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OUTSOURCING FEDERAL TAX COLLECTION

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I. INTRODUCTION

On October 22, 2004, President Bush signed into law the American Jobs Creation Act often referred to as the corporate tax-cut bill.[1] Buried in the 633 page American Jobs Creation Act are provisions that allow the IRS to use private debt collection companies (PCAs) and private law firms in the collection of delinquent taxes.[2] This follows a pilot program that was authorized by Congress and tested in 1996.[3] After the initial pilot, the Clinton Administration opposed renewal of the program.[4] However, the Bush administration has strongly supported the implementation of a permanent program for the collection of tax debts.[5] For various reasons, there are many who strongly opposed such legislation.[6] This article explores some of the areas of controversy. First, I will provide some background on the use of private debt collectors by the government in the context of historic use for tax collection and current use by other agencies. Next, I will examine the 1996 pilot program and discuss many of its problems. Then I will discuss considerations

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1. American Jobs Creation Act of 2004, Pub. L. No. 108-357, 118 Stat. 1418.

2. *See id.*

3. Treasury, Postal Service, and General Government Appropriations Act of 1996, Pub. L. No. 104-52, 109 Stat. 468, 473-74; *Use of Private Collection Agencies by the IRS: Testimony Before the Subcomm. on Oversight of the House Comm. on Ways and Means*, 108th Cong. (May 13, 2003) (Testimony of Colleen M. Kelley, National President of National Treasury Employees Union), *available at* http://waysandmeans.house.gov/hearings.asp?formmode=view&id=365 [hereinafter 2003 Kelley Testimony].

4. *Statement of Administration Policy on Treasury Funding Bill*, 96 TAX NOTES TODAY 179-45 (Sep. 12, 1996).

5. BUDGET OF THE UNITED STATES GOVERNMENT, OFFICE OF MANAGEMENT AND BUDGET, FISCAL YEAR 2004 (H. Doc. 108-3), ANALYTICAL PERSPECTIVES (Vol. III) at 76, *available at* http://www.gpoaccess.gov/usbudget/fy04/pdf/spec.pdf; *see also* SUMMARY TABLE S-9, *available at* http://www.gpoaccess.gov/usbudget/fy04/pdf/budget/tables.pdf.

6. *See generally NTEU Views on Investing in the IRS Workforce: IRS Oversight Board Hearing* (Jan. 26, 2004) (Testimony of Colleen M. Kelley, National President of National Treasury Employee's Union) [hereinafter 2004 Kelley Testimony], *reprinted in* NTEU's Kelley Testifies at IRS Oversight Board Hearing, Tax Notes Today, Jan. 29, 2004, LEXIS, 2004 TNT 19-40. Groups opposing the legislation include

> Several taxpayer advocacy groups: the Tax Executives Institute; the National Association of Enrolled Agents; Citizens for Tax Justice; Consumer Federation of America; Consumers Union; National Consumer Law Center; National Consumers League; and large segments of the taxpaying public oppose the privatization of collection duties. Specifically, Global Strategy Group, Inc. conducted a poll last year that found 66% of respondents disapprove of allowing the IRS to hire private debt collection companies. When details of the IRS's plan were provided, the number in opposition rose to 79%. The results of this poll strongly indicate that Americans across all political, geographic and income lines oppose this proposal.

Id.

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that must be taken into account before the implementation of any future program for outsourcing of tax collection activities. Finally, I will examine the recently passed legislation in light of those considerations and evaluate implementation of such a program.

II. THE USE OF PRIVATE DEBT COLLECTORS BY THE UNITED STATES GOVERNMENT

A. *Historically*

The use of private debt collectors to collect revenue, while novel in the modern era, is not entirely foreign to the United States. The early history of the United States includes the use of "collectors of internal revenue" to collect tariffs and excise taxes on distilled spirits.[7] These collectors were a class of agents authorized in 1798 who received a percentage of the money collected.[8] The first documented case of contracting out for tax collection occurred in 1872, "when the Secretary of the Treasury hired John Stanborn to collect excise taxes from thirty-nine whiskey manufactures and merchants."[9] Sanborn was compensated by half of the revenue collected.[10] He continued to work until 1873 accumulating more than $200,000 in personal gain.[11] Sanborn's enterprise came to an end in 1873 with a Congressional investigation concluding that such contracts were improper.[12] Until the recent IRS pilot, this was the last instance of private collectors for tax debt in the United States.[13]

B. *Private Debt Collectors in Other Government Agencies*

The use of private debt collectors to collect government receivables is a practice applied in other government departments.[14] In 1966, Congress passed the first legislation allowing for use of private debt collectors by the federal

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7. Adam Melita, *Much Ado About $26 Million: Implications of Privatizing the Collection of Delinquent Federal Taxes*, 16 Va. Tax Rev. 699, 703 (1997) (citing DEPARTMENT OF THE TREASURY AND INTERNAL REVENUE SERVICE, IRS HISTORICAL FACT BOOK: A CHRONOLOGY 12 (1993)).

8. *Id.* at 703-04.

9. *Id.* at 704.

10. *Id.*

11. *Id.*

12. *Id.* (citing DEPARTMENT OF THE TREASURY AND INTERNAL REVENUE SERVICE, IRS HISTORICAL FACT BOOK: A CHRONOLOGY 12 (1993)).

13. Melita, *supra* note 7, at 704.

14. *See id.* at 705-06.

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government when it enacted the Federal Claims Collection Act.[15] This legislation was first applied by the Department of Education in its efforts to collect on student loan debts.[16]

In 1982, Congress enacted the Debt Collection Act (DCA).[17] This act gave federal and legislative agencies broad discretion to enter into collection contracts with collection agencies and law firms.[18] However, the act specifically excluded collection of federal tax debts.[19]

The Justice Department initiated a limited pilot program in 1997 under the Federal Debt Recovery Act of 1986.[20] By 1990, the scheduled termination date of the initial three year program, the Justice Department had only implemented five collection districts.[21] These pilot programs were renewed numerous times, and by 1995, at least twenty federal agencies were using private debt collectors.[22]

In 1996, Congress enacted the Debt Collection Improvement Act (DCIA).[23] The DCIA made several amendments to the DCA.[24] The amendments included provisions designed to provide greater safeguards for debtors' due process rights.[25] The DCIA also included provisions designed to enhance debt collection including increased inter-agency information sharing through computer matching programs for purposes of offset, and to encourage use of inter-agency teams designed to integrate the debt collection process.[26]

III. IRS PILOT PROGRAM

A. *Lost Revenue*

Each year, the federal government loses millions of dollars of potential revenue as a result of its failure to collect delinquent

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15. Federal Claims Collection Act of 1966, Pub. L. No. 89-508, 80 Stat. 308.

16. Melita, *supra* note 7, at 705. This article provides a more in depth analysis of the history of debt collection acts employed by the federal government.

17. Debt Collection Act of 1982 (DCA), Pub. L. No. 97-365, 96 Stat. 1749; 31 U.S.C. § 3718(a) (2000).

18. Melita, *supra* note 7, at 704.

19. 31 U.S.C. § 3718(f).

20. Federal Debt Recovery Act of 1986, Pub. L. No. 99-578, 100 Stat. 3305, 3307.

21. Melita, *supra* note 7, at 705-706.

22. *Id.* at 706.

23. Debt Collection Improvement Act of 1996 (DCIA), Pub. L. No.104-134 § 31001, 110 Stat. 1321.

24. *See id.*

25. *See id.*

26. *See id.*; *see also* Metila, *supra* note 7, at 707-10.

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taxes.[27] The IRS must forgo these delinquent taxes due to increasingly overly burdened IRS collection resources. As of March 2003, $13 billion in individual income tax debt was designated as "uncollectible" due to a lack of IRS resources.[28] As of May 2003, the IRS had an inventory of potentially collectible debt of $78 billion of which approximately 38% was in inactive status.[29] Potentially collectible debt is debt that the taxpayer has either agreed is due and owing or debt on which the taxpayer has made at least three payments but the IRS is unable to collect either due to insufficient resources or the inability to locate the taxpayer.[30] The total accounts receivable dollar inventory is growing at an annual rate of 3-4%.[31]

Numerous factors contribute to the escalating overburdening of IRS resources. Between 1992 and 2001, the IRS' workload increased 16% while, during this same period, the number of federal tax employees decreased by 16%.[32] A disproportionate reduction occurred in Field Compliance personnel which decreased by 28%.[33] From 1997-2002 alone, 12 million more tax returns were filed.[34] Another factor is the ever-changing tax code. During the 1997-2002 period there were nineteen tax bill changes affecting 292 code provisions and requiring 515 changes

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27. I.R.S., 2003 IRS Data Book (March 2004), Table 16 Delinquent Collection Activities Fiscal Years 2000-03, *available at* http://www.irs.gov/pu/irs-soi/03db16co.xls (last visited Nov. 6, 2004).

