to see if there has been a "clear error of judgment" by the agency.<sup>273</sup> In *Motor Vehicle Manufacturers Association of the United States v. State Farm Mutual Automobile Insurance Co.*,<sup>274</sup> the Court articulated four ways in which an agency's determination or actions are arbitrary and capricious:<sup>275</sup>

[I]f the agency has relied on factors which Congress has not intended it to consider, entirely failed to consider an important aspect of the problem, offered an explanation for its decision that runs counter to the evidence before the agency, or is so implausible that it could not be

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<sup>267</sup> *Id.*

<sup>268</sup> U.S. DEP'T OF JUSTICE, *supra* note 263, at 9.

<sup>269</sup> Allegra, *supra* note 225 at 457-58 (citing U.S. DEP'T OF JUSTICE, *supra* note 263, at 9).

<sup>270</sup> *Id.*

<sup>271</sup> *Id.*

<sup>272</sup> *Citizens to Preserve Overton Park, Inc. v. Volpe*, 401 U.S. 402, 416 (1971), *overruled by Califano v. Sanders*, 430 U.S. 99 (1977).

<sup>273</sup> *Id.*

<sup>274</sup> 463 U.S. 29 (1983).

<sup>275</sup> *Id.* at 42.

ascribed to a difference in view or the product of agency expertise.<sup>276</sup>

The Court thus articulates its limitations and the circumstances that call for judicial overturning of agency actions.<sup>277</sup> The Court's position has been summarized as insuring that agencies use reasoned decision-making in determinations.<sup>278</sup> Therefore, the court system's role in judicially reviewing agency determinations is primarily to make sure the decision-making process was rational, and not necessarily whether the decision itself was the decision the court would have reached.<sup>279</sup> However, the substantive decision is subject to reversal in cases where the result is not within the bounds of reasoned decision-making.<sup>280</sup>

The abuse of discretion standard of review involves the use of such terms as arbitrary, capricious, and lack of rationality.<sup>281</sup> This standard of review, as defined by the courts, appears to place quite a restriction on the court's ability to interfere in agency determinations.<sup>282</sup> Conversely, the legislative history states that §706(2)(A) of the A.P.A. was only meant to restate the concept of judicial review, which would appear to be a less strict view than the Supreme Court's vision of the standard.<sup>283</sup> However, it is difficult to gauge just how restrictive the standard is without looking to other standards of review to help place the abuse of discretion standard on a continuum of judicial power.<sup>284</sup>

The standard that grants a court the most power to determine cases is the "de novo" standard of review.<sup>285</sup> Under de novo review, the court is allowed to make its own independent determination of the substantive issues involved in an administrative proceeding.<sup>286</sup> However, even under de novo review, the court is sometimes bound to give deference to an administrative interpretation.<sup>287</sup> The next

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<sup>276</sup> *Id.* at 43.

<sup>277</sup> *Id.*

<sup>278</sup> *See* United States v. Garner, 767 F.2d 104, 116 (5<sup>th</sup> Cir. 1985).

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

<sup>280</sup> Baltimore Gas and Elec. Co. v. Natural Resources Defense Council, Inc., 462 U.S. 87, 104-06 (1983).

<sup>281</sup> Allegra, *supra* note 225 at 460.

<sup>282</sup> *See id.*

<sup>283</sup> *Id.* at 457 (citing U.S. DEP'T OF JUSTICE, *supra* note 269 at 9).

<sup>284</sup> *Id.* at 461-62.

<sup>285</sup> *Id.* at 462.

<sup>286</sup> *Id.* (citing United States v. Raddatz, 447 U.S. 667, 690 (1980)).

<sup>287</sup> Allegra, *supra* note 225 at 463. (citing Chevron, U.S.A., Inc. v. Natural Resources Defense Council, Inc., 467 U.S. 837, 843 (1984)).



standard along the continuum is the “clearly erroneous” standard of review.<sup>288</sup> Under this standard, the court is more restricted than under *de novo* because the court is allowed to review the entire body of evidence under which the agency made its determination, and only if the administrative agency has made a mistake can its determination be overruled.<sup>289</sup> Thus, only when the court holds a definite and firm conviction that the agency made a mistake can it change the determination made by the agency.<sup>290</sup>

The “substantial evidence” standard of review restricts the courts more than the previous two standards.<sup>291</sup> The purpose of the substantial evidence standard is to have the court determine that “there is a relatively high probability that the agency’s determination is correct.”<sup>292</sup> Thus, the substantive question’s correctness should almost be ignored and the court should look to see if a reasonable person could come to the same decision based on all the relevant factors.<sup>293</sup> Substantial evidence thus becomes a mostly procedural question, and a higher degree of error from the administrative agency can be tolerated than under the previous two standards.<sup>294</sup> Finally along the spectrum of standards of review, the abuse of discretion or arbitrary and capricious standard of review falls the furthest toward procedural inquiry and error toleration.<sup>295</sup> According to Maurice Rosenberg, under the abuse of discretion standard of review, the agency’s decision is protected by:

a kevlar shield, theoretically all but impregnable to the reviewing court’s prodding, provided that the agency’s decision has been forged in a process in which it considered all relevant factors and balanced those factors in a rational fashion. In short, an agency operating under this standard is granted an uncommon privilege in the American legal system – ‘a limited right to be wrong ... without being reversed.’<sup>296</sup>

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<sup>288</sup> Allegra, *supra* note 225 at 464-65.

<sup>289</sup> *Id.* at 465. (citing *United States v. United States Gypsum Co.*, 333 U.S. 364, 395 (1948)).

<sup>290</sup> Allegra, *supra* note 225 at 465 (citing *Gypsum*, 333 U.S. at 395).

<sup>291</sup> Allegra, *supra* note 225 at 467.

<sup>292</sup> *Id.* at 469. (citing 2 CHARLES H. KOCH, JR., *ADMINISTRATIVE LAW AND PRACTICE* § 9.4 (1985)).

<sup>293</sup> Allegra, *supra* note 225 at 469.

<sup>294</sup> *Id.* at 469-70.

<sup>295</sup> *Id.* at 470-72.

<sup>296</sup> *Id.* at 473. (quoting Maurice Rosenberg, *Judicial Discretion of the Trial Court: Viewed from Above*, 22 SYRACUSE L. REV. 635, 649 (1971)).

Thus, the abuse of discretion standard of review is the most limited in scope, and the standard that most binds the hands of the courts reviewing an agency's determination.<sup>297</sup>

In summary, the A.P.A. has given guidance as to the definition of the abuse of discretion standard of review.<sup>298</sup> The standard was created with the purpose to reinstate judicial review over administrative agency determinations.<sup>299</sup> The Supreme Court has noted that under the standard, a court can only invalidate a determination when the determination is irrational or not based upon all the relevant factors that should have been taken into account.<sup>300</sup> In no way does this standard of review allow a court to invalidate a determination simply because it would have come to a different conclusion than the agency.<sup>301</sup> Furthermore, when looking to the continuum of review granted to courts, the abuse of discretion standard limits the power of the courts to the greatest extent when compared to the other standards.<sup>302</sup> Thus, the reversal of an agency determination when the court is limited to the abuse of discretion standard of review should be rare and only occur in the most extreme of cases.<sup>303</sup>

### *B. Fleshing Out The Abuse of Discretion Standard – Judicial Tax Determinations*

The abuse of discretion standard is the standard of review courts use when the Commissioner has determined a taxpayer does not clearly reflect his income under §446.<sup>304</sup> As scholars have noted, courts in §446 cases generally do not spend much of their opinions dissecting or defining the standard of review they will be using in the case.<sup>305</sup> Courts instead apply the standard in taxation cases based on their experience and understanding of the standard with very conclusory methods.<sup>306</sup> The first part of this section will discuss the burden of proof placed on the taxpayer in §446 clear reflection of income cases. Next, guidance will be taken from §446 cases where the taxpayer has prevailed by analyzing some of the language the courts have used in illustrating what an abuse of discretion is. Finally, the difficulty that

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<sup>297</sup> See Allegra, *supra* note 225 at 473.

<sup>298</sup> 5 U.S.C. § 706(2)(A) (1994).

<sup>299</sup> U.S. DEP'T OF JUSTICE, *supra* note 263, at 9.

<sup>300</sup> United States v. Garner, 767 F.2d 104, 116 (5<sup>th</sup> Cir. 1985).

<sup>301</sup> *Id.*

<sup>302</sup> Allegra, *supra* note 225 at 473.

<sup>303</sup> *Id.* at 472.

<sup>304</sup> *Id.* at 478-79 (citing Thor Power Tool Co. v. Commissioner, 439 U.S. 522, 532-33 (1979)).

<sup>305</sup> *Id.* at 473.

<sup>306</sup> *Id.*

the abuse of discretion standard of review places on the courts will be illustrated by showing when great legal minds have differed in their opinion of how the standard functions.

The burden of proof in clear reflection of income cases is placed solely on the taxpayer who is challenging the Service's determination.<sup>307</sup> The taxpayer must prove that the Commissioner has abused his power and discretion in coming to his determination that the taxpayer is not clearly reflecting income.<sup>308</sup> Because there are two separate and distinct powers granted to the Service in deciding §446 cases, the power to find that the taxpayer has not clearly reflected income and the power to choose an alternative method of accounting for the taxpayer, the taxpayer appears to have a choice in showing where the Service has abused its power.<sup>309</sup> However, a taxpayer will not win his case unless he has shown that the Service was abusing its discretion with respect to the determination that the taxpayer's accounting method did not clearly reflect income.<sup>310</sup> Thus, the thrust of the issue of the burden of proof, is to show that the chosen method by the taxpayer is clearly reflective of income, and that the Commissioner did not rationally come to his conclusion.<sup>311</sup>

Because the regulations state that generally a method of accounting that is in conformity with G.A.A.P., will be found to clearly reflect income, some taxpayers have argued that they have met their burden.<sup>312</sup> The crux of this argument is that they have met a burden by proving their conformity with G.A.A.P. and thus, the burden of proof should shift to the Commissioner to prove that the taxpayer does not clearly reflect income.<sup>313</sup> However, the courts have not given this argument weight because the regulations are only meant to be a guideline to the taxpayer, and do not statutorily provide for a burden shifting to the Commissioner.<sup>314</sup> The courts have further held that the establishment of any other specific fact will also not shift the burden of proof to the Service.<sup>315</sup> Thus, the

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<sup>307</sup> Thor, 439 U.S. at 532. See also *Tog Shop v. United States*, 721 F.Supp. 300 (M.D. Ga. 1989), *aff'd*, 916 F.2d 720 (11<sup>th</sup> Cir. 1990).

<sup>308</sup> Thor, 439 U.S. at 533.

<sup>309</sup> *Asphalt Products Co. v. Commissioner*, 796 F.2d 843, 847 (6<sup>th</sup> Cir. 1986), *rev'd*, *Commissioner v. Asphalt Products Co.*, 482 U.S. 117 (1987). See also *Allegra*, *supra* note 225 at 478.

<sup>310</sup> *Allegra*, *supra* note 225 at 479.

<sup>311</sup> *Id.* at 478-79.

<sup>312</sup> Thor, 439 U.S. at 538-40; *American Auto. Ass'n v. United States*, 367 U.S. 687, 693 (1961).

<sup>313</sup> Thor, 439 U.S. at 538-39.

<sup>314</sup> See *id.* at 540.

<sup>315</sup> See *id.*

burden of proof throughout the litigation of a clear reflection of income case rests solely with the taxpayer.<sup>316</sup> In the words of the late Justice Brandeis, the taxpayer bears a "heavy burden of proof" in clear reflection of income cases.<sup>317</sup>

A few words have been said about the standard of review in §446 cases. For example, the standard has been drawn out by Justice Blackmun who stated that the Service's determination will not be overturned unless it is plainly arbitrary.<sup>318</sup> In *Thor Power Tool Co. v. Commissioner*,<sup>319</sup> quoting *Lucas v. American Code Co.*,<sup>320</sup> the Court stated that: "Since the Commissioner has 'much latitude for discretion,' his interpretation of the statute's clear-reflection standard 'should not be interfered with unless clearly unlawful.'"<sup>321</sup> Therefore, the Court combined the concept of the abuse of discretion standard in terms of the lawfulness of the actions of the administrative agency.<sup>322</sup> However, the lawfulness of the agency action relates back to A.P.A.'s definition of judicial review.<sup>323</sup> Hence, no further guidance is really gained from the few words the Court used to describe the standard of review. But, the Court does recognize that the standard of review has some teeth to it when, as it was upholding the Commissioner's determination, it stated "the Commissioner's discretion is not unbridled and may not be arbitrary. . . ."<sup>324</sup> Therefore, the Court does allude to the fact that in some cases the Commissioner will be reversed, and the abuse of discretion standard of review will not always require the courts to uphold the determinations of the Commissioner.<sup>325</sup>