28. NATIONAL TAXPAYER ADVOCATE'S REPORT TO CONGRESS, FISCAL YEAR 2004 OBJECTIVES 13 (June 30, 2003), *available at* http://www.irs.ustreas.gov/pub/irs-utl/nta_fy04_objrpt.pdf.

29. *Use of Private Collection Agencies by the IRS: Testimony Before the Subcomm. on Oversight of the House Comm. on Ways and Means*, 108th Cong. (2003) (statement of National Taxpayer Advocate Nina E. Olson, The Current Tax Gap and Potentially Collectable Inventory), *available at* 2003 WL 11717932 [hereinafter Olson Testimony]. As of September 30, 2003, the amount of potentially collectible debt had risen to $89 billion, but the audit report containing that information does not indicate what percentage of that amount is in inactive status. U.S. GEN. ACCOUNTING OFFICE, GAO-04-126, FINANCIAL AUDIT: IRS'S FISCAL YEARS 2003 AND 2002 FINANCIAL STATEMENTS 79 (2003), available at http://www.gao.gov/new.items/d04126.pdf [hereinafter GAO Financial Audit].

30. *Use of Private Collection Agencies by the IRS: Testimony Before the Subcomm. on Oversight of the House Comm. on Ways and Means* (2003) (statement of Commissioner of IRS Hon. Mark W. Everson), *available at* 2003 WL 11717931 [hereinafter Everson Testimony].

31. GAO Financial Audit, *supra* note 29, at 79.

32. COMM'R CHARLES ROSOTTI, INTERNAL REVENUE SERVICE, REPORT TO THE IRS OVERSIGHT BOARD: ASSESSMENT OF THE IRS AND THE TAX SYSTEM 12 (2002), *available at* http://www.treas.gov/irsob/documents/commissioner_report.pdf [hereinafter 2002 Report to IRS Oversight Board]. Workload is calculated using the weighted average of returns filed, a measure of overall IRS workload. *Id.* The number of IRS employees decreased from 115,204 to 95,511 during this period. *Id.*

33. *Id.* at 12-13. Field Compliance personnel fell from 29,730 in FY 1992 to 21,421 in FY 2002. *Id.*

34. *Id.* at 13.

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to IRS forms and instructions.[35] Additional factors include the recent massive Y2K compliance project undertaken by the IRS, September 11 related issues such as victims' relief, the IRS' security response, a money laundering task force, and the advance rate reduction credit requiring 126 million notices, which affected 91 million taxpayers.[36]

The IRS' inability to enforce debt collection not only results in lost revenue from debt due but also increases lost revenue from future tax collection because voluntary compliance is undermined when taxpayers believe that they can get away with not paying their taxes.[37] This problem increases when taxpayers and tax professionals become increasingly aware of the IRS' inability to collect debt as the issue is reported in a wide range of publications including *The Wall Street Journal*, *New York Times*, *Fortune*, and *Forbes* and on national television.[38]

B. *The Pilot Program*

On November 19, 1995, Congress earmarked $13 million as part of the IRS' fiscal year 1996 appropriations legislation for a pilot program to test the use of private law firms and debt collection agencies to help collect delinquent tax debts.[39] An additional $13 million was earmarked on September 30, 1996 as part of the IRS' 1997 budget as well as $13 million for a second pilot program to be performed by the Treasury.[40]

Many interested parties including the IRS Oversight Committee Board, the General Accounting Office (GAO), and the National Treasury Employees Union, considered the 1996 pilot a failure.[41] In addition to the pilot's failure to reap any financial

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35. *Id.*

36. *Id.* at 14.

37. Everson Testimony, *supra* note 30, *Reasons for Change.*

38. 2002 Report to IRS Oversight Board, *supra* note 32, at 17.

39. I.R.S INSPECTOR GENERAL FOR TAX ADMINISTRATION, MANAGEMENT ADVISORY REPORT NO. 2001-40-122: ADDITIONAL OPTIONS TO COLLECT TAX DEBTS NEED TO BE EXPLORED, REF. 2 (2001), *available at* http://www.ustreas.gov/tigta/2001reports/200140122fr.pdf; *see also* U.S. GEN. ACCOUNTING OFFICE, GAO/T-GGD-96-112, TAX ADMINISTRATION, IRS TAX COLLECTION PRACTICES: HEARING BEFORE SUBCOMM. ON OVERSIGHT, HOUSE WAYS AND MEANS COMM. 6-7 (1996) (prepared Statement of Lynda D. Willis, Director, Tax Policy and Admin. Issues, Gen. Gov't Div.), *available at* http://www.gao.gov/archive/1996/gg96112t.pdf.

40. U.S. GEN. ACCOUNTING OFFICE, GAO/T-GGD/AIMD-97-130, TAX ADMINISTRATION, I.R.S' FISCAL YEAR 1998 BUDGET REQUEST: HEARING BEFORE THE SUBCOMM. ON TREASURY AND GEN. GOV'T, S. COMM. ON APPROPRIATIONS 6 (statement of James R. White, Assoc. Director, Tax Policy and Admin. Issues, Gen. Gov't Div.), *available at* http://www.gao.gov/archive/1997/g197130t.pdf [hereinafter GAO/T-GGD/AIMD-97-130].

41. *See, e.g.*, GAO/T-GGD/AIMD-97-130, *supra* note 40, at 6; 2003 Kelley

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benefits for the IRS, the IRS cited lost-opportunity costs of about $17 million because it had to move collection personnel off line to work on the pilot.[42] Due to problems in the 1996 pilot program, the GAO recommended that the $26 million allocated for 1997 not be spent until problems in the pilot were worked out, and the program was halted.[43]

Specifically, the GAO identified three main problems with the pilot.[44] First, the IRS' legal interpretations prevented the pilot from being a true test of private contractors' ability to collect delinquent taxes.[45] Second, systems and operations problems made it difficult to identify, select, and transmit cases to the contractors.[46] The third problem involved a lack of performance measures whereby the IRS could learn from the collection practices and techniques used by the private collectors and apply them to the IRS' own collection practices.[47] These problems are discussed in more detail in the following sections of this article.

The IRS reported that through January 1997, private collectors contacted 14,000 taxpayers and had attributable total revenues collected of about $3.1 million.[48] Performance payments to the private collectors during the pilot were $1,049,648.[49] The IRS also reported that pilot design, startup, and administrative expenses through the same period were $3.1 million.[50] While design and startup expenses will likely decrease after the initial implementation of a permanent program, administrative expenses for oversight of the private collectors as well as those associated with cases that require referral back to the IRS would be ongoing.

C. *Compensation for Private Debt Collectors*

One conflict in legal interpretations that hindered

Testimony, *supra* note 3, *Privatization of Tax Was Tried and It Failed*.

42. U.S. GEN. ACCOUNTING OFFICE, GEN. GOV'T DIV., GAO/GGD-97-129R, INTERNAL REVENUE SERVICE: ISSUES AFFECTING THE IRS' PRIVATE DEBT COLLECTION PILOT 2 (1997), *available at* http://161.203.16.4/papr2pdf/159007.pdf [hereinafter GAO/GGD-97-129R].