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<sup>316</sup> *See id.*

<sup>317</sup> *Id.* at 532. (quoting *Lucas v. Kansas City Structural Steel Co.*, 281 U.S. 264, 271 (1930)). Note The Taxpayer Bill of Rights 3 contains a change in the burden of proof for the litigation of tax cases. *See* 26 U.S.C.A. § 7491 (West Supp. 1999). The change states that upon the showing of credible evidence by the taxpayer in a court proceeding the burden of proof will shift to the Commissioner to prove his case. § 7491 (a)(1). This change applies to tax litigation stemming from examinations that begin after the date of enactment. Thus, the effects of the change in the burden of proof, if any, will not be evident for some time.

<sup>318</sup> *Thor*, 439 U.S. at 533. (citing *Lucas*, 281 U.S. at 271).

<sup>319</sup> 439 U.S. 522 (1979).

<sup>320</sup> 280 U.S. 445 (1930).

<sup>321</sup> *Thor*, 439 U.S. at 532. (quoting *Lucas V. American Code Co.*, 280 U.S. 445, 449 (1930)).

<sup>322</sup> *See Thor*, 439 U.S. at 532.

<sup>323</sup> *See* 5 U.S.C. § 706(2)(A) (1994).

<sup>324</sup> *Thor*, 439 U.S. at 533.

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

Despite the nearly insurmountable task of overcoming the burden of proof on the taxpayer and the strict standard of review affording considerable deference to the Commissioner, the taxpayer has won in some instances, albeit very few. In order to fully understand the abuse of discretion standard, it is important to look to a few cases and why the courts have found an abuse of discretion by the Commissioner. In the cases where the taxpayer has won, the facts are very important to the court's decision that the Commissioner abused his power.<sup>326</sup> The judgment of abuse of discretion is based in part on the same factual circumstances the Commissioner uses to see if a taxpayer has clearly reflected his income.<sup>327</sup> The Commissioner judges the taxpayer based on the facts, and the courts judge the Commissioner based on those same facts. Therefore, the Commissioner must have incorrectly determined that the taxpayer failed to clearly reflect his income as a prerequisite to the determination that the Commissioner abused his power.<sup>328</sup> The Commissioner must then be found to have no rational basis in fact for his incorrect determination in order to have abused his discretion.<sup>329</sup> Therefore, a two level analysis is used to illustrate the abuse of discretion standard of review.

In the case *Van Pickerill & Sons, Inc. v. United States*,<sup>330</sup> a taxpayer used a method of accounting for inventories that the Commissioner determined was not clearly reflective of income.<sup>331</sup> Van Pickerill, a wholesale distributor of liquor, would purchase whiskey and have it aged it for approximately four years by the seller before it would engage in bottling and selling the whiskey.<sup>332</sup> The seller would charge the taxpayer/distributor a monthly fee for storing and aging the whiskey, but the taxpayer would not pay the fees until the end of the four-year aging period.<sup>333</sup> The taxpayer/distributor expensed these costs yearly, along with insurance fees and some state taxes the seller charged to the taxpayer.<sup>334</sup> The Commissioner argued that these expenses should not have been deducted yearly and instead should have been capitalized into cost of goods sold and matched against sales receipts at the time of sale.<sup>335</sup>

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<sup>326</sup> See generally Allegra, *supra* note 225 at 473-84.

<sup>327</sup> See Rosow, *supra* note 135 at 1227-28.

<sup>328</sup> See Allegra, *supra* note 225 at 481-82.

<sup>329</sup> See *id.*

<sup>330</sup> 445 F.2d 918 (7<sup>th</sup> Cir. 1971).

<sup>331</sup> *Id.* at 920.

<sup>332</sup> *Id.* at 919.

<sup>333</sup> *Id.* at 919-20.

<sup>334</sup> *Id.* at 920.

<sup>335</sup> *Id.*

In coming to its decision, the Seventh Circuit noted that throughout the industry this expensing was practiced by a great majority of distributors.<sup>336</sup> The Court also noted that the Service approved of the taxpayer's method in previous audits of the taxpayer.<sup>337</sup> Further, the Court stated that the tax liability for the taxpayer would only minimally be affected, so matching principles were not violated.<sup>338</sup> In finding that the Commissioner abused its discretion, the Court concluded that based on the facts the District Court's finding that the taxpayer did clearly reflect income was not clearly erroneous.<sup>339</sup> The Court concluded by stating: "Thus it appears that the decision by the Commissioner is more an expression of preference for capitalizing these charges rather than a determination that taxpayer's consistent use of its methods will not reasonably reflect income in the long run."<sup>340</sup> The Court implicitly stated it will generally not uphold a mere preference by the Commissioner as being a rational basis for his determination.<sup>341</sup> Therefore, the finding of an abuse of discretion was based both on the fact that the taxpayer did clearly reflect his income, and on the fact that the Commissioner had no rational basis for his determination that the taxpayer did not clearly reflect his income.<sup>342</sup>

In the case of *Ansley-Sheppard-Burgess Co. v. Commissioner*,<sup>343</sup> the Tax Court also stated that it would not uphold the Commissioner's determination based on a preference in methods of accounting.<sup>344</sup> The taxpayer in this case was a construction contractor who used the cash method of accounting, as many other construction contractors in his industry did.<sup>345</sup> The Commissioner argued that the cash method did not clearly reflect the taxpayer's income.<sup>346</sup> The Commissioner also argued that the taxpayer in order to clearly reflect his income must use the percentage of completion method.<sup>347</sup>

The Tax Court reiterated that in order to be upheld, the Commissioner must have a rational basis for the change in methods, and the taxpayer must not clearly

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<sup>336</sup> Van Pickerill, 445 F.2d at 921.

<sup>337</sup> *Id.*

<sup>338</sup> *Id.*

<sup>339</sup> *Id.*

<sup>340</sup> *Id.* at 921. (citing *Klein Chocolate Co. v. Commissioner*, 36 T.C. 142, 146 (1961)).

<sup>341</sup> Van Pickerill, 445 F.2d at 921.

<sup>342</sup> *See id.* at 921-22.

<sup>343</sup> 104 T.C. 367 (1995).

<sup>344</sup> *Id.* at 371.

<sup>345</sup> *Id.* at 375.

<sup>346</sup> *Id.* at 367.

<sup>347</sup> *Id.*

reflect his income with the method he currently uses.<sup>348</sup> The Tax Court, in coming to its conclusion that the Commissioner abused his discretion, stated:

Although the Commissioner's determination that a taxpayer's method of accounting does not clearly reflect its income is given great deference by this court, we have held that the Commissioner cannot require a taxpayer to change from an accounting method which clearly reflects its income to an alternate method of accounting merely because the Commissioner considers the alternate method to more clearly reflect the taxpayer's income.<sup>349</sup>

The Tax Court, in finding an abuse of discretion, held that this preference for one method over another does not have an "adequate basis in law for the Commissioner's conclusion."<sup>350</sup> Once again, the courts have found for the taxpayer not only because the taxpayer clearly reflected his income, but also because a preference for another method does not equate to a rational basis for the change.<sup>351</sup>

Another example of the taxpayer proving the abuse of discretion by the Commissioner is in *RLC Industries Co. v. Commissioner*.<sup>352</sup> Much like in the two previous cases, the taxpayer used a method in conformity with G.A.A.P. and industry practice, and was consistently applied, yet the Commissioner found that the method did not clearly reflect income.<sup>353</sup> The Tax Court stated that fiscal concerns, much like a mere preference in the previous cases, was not a rational basis for a determination that the taxpayer did not clearly reflect income.<sup>354</sup> The Tax Court reasoned:

Respondent argues that the method that she determined would more clearly reflect income. 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,

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<sup>348</sup> Ansley-Sheppard-Burgess, 104 T.C. at 371.

<sup>349</sup> *Id.* at 371 (citing *Molsen v. Commissioner*, 85 T.C. 485, 498 (1985)).

<sup>350</sup> *Id.* at 371-77.

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

<sup>352</sup> 98 T.C. 457 (1992), *aff'd*, 58 F.3d 413 (9<sup>th</sup> Cir. 1995).

<sup>353</sup> *Id.* at 477, 502.

<sup>354</sup> *Id.* at 502.

is an insufficient reason for the imposition of a differing method determined by respondent. The best method is not necessarily the one which produces the most tax in a particular year. If, as here, a taxpayer's method is consistently applied and clearly reflects income, we will not sustain respondent's determination merely because it produces more income tax for the taxable year under consideration.<sup>355</sup>

The Court thus articulates another instance where the Commissioner's preference for a change in method without more will be found to be an abuse of discretion.<sup>356</sup>

In some cases, courts have disagreed on the judgment as to whether or not an abuse has taken place. For example, in *RCA Corporation v. United States*,<sup>357</sup> the Second Circuit stated that the District Court was wrong in holding that the Commissioner abused his power because the Circuit Court found an adequate basis for the Commissioner's determination.<sup>358</sup> The Second Circuit further took a more deferential approach that allowed it to uphold the Commissioner's conclusion, "even if it does not agree with them [the Commissioner's determinations]."<sup>359</sup> The Supreme Court has run into difficulties as well. In *American Automobile Association v. United States*,<sup>360</sup> the Court entered a decision with four dissenters upholding the determination of the Commissioner.<sup>361</sup> The dissenters stated in their opinion that the accounting method did clearly reflect income and thus the Commissioner's interference was unwarranted.<sup>362</sup> The Eleventh Circuit summed up such a problem nicely by stating: "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

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<sup>355</sup> *Id.*

<sup>356</sup> *Id.*

<sup>357</sup> 499 F.Supp. 507 (S.D. N.Y. 1980), *rev'd* 664 F.2d 881 (2d Cir. 1981).

<sup>358</sup> *RCA*, 664 F.2d at 886. *See also* Allegra, *supra* note 225 at 481-83 (addressing the criticism the Second Circuit has received about its refusal to determine whether the taxpayer did in fact clearly reflect his income).

<sup>359</sup> Allegra, *supra* note 225 at 482.

<sup>360</sup> 367 U.S. 687 (1961).

<sup>361</sup> *Id.* at 697-98.

<sup>362</sup> *Id.* at 711-12.



vividly?"<sup>363</sup> Thus, those sitting in judgment do not always come to the same conclusion and do not always agree as to what constitutes an abuse of discretion.<sup>364</sup>

The abuse of discretion standard in tax cases places the burden of proof solely on the taxpayer to prove that the Commissioner has abused his discretion. The burden of proof also will not shift to the Commissioner to justify his determinations upon the showing of any independent facts. Thus, the taxpayer has a heavy burden when it brings suit against the Commissioner for a refund in a clear reflection of income case. The courts have an equally large hurdle in deciding abuse of discretion cases because they are limited in the scope of their review. The review encompasses a twofold inquiry. First, the court looks to see if the taxpayer has clearly reflected his income using the same facts and circumstances the Commissioner used to make his determination. Second, if the court finds that the method was a clear reflection of the taxpayer's income, then the court must look to see if there was a rational basis for the Commissioner's decision. As we have seen, the courts will not uphold a mere preference for a different method or a generation of a greater tax liability to the taxpayer as a rational basis for finding that there is no clear reflection of income by the taxpayer. Finally, the courts disagree as to whether an abuse of discretion has taken place due to differing views on the role the court should play in review, and because the courts sometimes define a rational basis differently.

## V. THE CASE FOR A LESSER STANDARD OF REVIEW

### A. *A Lesser Standard is Warranted*

The rule of law mandates a system where the written law predominates over the discretion of individuals.<sup>365</sup> However, discretion is an indispensable component to any workable system of laws.<sup>366</sup> Thus, the balance between the rule of law and the rule of man must be kept in mind during this inquiry into whether rule of law principles have been impermissibly violated through the workings of §446. The rule of law mandates a system that treats taxpayers equally.<sup>367</sup> Finally, the rule of law requires the separation of powers as understood by the checks and balances theorists and encompasses the essential concept of judicial review.<sup>368</sup>

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<sup>363</sup> Knight-Ridder Newspapers, Inc. v. United States, 743 F.2d 781, 788 (11<sup>th</sup> Cir. 1984).