43. GAO/T-GGD/AIMD-97-130, *supra* note 40, at 6–7; GAO /GGD-97-129R, *supra* note 42, at 2.

44. GAO/T-GGD/AIMD-97-130, *supra* note 40, at 6.

45. *Id.*

46. *Id.*

47. *Id.*

48. GAO /GGD-97-129R, *supra* note 42, at 2.

49. *Id.*

50. *Id.*

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implementation of the pilot regarded compensation of the private collectors.[51] Many supporters of the pilot believed that private collectors should be compensated on a percentage basis for the debts collected.[52] Detractors believed, however, that this would conflict with the intent of the Internal Revenue Service Restructuring and Reform Act of 1998 (RRA).[53]

Congress enacted the RRA in an attempt to further protect taxpayer's rights. Section 1204 of the RRA prohibits evaluation of IRS employees based on "tax performance results."[54] "Tax performance results" include "a lien filed; a levy served; a seizure executed; the amount assessed; the amount collected; and a fraud referral."[55] Provisions such as this in the RRA were implemented in an attempt by Congress to facilitate more equitable treatment of taxpayers by the IRS.[56] Therefore, the IRS believed that compensating private collectors on a percentage basis would undermine the intent of the RRA by providing private collectors an incentive to collect as much as possible without any regard for taxpayers' rights, an incentive which is inappropriate when collection is conducted by IRS employees.[57]

D. *Inherently Governmental Activities and the FAIR Act*

Another legal interpretation that limited implementation of the pilot program involved the definition of "inherently governmental activities." Both the IRS and the Office of Management and Budget consider the "collection of taxes" to be an inherently governmental activity that must be performed by government employees.[58] The Federal Activities Inventory Reform Act of 1998 (FAIR) prohibits executive agencies from contracting out inherently governmental activities.[59]

Section 5 of the FAIR Act defines "inherently governmental activities."[60] Generally, an activity is inherently governmental if

51. *Id.*

52. Everson Testimony, *supra* note 30, *PCA Compensation*.

53. 2003 Kelley Testimony, *supra* note 3, *Incentives for Private Debt Collectors to Harass Taxpayers*.

54. Internal Revenue Service Restructuring and Reform Act of 1998 (RRA), Pub. L. No. 105-206, 112 Stat. 685 (codified at 26 U.S.C. § 7804, Notes).

55. 26 C.F.R. § 801.6(d)(i) (2004).

56. *See generally* 143 Cong. Rec. H10040-02 (daily ed. Nov. 5, 1997), *available at* 1997 WL 687037.

57. *Id.*

58. GAO/GGD-97-129R, *supra* note 42, at 2.

59. Federal Activities Inventory Reform Act of 1998 (FAIR), Pub. L. No. 105-270, 112 Stat. 2382 (codified at 31 U.S.C. 501, Notes).

60. *Id.*

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"it is so intimately related to the public interest as to require performance by Federal Government employees."[61] These activities require either the "exercise of discretion" in applying governmental authority or the "making of value judgments relating to monetary transactions and entitlements."[62] The FAIR Act specifically lists some activities that are inherently governmental.[63] These activities include "the interpretation and execution of laws. . .such as: (1) "to bind the United States to take or not take some action;" (2) "to determine, protect and advance United States. . .interests;" and (3) "to significantly affect the. . .property of private persons."[64] The FAIR Act also specifically excludes from the definition of "inherently governmental activities" the gathering of information for government officials.[65] Based on the FAIR Act and the Office of Management and Budget's Circular A-76 issued pursuant to the FAIR Act, the IRS limited use of private collectors to assisting the IRS in locating and contacting taxpayers to remind them of their outstanding tax liability and to suggest various payment methods.[66] Application of the FAIR Act to PCA collection is discussed in greater detail in the next section of this article.

E. *IRS Computer Databases*

Another factor limiting the success of the pilot program involved the IRS' reliance on computer systems, which made it difficult to identify, select, and transmit collection cases to private collectors.[67] One problem involved developing computer programs to filter out delinquent taxpayers that were appropriate for use in the pilot.[68] More importantly, the IRS had to develop computer programs to remove sensitive taxpayer information before transmittal to the PCAs.[69] Such computer related problems are startup in nature and, once resolved, would not likely be ongoing in any future program.

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61. FAIR § 5(2)(A).
62. *Id.* § 5(2)(B).
63. *Id.*
64. *Id.*
65. *Id.* § 5(2)(C).
66. GAO/GGD-97-129R *supra* note 42, at 2.
67. *Id.*
68. *Id.*
69. *Id.* at 3.

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IV. Considerations for Future Use of Private Debt Collectors

A. *Appropriate Cases*

An important consideration in any future program utilizing PCAs to collect tax debts involves the types of cases that are appropriate for PCA collection. There are two considerations in determining which cases are appropriate for delegation to private collectors. First, there are economic considerations that should be taken into account.[70] Cases need to be chosen for delegation to private collectors in a manner that brings about the greatest economic benefit to the IRS. Second, legal considerations need to be taken into account.[71] The FAIR Act prohibits cases where any "inherently governmental" activity is required in the collection process from delegation to PCAs.[72] In many instances these considerations are overlapping because any case that may require referral back to the IRS due to issues that arise requiring the exercise of inherently governmental activities will result in greater administrative costs than if the IRS handles the case from the start.[73]

Often, it will not make sense from an economic standpoint to transfer cases with rather small balances due to PCAs for collection purposes. This is due to the fact that the IRS has a high success rate for collecting on cases with smaller balances with the exercise of minimal collection action.[74] In many instances, the IRS can collect on these cases merely by offsetting the balance due against refunds in future years.[75]

The IRS places many of these cases in the "deferred" category.[76] The original design of the 1996 pilot called for a transfer of an inventory of cases to private collectors of which 6% would be from the "deferred" category.[77] In execution of the pilot, however, private collectors received 153,000 cases, of which about 53% were from the deferred category.[78] Any future use of private collectors should limit the percentage of cases transferred from

70. *Id.* at 2.

71. *Id.*

72. Federal Activities Inventory Reform Act of 1998, Pub. L. No. 105–270, 112 Stat. 2382 (codified at 31 U.S.C. § 501, Notes).

73. *See id.*

74. GAO/GGD-97-129R *supra* note 42, at 3.

75. *Id.*

76. *Id.*

77. *Id.*

78. *Id.*

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the deferred category that can likely be collected by future offsets.

When an executive agency activity can be performed either by agency employees or by a source in the private sector, the FAIR Act encourages the agency to perform a comprehensive cost comparison analysis.[79] The FAIR Act specifically includes "the costs of quality assurance, technical monitoring of the performance of such function, liability insurance, employee retirement and disability benefits, and all other overhead costs."[80] Therefore, in determining guidelines for determining which cases to place in the hands of private collectors, the IRS should take into all account all costs, including costs for oversight and potential costs if cases need to be referred back to the IRS. As a result, the cases contracted out to private collectors should require minimal oversight efforts and have a low risk of requiring referral back to the IRS.

The second consideration in selecting appropriate cases for placement with public collectors is whether the case will require the exercise of "inherently governmental" activities.[81] As I mentioned above, one problem identified in the 1996 pilot program involved legal interpretations regarding the FAIR Act which prohibits executive agencies from contracting out inherently governmental activities.[82] Inherently governmental activities include any activity that requires the exercise of discretion in applying governmental authority.[83] Due to the unique features of tax debt, application of the FAIR Act makes many delinquent cases inappropriate for placement with private collectors.

One complication arises from the fact that "correct tax liability often cannot be determined from the 'four corners' of the taxpayer's own return or even an IRS notice, thus the taxpayer is allowed to dispute the correctness of a tax assessment. . . ."[84] Complicated cases involving disputes over interpretation of Internal Revenue Code (Code) sections clearly require the exercise of discretion and, therefore, are not suitable for placement with PCAs for collection purposes. In addition to these complicated cases, any case where a return was filed and the debt arose after the IRS disputed the taxpayer's return will

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79. FAIR § 2(e).
80. *Id.*
81. *Id.* § 5.
82. *Id.*
83. *Id.*
84. Olson Testimony, *supra* note 29, *Unique Nature of Tax Debt*.

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involve the exercise of inherently governmental activities.[85] These cases would only be appropriate for placement with private collectors after review by an IRS employee and a clear determination that there is no viable basis for the dispute.

The IRS has developed proposals for any future use of private collectors.[86] The IRS proposes to select taxpayer accounts for referral to private collectors based on those debts that are the simplest to collect.[87] This would be based on factors indicating that the taxpayer will likely pay the liability if contacted by telephone.[88] The initial identification of referable accounts would target taxpayers who have indicated an amount of tax due on a return but who have not paid that amount ("balance-due" taxpayers).[89] The initial identification would also target taxpayers who have been assessed tax by the IRS (such as where the taxpayer fails to file a return or report all of their income) and who have made three or more voluntary payments on the assessed tax.[90] The IRS would not refer accounts where there is an indication that enforcement action would be required to collect tax liabilities.[91]

B. *Taxpayers with Economic Hardships*

The Code provides taxpayers facing financial hardship many rights. These include the rights to enter into offers in compromise and installment agreements.[92]

The Internal Revenue Service Restructuring and Reform Act of 1998 (RRA) expanded the use of offers in compromise under 26 U.S.C. § 7122 where there is doubt as to collectibility.[93] At a minimum, the IRS must accept offers where payment in full would not leave the taxpayer with sufficient amounts to cover basic living expenses.[94] Settling claims for less than the full amount is the type of inherently governmental activity that may not be outsourced under the FAIR Act.[95] Additionally, taxpayers

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85. *Id.* at *The Inherently Governmental Nature of Tax Collection.*

86. Everson Testimony, *supra* note 30, *Introduction.*

87. *Id.*

88. *Id.* at *Reasons for Change.*

89. *Id.* at *Introduction.*

90. *Id.*

91. *Id.* at *Reasons for Change.*

92. 26 U.S.C. § 7122 (2000) (Offers in Compromise); *id.* § 6159 (Installment Agreements).

93. Internal Revenue Service Restructuring and Reform Act of 1998, Pub. L. No. 105-206, 112 Stat. 685 (codified at 26 U.S.C. § 7804, Notes).

94. 26 U.S.C. § 7122(c)(2).

95. *See* 31 U.S.C. § 501, Notes (2000).

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with significant economic hardship may be eligible for currently not collectible (CNC) status.[96] Therefore, cases in which the taxpayer seeks an offer in compromise or CNC status will require referral back to the IRS and should not be outsourced.

Under 26 U.S.C. § 6159, the IRS may enter into installment agreements with taxpayers for their outstanding tax liability.[97] Where the tax liability does not exceed $10,000, the IRS may be required to enter into a three-year installment agreement with the taxpayer.[98] If the taxpayer is unable to make payment in full when the tax is due, the taxpayer is eligible for the three-year installment agreement if, during the previous five years, the taxpayer has paid all tax liabilities when due, filed all required returns, and not entered into a prior installment agreement.[99] While the discretion to determine which taxpayers are eligible for installment agreements is inherently governmental, offering a uniform installment agreement to all taxpayers does not involve the use of discretion and, therefore, is an appropriate activity for delegation to private collectors.

The IRS stated that it would not refer any cases requiring IRS expertise or the exercise of discretion.[100] The IRS proposes that private collectors first request taxpayers pay their outstanding tax liabilities in full.[101] The private collectors would provide taxpayers with a specific statement regarding the benefits of payment in full including the stopping of interest and penalties, and the release of any tax liens.[102] If the taxpayer is unable to make payment in full, the private collector would then be authorized to offer the taxpayer a three-year installment agreement for the full amount.[103] Since the public collectors would be required to offer the same three-year installment agreement to all taxpayers, this would not constitute an exercise of discretion in violation of the FAIR Act (assuming that all taxpayers qualify or there is a specific set of guidelines that do not allow for the exercise of discretion such as a schedule based on specified dollar amounts).[104]

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96. 26 U.S.C. § 6330(c).
97. *Id.* § 6159.
98. *Id.* § 6159(c)(1).
99. *Id.* § 6159.
100. Everson Testimony, *supra* note 30, *Introduction*.
101. *Id.* at *PCA Activities.*
102. *Id.*
103. *Id.*
104. *See, e.g.*, 31 U.S.C. § 501 (2000) (Definitions).

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C. *Taxpayer Rights*

One of the most important considerations for any plan utilizing private collectors to collect taxpayer debts should be the protection of taxpayers' rights. Any future plan for the use of private collectors must supply measures to protect taxpayers from abuses by private debt collectors, ensure that taxpayers are adequately informed of their options and rights, and ensure that their privacy is adequately protected.[105]

In recent years, Congress has passed legislation to protect the rights of taxpayers. This legislation includes the Taxpayer Bill of Rights,[106] the Taxpayer Bill of Rights 2,[107] and the RRA.[108] One important right is the right to be adequately informed by the IRS of rights and options.[109] The Taxpayer Bill of Rights provides that the IRS shall prepare a statement informing taxpayers in "simple and nontechnical terms" the rights of the taxpayer and the obligations of the IRS.[110] The statement must also explain to the taxpayer the procedures by which the taxpayer may appeal any IRS decision, the procedures for filing taxpayer complaints, and the enforcement procedures available to the IRS.[111] Most of these rights are explained in IRS Publications 1, 5, 556, and 594.[112]

The Taxpayer Bill of Rights 2 created the position of the Taxpayer Advocate.[113] Taxpayers have the right to enlist the Taxpayer Advocate's assistance in resolving problems with the IRS.[114] In certain instances, the taxpayers have the right to apply to the Taxpayer Advocate for collection relief where the taxpayer would face significant hardship.[115]

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105. Everson Testimony, *supra* note 30, *Introduction*.

106. Omnibus Taxpayer Bill of Rights, Title VI, Subtitle J, Pub. L. No. 100-647, 102 Stat. 3342 (1988).

107. Taxpayer Bill of Rights 2, Pub. L. No. 104-168, 110 Stat. 1452 (1996).

108. Internal Restructuring Act and Reform Act of 1998 (RRA), Pub. L. No. 105-206, 112 Stat 685.

109. *See* Technical and Miscellaneous Revenue Act of 1998, Pub. L. No. 100-647, 102 Stat. 3342.

110. *Id.* (relevant portion codified at 26 U.S.C. § 7801, notes).

111. *Id.*

112. IRS, PUBLICATION 1, YOUR RIGHTS AS A TAXPAYER (Rev. Aug. 2000); IRS, PUBLICATION 5, YOUR APPEAL RIGHTS AND HOW TO PREPARE A PROTEST IF YOU DON'T AGREE (Rev. Jan. 1999); IRS, PUBLICATION 556, EXAMINATION OF RETURNS, APPEAL RIGHTS, AND CLAIMS FOR REFUND (Rev. Jul. 2002); IRS, PUBLICATION 594, WHAT YOU SHOULD KNOW ABOUT THE IRS COLLECTION PROCESS (Rev. Feb. 2004), *available at* http://www.irs.gov/formspubs/lists/0,,id=97796,00.html.

113. Taxpayer Bill of Rights 2, Pub. L. No. 104-168, 110 Stat. 1452 (1996).

114. 26 U.S.C. § 7803(c)(2)(A) (2000).

115. *Id.* § 7811(a).

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It is crucial to rights of taxpayers that steps are taken to ensure that private collectors adequately inform taxpayers of these rights. Under IRS proposals for future use of private collectors, private collectors would initiate the collection process with a notice sent to the taxpayer's last known address informing the taxpayer that the collector is attempting to collect a debt owed to the IRS.[116] A copy of IRS Publication 1 ("Your Rights as a Taxpayer") which provides a brief overview of the collection process, including the right to seek assistance from the Taxpayer Advocate, would accompany the notice.[117] The notice would comply with the requirements applicable to comparable notices issued by the IRS, as well as the requirements imposed by the Fair Debt Collection Practices Act (FDCPA).[118]

Other government agencies either do not apply the FDCPA to PCAs or exempt them from some provisions.[119] It is important that this not be the case with regard to the IRS. The FDCPA provides significant protections for debtors in the collection process.[120] Among other things, the FDCPA sets out requirements for collection related communications.[121] Section 1692c of the FDCPA prohibits communications: (1) "at any unusual time or place or a time or place known or which should be known to be inconvenient to the consumer" (generally, communications may only be made between 8 a.m. and 9 p.m. local time)[122] or (2) at the consumer's place of employment if the collector knows or has reason to know that such communications are prohibited by the consumer's employer.[123] Additionally, if the consumer is represented by an attorney, collectors may not communicate directly with the consumer where the collector knows or can easily ascertain the attorney's name and address.[124]

Within five days after initial communication with a consumer, the FDCPA requires the collector to send a written notice to the consumer.[125] The notice must include the amount of the debt and the name of the creditor.[126] The notice must also

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116. Everson Testimony, *supra* note 30, *Reasons for Change*.