<sup>364</sup> See *id.*

<sup>365</sup> Epstein, *supra* note 8 at 151.

<sup>366</sup> ARISTOTLE, *supra* note 2.

<sup>367</sup> See Epstein, *supra* note 8 at 151.

<sup>368</sup> See Sargentich, *supra* note 71 at 442-44 (addressing the position that courts should not intervene in separation of powers issues).

Generally, there is some disagreement as to what amounts to a rule of law violation.<sup>369</sup> Some clues as to the existence of a rule of law violation can be gleaned from the results of the workings of the system of law. The resulting problems that occur when the rule of law is overly compromised include the uncertainty in results from the application of the law, and the inability of the governed to rely on and plan their activities in accordance with the law.<sup>370</sup> Further, with the analysis of an anti-abuse rule we must also look for cases where the Service has tried to override legal precedence, and/or interfere with legitimate taxpayer transactions.<sup>371</sup> Rule of law violations can also be seen when similarly situated taxpayers within the same industry are treated differently by the legal system.<sup>372</sup> An inconsistency in the results between jurisdictions is also a problem that becomes more frequent when the rule of law has been compromised.<sup>373</sup> Finally, we must look to see if the Service has usurped too much legislative and judicial powers by escaping judicial review.<sup>374</sup> All of these problems exist with §446(b), and will be analyzed in the order of Dicey's three facets of the rule of law.

The predominance of written law over discretion means that the rule of law trumps the rule of man.<sup>375</sup> Under §446(b), the rule of man is in full force. The Secretary is given statutory power to decide whether a taxpayer has clearly reflected his income.<sup>376</sup> Thus, the discretion of an individual takes precedence over a system of written guidance to the taxpayer. Further, given the reluctance of the courts to question determinations of the Commissioner, this opinion is many times controlling on the issue of taxpayer treatment. This type of system fosters uncertainty and an inability to rely by the taxpayer because the determinations made are the product of an individual's value judgment.<sup>377</sup>

As Hayek stated, the rule of law requires that the rules be fixed and known beforehand.<sup>378</sup> Thus, the rule of law value that taxpayers have the ability to organize their affairs according to the law is lost because individual judgement is subjective. This resulting uncertainty also erodes the taxpayer's confidence in the

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<sup>369</sup> Fallon, *supra* note 5 at 5.

<sup>370</sup> *Id.* at 7-8.

<sup>371</sup> See Rosow, *supra* note 135 at 1245.

<sup>372</sup> See HAYEK, *supra* note 26 at 74.

<sup>373</sup> See *id.*

<sup>374</sup> See *supra* Section II.B.2.

<sup>375</sup> Epstein, *supra* note 8 at 151.

<sup>376</sup> §446(b).

<sup>377</sup> See Segall, *supra* note 63 at 992-93.

<sup>378</sup> See Epstein, *supra* note 8 at 151 (quoting Hayek, *supra* note 26 at 74).

system in which he participates.<sup>379</sup> This loss of confidence, the can't win mentality, can lead to more taxpayers playing the audit lottery.<sup>380</sup> If the taxpayer does not know the correct way to structure his affairs then he will structure them in the manner that best suits himself because the perception is that no matter which way he structures the transaction, he may be subject to liability. Thus, the loss of certainty and resulting loss in confidence and ability to rely can lead to less overall compliance with the laws.

The *Van Pickerill & Sons* case was an instance where the taxpayer engaged in a legitimate expensing of items that has clearly been allowed for a long period of time and the Service interfered.<sup>381</sup> One of the results that occurs when the rule of law has been overly compromised in the context of an anti-abuse rule is the interference of the Service in legitimate taxpayer practices.<sup>382</sup> In the *Van Pickerill & Sons* case, the Service had even "itself consistently approved this method of accounting in its audits of taxpayer."<sup>383</sup> Thus, not only was the Service interfering with a legitimate taxpayer practice but it was contradicting its prior judgments. This action by the Service is inconsistent with the principles of the rule of law and a direct result of the Service being granted too much discretion without review.

Furthermore, in the context of anti-abuse rules, the Service sometimes will try to override set legal precedence.<sup>384</sup> In the *Ansley-Sheppard-Burgess Co. v. Commissioner*<sup>385</sup> case, the Commissioner tried to override the use of the cash method by the construction company taxpayer.<sup>386</sup> If the Court were to follow the Commissioner's arguments in the case, the result would essentially be to "prohibit the cash method of accounting for tax purposes."<sup>387</sup> The Court refused the Commissioner's arguments and acknowledged the effort to override the acceptability of the cash method as inconsistent.<sup>388</sup> "The cash method of accounting has been widely used throughout the contracting industry and accepted by the respondent since time immemorial."<sup>389</sup> The Service was plainly trying to override

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<sup>379</sup> See Rosow, *supra* note 122 at 529-30.

<sup>380</sup> *Id.* at 497.

<sup>381</sup> *Van Pickerill & Sons, Inc. v. United States*, 445 F.2d 918 (7<sup>th</sup> Cir. 1971).

<sup>382</sup> Rosow, *supra* note 135 at 1245.

<sup>383</sup> *Van Pickerill*, 445 F.2d at 921.

<sup>384</sup> See *Ansley-Sheppard-Burgess Co. v. Commissioner*, 104 T.C. 367, 372-75 (1995).

<sup>385</sup> *Id.*

<sup>386</sup> *Id.* at 367-68.

<sup>387</sup> *Id.* at 374 (quoting *RLC Indus. Co. v. Commissioner*, 98 T.C. 457, 493 (1992)).

<sup>388</sup> *Id.* at 375.

<sup>389</sup> *Id.*

the long-standing precedent that the cash method clearly reflects income.<sup>390</sup> Such arguments are a clear case where the Commissioner has tried to overuse his discretion in contravention of the rule of law.

The reduction in taxpayer certainty and ability to rely on the tax system is a direct result of the unquestioned discretion given to the Commissioner. Taxpayers are faced with a situation where the singular judgment of the staff at the Service will govern their affairs. Taken to its logical conclusion, this system is the essence of the rule of man because legal determinations become wholly subjective judgments, with no protection from the rule of law to keep such subjectivity in check. Furthermore, instances such as *Van Pickerill & Sons* and *Ansley-Sheppard-Burgess* show how the Service has the potential to overuse its discretion. This nearly unreviewable and nearly unbridled treatment of the citizenry by the Service under §446 runs afoul of Dicey and Hayek's first and possibly most essential mandate of the rule of law.