117. *Id.*

118. *Id.*; Fair Debt Collection Practices Act, Pub. L. No. 104-208, 110 Stat. 3009 (1996) (codified at 15 U.S.C. § 1692).

119. Olson Testimony, *supra* note 29; Fair Debt Collection Act.

120. 15 U.S.C. § 1692(e) (2000).

121. *Id.* § 1692c.

122. *Id.* § 1692c(a)(1).

123. *Id.* § 1692c(a)(3).

124. *Id.* § 1692c(a)(2).

125. *Id.* § 1692g(a).

126. 15 U.S.C. § 1692g(a)(1)–(2).

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include a statement that unless the consumer disputes validity of the debt within thirty days after receipt of the notice, the debt will be assumed to be valid.[127] If the consumer notifies the collector within the thirty-day period that the debt is disputed, the collector must cease collection activities until the collector obtains verification of the debt or a copy of the judgment.[128]

The FDCPA also prohibits collectors from using false or misleading representations.[129] False or misleading communications include the false representation or implication that the collector is affiliated with the United States.[130] Among other prohibited activities, the FDCPA specifically prohibits the following: (1) misrepresenting the character, amount or legal status of any debt or any services rendered or compensation which may be lawfully received by any debt collector for the collection;[131] (2) the false representation or implication that nonpayment of any debt will result in the arrest or imprisonment of any person or the seizure, garnishment, attachment, or sale of any property or wages of any person unless such action is lawful and the debt collector or creditor intends to take such action;[132] (3) the threat to take any action that cannot legally be taken or that is not intended to be taken;[133] (4) the use or distribution of any written communication which simulates or is falsely represented to be a document authorized, issued, or approved by any court, official, or agency of the United States or any State, or which creates a false impression as to its source, authorization, or approval;[134] (5) the use of any false representation or deceptive means to collect or attempt to collect any debt or to obtain information concerning a consumer;[135] (6) the failure to disclose that the debt collector is attempting to collect a debt and that any information obtained will be used for that purpose, and the failure to disclose in any communications that the communication is from a debt collector[136]; and (7) the false representation or implication that documents are legal process.[137] Additionally, the FDCPA prohibits the use of "unfair or

127. *Id.* § 1692g(a)(3).
128. *Id.* § 1692g(b).
129. *Id.* § 1692e.
130. *Id.* § 1692e(1).
131. *Id.* § 1692e(2).
132. 15 U.S.C. § 1692e(4).
133. *Id.* § 1692e(5).
134. *Id.* § 1692e(9).
135. *Id.* § 1692e(10).
136. *Id.* § 1692e(11).
137. *Id.* § 1692e(13).

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unconscionable means to collect" debt[138] and prohibits the furnishing of deceptive forms.[139] All of these provisions are relevant in the context of outsourcing tax collection.

The FDCPA also includes provisions that prohibit debt collectors from engaging in harassing behavior.[140] A debt collector may "not engage in any conduct the natural consequence of which is to harass, oppress, or abuse any person in connection with the collection of a debt."[141] Harassing behavior includes the use or threat of violence, the use of obscene or profane language, the publication of consumers who allegedly refuse to pay debts, engaging in repeated phone communications with the intent to harass any person, and the placement of calls without meaningful disclosure of the debtor's identity.[142] The debt collector must also cease communications with the debtor upon receipt of a written request to do so.[143]

The RRA enacted similar provisions with respect to the activities of IRS employees.[144] Section 6304 of the Code prohibits IRS employees from contacting taxpayers at unusual times and places as well as at the taxpayer's place of employment where the IRS has reason to know that the taxpayer's employer prohibits the taxpayer from receiving such communication.[145] Section 6304 also prohibits contact with the taxpayer when the taxpayer is represented by an attorney or other tax professional.[146] Additionally, this section contains other provisions preventing harassment and abuse of the taxpayer similar to those found in the FDCPA.[147]

While the FDCPA provides strict guidance for the activities of debt collectors, it may not alone be sufficient to prevent harassment of taxpayers. For example, the results of the 1996

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138. 15 U.S.C. § 1692f (prohibiting activities under this section include but are not limited to collection of amounts above the debt not authorized by law, depositing post-dated checks prior to the date on the instrument, and using language or other symbols, other than the collector's name or address on an envelope).

139. *Id.* § 1692j.

140. *Id.* § 1692d.

141. *Id.*

142. *Id.*

143. *Id.* § 1692c (permitting collectors to advise the consumer that the debt collector's further efforts are being terminated, to notify the consumer that the debt collector or creditor may invoke specified remedies which are ordinarily invoked by such debt collector or creditor; or where applicable, to notify the consumer that the debt collector or creditor intends to invoke a specified remedy).

144. *See generally* Internal Revenue Service Restructuring and Reform Act of 1998 (RRA), Pub. L. No. 105-206 § 3466, 112 Stat. 685.

145. 26 U.S.C. § 6304(a) (2000).

146. *Id.*

147. *Id.* § 6304(b).

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pilot program found that "contractors made hundreds of calls to taxpayers before 8 a.m. or after 9 p.m. and some calls were placed as early as 4:19 a.m."[148] During the course of the Department of Education's program for outsourcing collection of student loans, private collectors have "deceived consumers by misrepresenting themselves as Department of Education employees, overcharged consumers for collection fees, used misleading communications, browbeaten consumers into unaffordable payment plans, threatened actions that collectors can't take, and pressured consumers to borrow from relatives."[149] Some collectors in the Department of Education program fail to inform consumers of their rights or, even worse, steer them into options more profitable for the collectors.[150] While taxpayers would be afforded legal remedies under the FDCPA that will be discussed later in this article, any future program for outsourcing collection activities should include oversight adequate to prevent repeat offenders from receiving future IRS business. Otherwise, the threat of litigation from the few taxpayers that actually take steps to follow through and seek legal remedies may not be sufficient to curb abusive behavior.

Other laws currently regulate treatment of taxpayers by IRS employees during the collection process.[151] When IRS employees collect taxes, their performance evaluations are weighted heavily by their treatment of taxpayers.[152] As is discussed above, the RRA prevents evaluation based on records of tax enforcement.[153] The RRA provides that the IRS shall use "fair and equitable treatment of taxpayers" as one of the standards for employee evaluation.[154] The regulations also provide that part of the performance measures for evaluating IRS employees shall be based on customer satisfaction.[155] When IRS work units are evaluated for customer satisfaction purposes, information is "gathered from a statistically valid sample of the customers served by that operating unit. . . ."[156] These statistics are used to measure, among other things, "whether those customers believe

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148. 2003 Kelley Testimony, *supra* note 3, *Privatization of Tax Collection Was Tried and It Failed*.

149. *Federal Debt Management, Testimony Before Committee on House Government Reform* (Jun. 17, 2003) (Statement of Deanne Loonin, Staff Attorney, National Consumer Law Center), *available at* 2003 WL 56335387.

150. *Id.*

151. 26 U.S.C. § 7804; 26 C.F.R. § 801.2(b) (2004).

152. 26 U.S.C. § 7802(b)(5); 26 C.F.R. § 801.3(b).

153. 26 U.S.C. § 7804, notes; 26 C.F.R. § 801.1(b).

154. 26 C.F.R. § 801.3(b).

155. *Id.* §§ 801.3(a), 801.4.

156. *Id.* § 801.4.

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that they received courteous, timely and professional treatment by the [IRS]."[157]

Any future program for outsourcing collection should similarly evaluate the performance of private collectors based in part on their fair and equitable treatment of taxpayers and customer satisfaction. Otherwise, the intent of the RRA could be easily circumvented merely by outsourcing collection activities.

D. *Privacy and Security Concerns*

In the age of identity theft, any future program for outsourcing tax collection must take steps to protect both the security and privacy of taxpayers. First, legislation must prohibit private collectors from disclosing return information to third parties. Second, adequate background screening must be mandated for employees of private collectors handling sensitive taxpayer information.