The rule of law's second main principle is the equality of treatment of taxpayers in the same situations, and the subjugation of all taxpayers to the same law. In our legal system, for the most part all citizens are subject to the Internal Revenue Code and are taxpayers.<sup>391</sup> Thus, the violation of the rule of law's second main principle comes from the unequal treatment of similarly situated taxpayers. For example, in the case of *Van Pickerill & Sons v. United States*,<sup>392</sup> the taxpayer expensed a monthly service fee for the storage and aging of liquor and was challenged by the Service for not clearly reflecting income.<sup>393</sup> The Seventh Circuit noted that the practices used by the taxpayer were the same as those used by a majority of the other taxpayers in the same industry.<sup>394</sup> Which begs the question of why *Van Pickerill & Sons* was forced to litigate the case, when no other taxpayers in the same industry were forced to?<sup>395</sup> *Van Pickerill & Sons* was forced to shoulder the burden of expensive litigation when others similarly situated were not. This is unequal treatment, and it violates the rule of law.

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<sup>390</sup> Note that the text of § 446 itself specifically authorizes the cash method of accounting. See § 446.

<sup>391</sup> Note limited exceptions do exist such as nonprofit corporations, however such entities are still subject to the provisions of the Internal Revenue Code even if they do not pay taxes to the government.

<sup>392</sup> 445 F.2d 918 (7<sup>th</sup> Cir. 1971).

<sup>393</sup> *Id.* at 919-20.

<sup>394</sup> *Id.* at 921.

<sup>395</sup> Note that as long as there is a tax code, some taxpayers will be forced to litigate new or novel positions. However, in this case a long-standing unchallenged practice was questioned as a direct result of the overuse of discretion by the Service.

Unequal treatment is also evident with the inconsistency of results between different jurisdictions. For example in the Second Circuit decision of *RCA Corporation v. United States*,<sup>396</sup> the Court decided that it was prohibited through its abuse of discretion standard of review from reviewing the Commissioner's substantive determination.<sup>397</sup> Yet in other cases the courts readily review the substantive determination as a first step in order to judge whether an abuse of discretion has taken place.<sup>398</sup> Thus, many other taxpayers have had the ability to have erroneous determinations of the Commissioner at least reviewed and sometimes overturned, yet RCA was given no such opportunity.<sup>399</sup> This unequal procedural treatment under the application of §446 runs afoul of the rule of law.

The rule of law also mandates that the separation of powers must be maintained with a system of checks and balances and judicial review.<sup>400</sup> Administrative agencies pose an insurmountable violation of separation of powers unless one subscribes to the checks and balances theory.<sup>401</sup> However, even under the checks and balances theory, difficulties arise when an administrative agency oversteps its executive bounds to excess.<sup>402</sup> The Service is a prime example of such an overstepping of bounds. The Service is delegated the law-making power by Congress under §446, not only with its ability to issue regulations but also with the conferred discretion by which the agency can make determinations. Thus, the Service has the delegated power to state the law, to enforce the law, and due to an effective lack of judicial review, the power to decide specific instances of compliance or noncompliance under the law. Such a concentration of all three governmental powers into one agency is a violation of separation of powers and the rule of law.<sup>403</sup>

Even under the conflicts of interest theory of separation of powers, a problem exists with the Service's role in the operation of §446. The Service has the primary function of administering the tax laws in order to bring revenue into the government, and also has the power to determine when a taxpayer has not paid enough taxes to the government under §446. Thus, the system functions in a

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<sup>396</sup> 664 F.2d 881 (2d Cir. 1981).

<sup>397</sup> *Id.* at 886.

<sup>398</sup> *RCA Corp. v. United States*, 499 F.Supp. 507 (S.D. N.Y. 1980), *rev'd*, 664 F.2d 881 (2d Cir. 1981). *See also* *Van Pickerill & Sons v. United States*, 445 F.2d 918 (7<sup>th</sup> Cir. 1971); *Ansley-Sheppard-Burgess Co. v. Commissioner*, 104 T.C. 367 (1995).

<sup>399</sup> *RCA*, 664 F.2d at 886.

<sup>400</sup> *See* *Medina*, *supra* note 72 at 1554-55.

<sup>401</sup> *See* *Segall*, *supra* note 63 at 1013-14

<sup>402</sup> *See* *Sargentich*, *supra* note 71 at 440-41.

<sup>403</sup> THE FEDERALIST NO. 47 at 245-46 (James Madison)(Max Beloff ed., 1987).

manner that allows the agency to bring a complaint against a taxpayer for not conforming to the rules it has promulgated itself. Then the agency, which has the motive to bring funds into the government, has the power to determine whether the taxpayer has conformed to the rules. Analogously, the operation of §446 is like a system that allows the plaintiff in an adversarial dispute to have the power to adjudicate the case which he has brought. Because the Service has a vested interest in the adjudication of tax disputes, it cannot be allowed to have the power of adjudication as well because a conflict of interest arises. To allow §446 to operate in this manner is to violate separation of powers and the rule of law.

Far be it for this author or any other to state that Aristotle is incorrect and argue for an elimination of discretion from the system of taxation. In fact anti-abuse rules such as the general clear reflection of income provision contained in §446(b) are necessary for the Service to combat taxpayer abuses. However, the workings of §446 must place a limit as to how much discretion can be tolerated and still be in conformity with rule of law. The general discretion-conferring provision of §446(b) grants considerable power to the Service to audit taxpayers based upon no guidelines save its opinion that the taxpayer has not clearly reflected his income with his current accounting method. This opinion and ability to judge is tainted by the Service's conflicting interest of bringing revenue into the government. Further, when this discretionary power is combined with such a deferential standard of review as the abuse of discretion standard, it oversteps the bounds of what the rule of law will tolerate. Undeniably, the rule of law requires a change in the operation of §446.

The elimination of §446's anti-abuse rule, the Service's strongest weapon for combating taxpayer abuses in this area, is not an option for remedying the centralized power problem. Even just statutorily restraining the Service's discretionary power will only serve to strip the Service of its ability to fight novel taxpayer abuses. Reliance upon retroactivity, either by Congress or the Service, as a means of adding discretion after eliminating the discretion under §446 is also not a viable option from a rule of law standpoint. Finally, adding to the problem of hyperlexis by legislating more rules into §446 or its regulations is also not a viable solution. Although some would argue legislating is the best option for restoring rule of law principles, enacting more rules that are easily circumventable will only lead to taxpayer abuse of the rules that the discretionary provision was meant to prevent. The enactment of more rules to give the taxpayer guidance about what accounting methods are acceptable, and/or a corresponding decline in the discretion granted to the Service, will not restore rule of law principles, but will instead create more difficult problems and exacerbate the current situation. Thus, the §446 discretion-conferring clear reflection of income anti-abuse rule should be left as it

is, and the Treasury should not promulgate more rules in order to give the taxpayer guidance.

The solution that would best minimize the current problems stemming from the operation of §446 is to remove the abuse of discretion standard of review from §446 cases, and to replace it with the clearly erroneous standard of review. This action would return power to the judiciary that has been taken by the Service under the operation of §446. This solution does not enact more rules that are easy to manipulate, and does not cripple the Service by ripping away its discretion to question taxpayers. The solution can be implemented relatively easily, either by congressional enactment as an amendment to §446 or as an adoption of a new standard by the court system. Either way it is accomplished, a change from the abuse of discretion standard of review to the clearly erroneous standard of review is an easily implemented and feasible solution to the troubling rule of law problems inherent in the operation of §446.

### *B. The Clearly Erroneous Standard*

In other tax litigation, the Service is not given so much deference that it will not be overturned if clearly wrong as is true under the abuse of discretion standard.<sup>404</sup> Generally, the Service is given a presumption of correctness,<sup>405</sup> but is not given the ability to be wrong and have such substantive decisions avoid review by a court with proper jurisdiction.<sup>406</sup> The workings of the anti-abuse rule of §446 and the abuse of discretion standard together give the Service more power than the Service is traditionally granted. Furthermore, in the case of §446 the Service is granted more power than is justifiable.

The clearly erroneous standard of review is incorporated directly by the Federal Rules of Civil Procedure in Rule 52(a), although it does not appear in the A.P.A.<sup>407</sup> The Rule states:

Findings of fact, whether based on oral or documentary evidence, shall not be set aside unless clearly erroneous, and due regard shall be

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<sup>404</sup> See PAULA M. JUNGHANS & JOYCE K. BECKER, FEDERAL TAX LITIGATION ¶ 18.02[1] (2d ed. 1992).

<sup>405</sup> *Id.*

<sup>406</sup> Rosenburg, *supra* note 296 at 649 (discussing the discretion granted a trial judge).

<sup>407</sup> Compare FED. R. CIV. P. 52(a), and 5 U.S.C. §, *supra* note 261.

given to the opportunity of the trial court to judge of the credibility of the witnesses.<sup>408</sup>

Thus, the standard of review allows the Service to have the power to make a determination as to whether the taxpayer's method of accounting clearly reflects income under §446(b). But the standard would allow the reviewing court to assess the determination and override the substantive decision if it clearly is incorrect.

The Supreme Court in analyzing the clearly erroneous standard stated that this standard is not a de novo standard to decide factual issues.<sup>409</sup> Instead, the function of a reviewing court in a clearly erroneous standard must look to the primary determination as to the facts and accept them as correct unless clear evidence suggests otherwise<sup>410</sup> As stated by the court:

The clearly erroneous standard plainly does not entitle a reviewing court to reverse the finding of the trier of fact simply because it is convinced that it would have decided the case differently. The reviewing court oversteps the bounds of its duty ... if it undertakes to duplicate the role of the lower court ... Where there are two permissible views of the evidence, the factfinder's choice between them cannot be clearly erroneous.<sup>411</sup>

Thus, if a clearly erroneous standard of review is instituted, a reviewing court cannot substitute in its own judgement for that of the Commissioner in §446 cases. However if the Commissioner is clearly wrong as to his determination, then the court is empowered to intervene and correct the error.

## VI. IMPLICATIONS OF A LESSER STANDARD OF REVIEW

### A. *Curing Problems – Advantages to the Clearly Erroneous Standard*

The greatest advantage to instituting the clearly erroneous standard of review from the standpoint of the government would be the return to respecting separation of powers principles, without eliminating the Service's flexibility to

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<sup>408</sup> FED. R. CIV. P. 52(a).

<sup>409</sup> See *United States v. United States Gypsum Co.*, 333 U.S. 364, 395 (1948).

<sup>410</sup> *Id.*

<sup>411</sup> *Anderson v. City of Bessemer City, N.C.*, 470 U.S. 564, 573-74 (1985).



challenge taxpayer actions. Although strict separation is not possible, the heightened review of the Service's determinations will strengthen the judiciary's role in the system of taxation. This will remove some of the adjudicatory power that the Service has acquired through §446, and limit the Service to a role of delegated legislating and administration of the tax laws.<sup>412</sup> The rule of law problem of concentrated power inherent with the use of administrative agencies, and the Service in particular in this case, can be curbed somewhat by the increased role of the judiciary. Therefore, the principles of separation of powers will be strengthened through the protection of judicial review over agency determinations, and the rule of law will again be placed in a more comfortable balance with the rule of man.

Another advantage to changing to the clearly erroneous standard of review will be the self-policing that the Service will place upon itself. If the Service knows that its determinations are subject to reversal if they are incorrect, it will be less likely to question legitimate taxpayer actions. The Service's limited resources would not permit challenges that will ultimately end in failure to sustain a deficiency. Thus, the Service will use its resources more efficiently in auditing and assessing deficiencies on those taxpayers that are truly not reflecting their income properly. Those taxpayers who are circumventing the system will be assessed to pay their share correctly. Therefore, the change in standard will lead to efficient and accurate Service assessments.

Another benefit to the government will be the ability to more effectively promote policy goals through tax legislation. Having a system that promotes taxpayer reliance on guidance facilitates the workings of incentives in the Code. Due to the certainty that will result from an increased judicial review, taxpayers will be able to rely on the Code and govern their affairs based on it more readily and more often. Thus, the achievement of policy goals through incentive legislation will be more easily and efficiently accomplished.