Both the Privacy Act of 1974[158] and the Code limit the transmission of taxpayer information by IRS employees.[159] The Privacy Act provides that, except in limited situations, "no [government] agency shall disclose any record which is contained in a system of records by any means of communication to any person, or to another agency, except pursuant to a written request by, or with the prior written consent of, the individual to whom the record pertains. . . ."[160] The act does allow for transmission of records to "those officers and employees of the agency which maintains the record who have a need for the record in the performance of their duties[.]"[161] When an agency contracts out to "accomplish an agency function," the agency must take steps to ensure that the government contractor is bound by the provisions of the Privacy Act.[162] Therefore, to ensure that private collectors are bound by the same standards as IRS employees with respect to the Privacy Act, it would not be necessary to include in future legislation specific provisions making the Privacy Act applicable to PCAs because the Privacy Act already requires the IRS to structure any contract agreements with private collectors to include provisions

157. *Id.*

158. Privacy Act of 1974, Pub. L. No. 93-579, 88 Stat. 1896 (codified as amended at 5 U.S.C. § 552a).

159. 5 U.S.C. § 552a(b) (2000).

160. *Id.*

161. 5 U.S.C. § 552a(b)(1).

162. 5 U.S.C. § 552a(m)(1).

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subjecting the collectors to Privacy Act standards.[163]

Section 6103 of the Code also places restrictions on IRS employees regarding the disclosure of taxpayer information.[164] Section 6103 provides that "returns and return information shall be confidential" and prevents disclosure of return information except as provided for in that section.[165] An internal revenue officer or employee may, in connection with any audit, collection activity, or civil or criminal tax investigation "disclose return information to the extent that such disclosure is necessary in obtaining information, which is not otherwise reasonably available, with respect to the correct determination of tax, liability for tax, or the amount to be collected or with respect to the enforcement of any other provision of [the Code]."[166] The current section 6103 would not allow private collectors to disclose any information since they are not internal revenue officers or employees.[167] If future legislation allows PCAs to disclose any information during the collection process such as for investigative purposes, the legislation should strictly regulate disclosures to protect taxpayers' privacy and security.

Section 6103 would not require amendment in order to permit disclosure of taxpayer information by IRS employees to private collectors because section 6103 allows disclosure to any person providing services to the extent necessary for purposes of tax administration.[168] Under the IRS proposals, information provided to PCAs "would be strictly limited to the information required for the collection of the specific tax liability at issue."[169] Under the proposal, PCAs would not receive information such as that "regarding a taxpayer's total or adjusted income, sources of

163. Privacy Act of 1974 § 3.

164. 26 U.S.C. § 6103 (2000).

165. *Id.* § 6103(a). Return information includes:

> a taxpayer's identity, the nature, source, or amount of his income, payments, receipts, deductions, exemptions, credits, assets, liabilities, net worth, tax liability, tax withheld, deficiencies, overassessments, or tax payments, whether the taxpayer's return was, is being, or will be examined or subject to other investigation or processing, or any other data, received by, recorded by, prepared by, furnished to, or collected by the Secretary with respect to a return or with respect to the determination of the existence, or possible existence, of liability (or the amount thereof) of any person under this title for any tax, penalty, interest, fine, forfeiture, or other imposition, or offense[.] *Id.*

Any agreements with or determinations regarding the taxpayer to the extent that they can be identified with the taxpayer are also included. *Id.* § 6103(b)(2)(A).

166. *See id.* § 6103(k)(6).

167. *Id.* § 6103(a).

168. 26 U.S.C. § 6103(a)(3), (n).

169. Everson Testimony, *supra* note 30, *PCA Activities*.

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income, IRS examination results, delinquency history for liabilities not being handled by the PCA, or employer information."[170] The National Taxpayer Advocate proposes limiting information shared with PCAs to the taxpayer's name, last known address, tax year, type and amount of tax liability, amount and date of payments made toward the tax debt, and the portion of the tax liability attributable to tax, penalty and interest.[171] These recommendations are prudent in creating an outsourcing plan that adequately protects taxpayer's privacy and security.

Additional safeguards are provided by the FDCPA, which limits communications between collectors and third parties.[172] Without the prior consent of the consumer given directly to the debt collector, by judicial order, or for purposes of effectuating a postjudgment judicial remedy, a debt collector may not communicate "with any person other than a consumer, his attorney, the creditor, the attorney of the creditor, or the attorney of the debt collector."[173]

The use of subcontractors must be considered in the context of these restrictions on disclosure of taxpayer information. The use of subcontractors by private collectors would likely result in greater costs to the IRS by creating additional oversight burdens.[174] The National Taxpayer Advocate recommends restricting use of subcontractors by private collectors in activities that involve either direct taxpayer contact or direct contact with or handling of taxpayer information in activities other than skip-tracing.[175] The National Taxpayer Advocate also recommends creating penalties for PCAs for violations committed by subcontractors.[176] This would create a strong incentive for PCAs to carefully select subcontractors and oversee their activities.

E. *Penalties*

The success of regulating the activities of private collectors will depend heavily on the penalties they face for infractions. Protecting taxpayer rights from the actions of private collectors will require taxpayer access to a wide range of remedies. Taxpayers have access to statutory remedies under the Code for

170. *Id.*
171. Olson Testimony, *supra* note 29, *Introduction*.
172. 15 U.S.C. § 1692c(b) (2000).
173. *Id.*
174. Olson Testimony, *supra* note 24, *PCA Use of Subcontractors*.
175. *Id.*
176. *Id.*

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infractions of the IRS and its employees.[177] While private collectors are subject to statutory remedies for debtors under the FDCPA, they should also be subject to the same sanctions provided under the Code as the IRS and its employees for tax collection purposes.

Under the FDCPA, remedies available to individual debtors are limited in the absence of actual damages.[178] The FDCPA allows individuals to recover actual damages plus other damages up to $1,000 and litigation costs.[179] In the case of a class action suit, the debt collector is subject to the same damages for class members, plus the lesser of $500,000 or 1% of the collector's net worth for all other class members.[180]

Section 7433 of the Code provides taxpayers with a cause of action against the IRS when an employee of the IRS recklessly, intentionally, or negligently disregards any provision of the code in connection with tax collection activities.[181] In an action brought under section 7433, the taxpayer may recover the amount of actual damages as well as litigation costs.[182] Damages for section 7433 actions are capped at $100,000 for negligence and $1,000,000 for reckless or intentional behavior.[183] In order to protect taxpayer rights, private collectors must be subject to causes of action under section 7433 for damages caused by the disregard of Code sections.

Under section 1203 of the RRA, employees of the IRS are subject to termination for violations of the Code and IRS policies committed for the purpose of "retaliating against, or harassing, a taxpayer."[184] In order to uphold the intent of the RRA, private collectors must similarly be required to terminate employees for such behavior.[185]

Both the Privacy Act and the Code provide for legal remedies for unlawful disclosure of taxpayer information. Specifically, section 6103 already prevents government contractors from disclosing return information.[186]

Under the Privacy Act, an unlawful disclosure by a private

177. 26 U.S.C. § 7433 (2000).

178. 15 U.S.C. § 1692k.

179. *Id.* § 1692k (1), (2)(A), (3).

180. *Id.* § 1692k(2)(B).

181. 26 U.S.C. § 7433(a).

182. *Id.* § 7433(b).

183. *Id.*

184. Internal Revenue Service Restructuring and Reform Act of 1998 (RRA), Pub. L. No. 105-206, 112 Stat. 685, § 1203 (codified at 26 U.S.C. § 7804, Notes).

185. *Id.*

186. 5 U.S.C. § 552a (2000); 26 U.S.C. § 6103(a) .