The court system will also benefit from the change in the standard of review. Having the clearly erroneous standard will alleviate some of the disagreement as to the court's role in deciding §446 cases. As the standard is now, courts disagree as to whether they are allowed to inquire into the substantive issues of a §446 case, and due to such a disagreement similarly situated taxpayers are

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<sup>412</sup> Note that the A.P.A.'s intention in instituting the abuse of discretion standard of judicial review was not to grant such an enormous amount of power to administrative agencies, but was intended to simply reiterate the common concept of judicial review. U.S. DEP'T OF JUSTICE, *supra* note 263, at 9. Thus, the operation of section 446 contravenes the intent behind section 706 of the A.P.A., and a change in the standard of review would put a stop to the misconstruction of section 706 in clear reflection of income cases.

treated differently. If the clearly erroneous standard is implemented the courts will all know that substantive inquiries as well as reversals of the Commissioner's findings are within the proper dominion of the courts. Thus, the disparity in procedural treatment of taxpayers will be lessened, and the disagreement between courts will be lessened.<sup>413</sup>

The greatest benefit to the individual taxpayer from changing the standard of review is the increased fairness that will result from a shift back to rule of law and away from the rule of man. The taxpayer will benefit from the reduction of Service interference in situations where the taxpayer has behaved correctly. As stated previously, the Service will have to manage its affairs more efficiently and will avoid challenging taxpayers that are operating within the bounds of precedence. Thus, the taxpayer will once again be able to rely on tax guidance without the justifiable fear that even if they comply with all precedents and standards they will be found noncompliant under §446.

Returning to a system that has judicial review and treats the taxpayer in a more just and fair manner will consequently have beneficial effects on the government. Increases in taxpayer reliance and confidence in the system may help to eliminate the poor image that plagues the Service because it will no longer be seen as an agency that oversteps its authority and burdens innocent taxpayers. Changing the standard of review will also lead to courts being viewed as the guardian of taxpayer rights again, rather than as the Commissioner's rubber stamp for his determinations. Increasing the legitimacy of the government's institutions with taxpayers by promoting fairness and judicial review strengthens the rule of law and benefits the taxpayer.

Although this list is not exhaustive, several of the largest advantages of changing the standard of review in §446 cases are stated. First, the burden of taxation will be shifted back to the taxpayers who should shoulder it, leading to the more fair treatment of taxpayers. This fair treatment will result in greater reliance on and compliance with the Code. Second, the Service will be forced to use its resources more effectively and efficiently. Third, policy goals will be easier to achieve through incentive legislation due to increased taxpayer reliance and compliance. Fourth, the court system will see a reduction in the disparity of taxpayer treatment and have less disagreement within itself because of unclear role of courts operating under the abuse of discretion standard. Fifth, the reputation and

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<sup>413</sup> Note that complete elimination of all discrepancies is impossible. As long as there is more than one way to define a term such as "error," there will always be some disagreements as to what actions amount to an error.

legitimacy of the Service and the courts will improve as they take on their more traditional functions and perform them better. Finally, the separation of powers doctrine will be bolstered by returning power to the judicial branch from the executive. Overall, all the three requirements of the rule of law would be better met by the operation of §446 if the standard of review is changed from the abuse of discretion standard to the clearly erroneous standard.

*B. Causing Problems – Disadvantages to the Clearly Erroneous Standard*

One commonly cited problem with a change to a lesser standard of review is that the Service and taxpayers may be forced to litigate cases more often.<sup>414</sup> Taxpayers who formerly would have submitted to the Commissioner rather than go through the hassle and expense of fighting his determination, may decide to bring suit due to the fact that they will be granted substantive judicial review. The cost of litigating a case is a difficult burden for the taxpayer to bear.<sup>415</sup> Increased litigation would also increase the costs of the Service in assessing deficiencies because they will be forced to go to court over more claims. The case load on the court system would also be increased, further adding to the government's costs. This increase in litigation would correspondingly lead to an increase in the size of the government, assuming adequate funding is appropriated. Thus, the result of a change in the standard of review may be increased costs from litigation both for the taxpayer and the Service.

However, with the new standard of review, the Service will be less likely to get involved with cases that must be litigated. Instead, the Service will focus on taxpayers who have unquestionable violations of the clear reflection principles and will no longer target the boarder-line or legitimate taxpayers. Thus, rather than an increase in litigation, the imposition of a clearer standard of review may help to lessen the amount of tax litigation. Further, the clearer standard will promote more certainty about the court's role in tax litigation for the appellate courts, and may decrease the need for reviewing cases because the lower court has misconstrued the meaning of the abuse of discretion standard of review.

Another problem that can occur with the decrease in the standard of review is a lessening of the amount of funding brought into the government. The burden

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<sup>414</sup> Note that an increase in litigation seems almost impossible when one looks to how many clear reflection of income cases have come through the courts. *See* 26 U.S.C.A. § 446 (West Supp. 1999) (case annotations).

<sup>415</sup> Note: In fact, the cost to a taxpayer of litigating a case may well be more than the amount of the deficiency judgment, which tends to be an incentive not to litigate.

of decreased funding to the fisc can occur due to the fact that many taxpayers who have been assessed and who previously may not have wished to pursue a claim for a refund, may refuse to submit to the Commissioner's under the new standard. Thus, the government will be deprived of that amount of taxes which it presently collects. However, Congress can cure this problem through more legitimate ways of bringing in funding. Legislating and budgeting for tax increases will more fairly bring in tax revenue and bring it in from the sources that are legitimately targeted. Targeted tax increases are a more fair way to fund the government, rather than bringing in revenues from unfairly charged taxpayers who wish to avoid the expense of litigation, especially when the courts refuse to overturn erroneous decisions.

## VII. CONCLUSION

After some scholars have finished their inquiry into the violations of the rule of law by administrative agencies they have stated that our system may require sweeping reforms in order to regain conformity to the rule of law.<sup>416</sup> In the context of §446, sweeping reforms are not necessary. Although the workings of §446(b) have run afoul of the rule of law, and the problems from this deserve serious consideration, the system only requires a push back in the right direction. Changing the standard of review over the Service's determinations in clear reflection of income cases reinstates meaningful judicial review. A power shift will result as some of the adjudicatory power the Service now holds will be given back to the judicial branch. The power shift will strengthen the separation of powers between the branches and promote rule of law ideals. Therefore, a change from the abuse of discretion standard to the clearly erroneous standard is a push along the continuum from the rule of man back to the rule of law, where the operation of §446 ultimately belongs.

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<sup>416</sup> Fallon, *supra* note 5 at 4.