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collector would give rise to a cause of action for actual damages as well as attorney's fees.[187] In any such case where the plaintiff is successful, the plaintiff is entitled to a minimum of $1,000, regardless of actual damages.[188] The individual actually responsible for the unlawful disclosure is also subject to misdemeanor charges and up to a $5,000 fine if the violation is willful.[189]

The penalties and fines for unlawful disclosure of taxpayer information are more severe under the Code. Section 7431 provides civil remedies for violations of section 6103.[190] Section 7431 applies to private collectors regardless of whether the disclosure is done knowingly or negligently.[191] Significant damages can arise from a violation of section 6103.[192] Under section 7431, the plaintiff is entitled to the greater of $1,000 for each unlawful inspection or disclosure or the actual damages.[193] In either case, the plaintiff is also entitled to litigation costs and attorney's fees.[194] Willful violations of section 6103 carry more severe penalties.[195] In addition to actual damages, a plaintiff bringing suit under section 7431 may also receive punitive damages if the unlawful inspection or disclosure is done willfully.[196] Willful disclosures and inspections also carry criminal penalties.[197] Employees of private collectors committing willful disclosures in violation of section 6103 are subject to felony conviction punishable by up to $5,000 plus litigation costs and five years in prison.[198] Unlawful inspections carry up to a $1,000 fine and one year in prison.[199]

The existence of the foregoing penalties is crucial to regulating the acts of private collectors and ensuring protection of taxpayer rights. Any future program for outsourcing tax collection activity should adequately inform taxpayers of their rights under the various laws. Well informed taxpayers would create a greater incentive for private collectors engaged in tax

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187. 5 U.S.C. § 552a(g)(4).
188. *Id.*
189. *Id.* § 552a(i), (m)(1).
190. 26 U.S.C. § 7431.
191. *Id.* § 7431(a)(2).
192. *Id.* § 7431(c).
193. *Id.* § 7431(c)(1).
194. *Id.* § 7431(c)(2), (3).
195. *Id.* § 7431(c)(1)(B)(ii).
196. 26 U.S.C. § 7431(c)(1)(B)(ii).
197. *Id.* §§ 7213, 7213A.
198. *Id.* § 7213(a).
199. *Id.* § 7213A(b).

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collection to respect the laws and regulations governing collection activities.

V. ANALYSIS OF LEGISLATION AS PASSED

A. *Proposed Bills*

The American Jobs Creation Act recently passed by Congress enacts provisions for use of private collectors to collect delinquent taxes.[200] The legislation adds section 6306 to the Code and allows the IRS to enter into "qualified tax collection contracts."[201] The legislation allows the IRS to retain up to 25% of the amount collected by a private collector for the costs of services performed under the contract.[202] The legislation applies many of the concepts previously discussed in this article.

Under the legislation, private collectors are allowed to locate and contact taxpayers, request full payment from taxpayers, and offer taxpayers three-year installment plans if they cannot pay in full.[203] As is discussed above, authorizing PCAs to offer installment agreements does not constitute an inherently governmental activity where the installment plans are statutorily limited in duration and the PCA does not exercise discretion over which taxpayers are eligible.[204] The legislation also authorizes PCAs to obtain financial information about the taxpayer when requested by the Secretary.[205] Overall, the legislation does not allow the PCAs to conduct any activity that is inherently governmental in nature or that would violate the FAIR Act.[206]

Under the legislation, the use of subcontractors will be greatly limited.[207] Subcontractors will not be allowed to contact taxpayers, provide quality assurance services, or compose collection notices.[208] Other activities can only be conducted by subcontractors with approval of the Secretary.[209] This measure lessens the burden on IRS employees charged with oversight of PCA activities. It also protects taxpayers by ensuring that only

200. American Jobs Creation Act of 2004, Pub. L. No. 108-357, 118 Stat. 1418.
201. *Id.* § 487 (to be codified at § 6306).
202. *Id.* (to be codified at § 6306(c)).
203. *Id.* (to be codified at § 6306(b)(1)(A), (B)).
204. *See supra* Part III.D.
205. American Jobs Creation Act § 487 (to be codified at § 6306 (b)(1)(C)).
206. *Id.* (to be codified at § 6306).
207. *Id.* (to be codified at § 6306 (b)(3)
208. *Id.*
209. *Id.*

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those contractors selected by the IRS in the application process and who have accepted all the obligations imposed by such contracts will be in direct contact with taxpayers and sensitive taxpayer information.[210]

The legislation prohibits private collectors from committing any act or omission that IRS employees are prohibited from committing during the course of tax collection.[211] It also applies the FDCPA to private collectors, but where superseded by the fair debt collection provisions found in section 6304 of the Code, any cause of action will arise from the tax code.[212] As a result, taxpayers will have all of the same rights and protections in PCA collection that they enjoy when collection is conducted by an IRS employee plus additional protections found in the FDCPA.

The legislation will exempt the IRS from liability for acts committed by private collectors.[213] § 801.1(b). The legislation adds section 7433A to the Code making remedies available to taxpayers under section 7433A for acts or omissions committed by IRS employees applicable to those committed by private collectors.[214] An action brought under section 7433A pursuant to section 7433A will not be a taxpayer's exclusive remedy against the private collector.[215] The monetary liability will likely provide PCAs an incentive to ensure that their employees are well trained and to take steps to prevent them from violating taxpayer rights. While insulating the IRS from liability may decrease the IRS' incentive to strictly regulate PCA activities, the fact that there is no joint liability with the IRS will likely increase incentives for PCAs to adhere to the law in collection activities. If joint liability existed, many PCAs might take comfort in the belief that any liability would be shared with a large government bureaucracy.

Employees of private collectors will cease to be permitted to perform work under a tax collection contract for willful retaliation against or harassment of taxpayers and their representatives to the same extent that IRS employees are subject to termination for such activities under section 1203.[216] Subjecting employees of private contractors to termination under

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210. The IRS has already proposed an extensive PCA contract that includes extensive provisions designed to protect taxpayers and taxpayer security. *See* TIRNO-03-H-00001, *available at* http://www.procurement.irs.treas.gov/collectionrelated/.

211. American Jobs Creation Act § 487 (to be codified at § 6306 (b)(2)).

212. *Id.* (to be codified at § 6306 (e)).

213. *Id.* (to be codified at § 6306 (d)).

214. *Id.* (to be codified at § 7433A (a)).

215. *Id.* (to be codified at § 7433A (b)(3)).

216. *Id.* (to be codified at § 7433A (e)).

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section 1203 for retaliation and harassment of taxpayers may not create the same level of incentive provided to IRS employees enjoying the benefits of a government job. However, as is discussed above, both the Privacy Act and section 6103, preventing unlawful disclosure of taxpayer information, already apply to private contractors.[217] Both would subject individual employees of PCAs to civil and criminal liability.[218] The IRS should prepare literature detailing the potential personal liabilities of PCA employees. PCA contracts should require all PCA employees to read and understand this literature. Notifying PCA employees of their potential liability would likely deter many from inappropriate behavior.

While the legislation allows for 25% of amounts collected to be set aside for PCA compensation, it does not specify how such money should be allocated. It is left to the IRS to implement a payment system consistent with the principles of the RRA. Therefore, the IRS should structure PCA contracts in such a way that incentives are not based solely on the amounts collected. A compensation plan based on a flat fee per return would not create incentives that conflict with the principles of the RRA, but such a plan would not create any incentive for PCAs to collect. It would also shift the costs associated with claims where the PCA is unable to collect to the IRS. Such a plan would likely result in huge costs to the IRS with little benefit.

It is difficult to design a system that provides both an incentive to collect and, at the same time, promotes fair and equitable treatment of taxpayers. The legislation provides that the IRS may "retain" the compensation amount.[219] Presumably, the use of "retain" implies that all taxes collected by PCAs will be first payable to the IRS, and PCA compensation will then be distributed from these funds.[220] The dual task of compensating PCAs both on the basis of amounts collected and on the treatment of taxpayers might be achieved by first providing in

217. *See supra* Part III.D.

218. 5 U.S.C. § 552a (2000); 26 U.S.C. § 7431 (2000).

219. American Jobs Creation Act § 487 (to be codified at § 6306 (c)).

220. *Id.* Section 7809(a) of the Code provided that collections received or collected by authority of the internal revenue laws shall be paid daily into the United States Treasury, without any deduction for compensation, fees, costs, charges, expenses, or claims of any description, but section 487 of the legislation provides an exception for PCA compensation. *Compare* 26 U.S.C. § 7809(a), *with* American Jobs Creation Act § 487 (to be codified at § 6306 (c)). The current IRS proposal calls for PCA compensation to be made from a revolving fund. U.S. GEN. ACCOUNTING OFFICE, GAO-04-492, TAX DEBT COLLECTION: IRS IS ADDRESSING CRITICAL SUCCESS FACTORS FOR CONTRACTING OUT BUT WILL NEED TO STUDY THE BEST USE OF RESOURCES (May 2003) at 1, *available at* http://www.gao.gov/new.items/d04492.pdf [hereinafter GAO Tax Debt Collection].

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contracts for compensation on a percentage of amounts collected and then allowing for deductions from that amount prior to distribution to PCAs for certain infractions. This objective could be furthered by reserving room in the percentage amount for bonuses that could be awarded to PCAs that receive positive feedback.[221] Such a system would rely heavily on informing taxpayers of both their rights and how to report infractions. IRS publications already contain much of this information,[222] but providing taxpayers subject to PCA collection with a specific publication outlining PCAs activities would be a prudent step. Well informed taxpayers are crucial to a system designed to protect taxpayer rights.

In addition to major infractions, PCAs should be subject to customer satisfaction evaluations. Providing taxpayers with a simple form evaluating PCA collection activities would aid in PCA oversight. If PCAs that performed poorly on such evaluations faced the possibility of losing lucrative government contracts, they would likely take additional steps to ensure fair and equitable treatment of taxpayers.

Many of the potential pitfalls in the legislation exist due to the fact that the legislation only provides a loose framework for any future PCA plan. For example, there is no guarantee that the IRS will implement a plan with a compensation structure that both furthers the principles of the RRA and provides incentives for PCA performance. Similarly, it is left up to the IRS to properly supervise PCA activities, to ensure that taxpayers are well informed of their rights with respect to PCAs, and to create a system that adequately collects and gauges taxpayer feedback on PCAs.

A final problem with the loose legislative framework is the failure to limit the types of cases appropriate for allocation to PCAs. As is discussed above, the IRS, in an effort to conform with the FAIR Act, proposes to only outsource cases where the tax payer has indicated a balance due or has made three or more payments on an amount assessed by the IRS.[223] The legislation, however, leaves this decision entirely up to the IRS.[224]

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221. IRS proposals call for some use of incentives and disincentives based on PCA performance. GAO Tax Debt Collection, *supra* note 220, at 11.

222. *Id.*

223. Everson Testimony, *supra* note 30, *Introduction*.

224. *Id.*

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B. *Economic Analysis*

Where the main objective is maximizing collection receipts, the question of whether the legislation will adequately protect taxpayers is irrelevant if an outsourcing system will not yield economic benefits to the IRS. If additional IRS allocations would yield greater returns than PCA use, then there is no justification for a PCA program.

In 2002, Commissioner Rossotti reported that hiring an additional 5,450 employees at a cost of $296.4 million would allow the IRS to collect an additional $9.47 billion of known tax debts.[225] This would mean a $31 return for every dollar spent versus $3 return for every dollar spent under the 25% commission scheme ($3.25 billion to collect $13 billion).[226] It is important to remember that any use of PCAs, in addition to PCA compensation, entails costs and a reduction of IRS resources to the extent necessary for oversight activities. According to the Joint Committee on Taxation, the use of PCAs at the 25% rate would bring in less than $1 billion over ten years, while the IRS could bring in that amount in 1 year with just $30 million of additional resources.[227] While there might be bias in these figures, there is a large margin of error in them that would still favor allocation of additional IRS resources over the use of PCAs.

In reality, these numbers do not justify legislating a PCA program where better results could be achieved by merely increasing IRS funding. The additional IRS resources necessary for PCA oversight will reduce existing IRS resources likely resulting in more collections that need to be outsourced to PCAs where the rate of return to the government will be lower. It is mind-boggling to think that Congress repeatedly refuses to provide the IRS with adequate funding to collect taxes which are already owed. Collecting the billions already due would provide a stream of revenue to the federal government that would not require members of Congress to anger their constituents by raising taxes. The IRS is the one area of government where allocating additional resources can yield increased, not decreased, federal revenue. Under the numbers discussed above, providing further IRS resources would yield exponential return rates, return rates higher than those under a PCA program. There is no plausible argument for refusing to fund a program that guarantees returns far in excess of its costs.

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225. 2002 Report to IRS Oversight Board, *supra* note 30, at 16.

226. 2003 Kelley testimony, *supra* note 3, *Spending Taxpayer Money Wisely*.

227. *Id.*

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Due to the enormous backlog in uncollected taxes that has built up over recent years, there still is a place for a PCA program in conjunction with increased IRS funding. PCAs should not be used in lieu of increased IRS funding but could be used to augment the IRS collection program. The sheer volume of uncollected taxes makes it unlikely that any increase in IRS funding would be sufficient to collect all of those taxes due.

In any system, PCAs would be best utilized to collect stale claims. Using a system that compensates PCAs on a percentage basis shifts most of the risk of costs incurred in the case of non-collection to the PCA. While this potentially leads to improper incentives, the system, discussed above, that would deduct from such amounts for infractions during the collection process could be applied. Less certain would be the profitability of a program that compensates PCAs based on other standards such as the number of taxpayers successfully contacted. The IRS should not give up 25% of receipts for claims that it could likely collect. By transferring stale claims to PCAs, however, IRS resources would be freed up to allow for more concentration on newer tax debts where collection is likely to take less effort. While stale claims are less desirable, a free market would determine the transferability of such claims, and, assuming that payment is on a commission basis, this would be at no cost to the IRS unless collected. This would also free up more IRS resources to enforce tax laws through audit activity. Increased audits will also yield more future revenues as taxpayers and tax professionals determine that false reporting and underreporting carries a greater risk in a cost-benefit analysis.

Since the legislation does not define which cases are appropriate for PCA allocation, it will be up to the IRS to implement a plan that best suits the government's needs. A prudent plan would also take into consideration the staleness of a claim determining which claims to allocate to PCAs. Additionally, the IRS should refrain from outsourcing many claims from the "deferred" category. As is discussed above, during the 1996 pilot program, a large percentage of the claims allocated to PCAs were the small claims from the deferred category that the IRS itself could easily have collected by merely offsetting the amounts due against future refunds.[228] The legislation leaves it up to the IRS to not repeat this same mistake.[229]

228. GAO/GGD-97-129R, *supra* note 42 at 3.

229. According to a recent GAO report, the IRS recognizes the need to develop methods for determining appropriate claims for PCA placement. GAO Tax Debt

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C. *Is the Outsourcing of Tax Collection Sound Public Policy?*

Determining whether outsourcing tax collection is sound governmental policy requires consideration of factors ancillary to statutory and economic analysis. The statutory analysis above discussed limitations that will be placed on PCA activities and protections that will be afforded to taxpayers. The economic analysis discussed economic advantages that could be achieved by the use of PCAs. Outsourcing taxes is a policy that could potentially affect every taxpayer, and therefore, other factors should be seriously considered. The question of whether we want to subject taxpayers to the actions of private collectors must be posed.

Statutory protections regulating PCA activity and providing for penalties do not guarantee that PCAs will not engage in inappropriate behavior during collection. While the same could be said about regulations with regard to government employees, government employees' main incentive is maintaining their comfortable government jobs while employees of PCAs may have incentives based on their employer's objectives of maximizing collections. It is unlikely that an IRS employee will take the time to harass a taxpayer at 4:00 a.m. as was the case with some PCAs during the pilot program.[230]

Similar concerns should be considered with respect to taxpayer security. Once sensitive taxpayer information leaves the confines of the IRS, there is no guarantee that taxpayer security will not be violated. Unlike an IRS employee who enjoys government wages and benefits as well as union membership, a low wage PCA employee may not feel the same level of risk in making a decision to misuse private taxpayer information. In a recent lockbox program where private banks were entrusted with taxpayer checks, Mellon Bank lost over $1.2 billion in taxpayer checks.[231] A GAO report on fiasco found that "oversight. . .was not fully effective to ensure that taxpayer data and receipts were

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Collection, *supra* note 220, at 3. After implementation of the PCA program, the IRS plans for continued comparison of PCA and IRS performance. *Id.* The GAO recommends that such evaluation should take into consideration which types of cases constitute the best allocation of IRS resources in light of the fact that there are limited IRS resources available to deal with more complicated, higher priority cases. *Id.* The GAO concluded that, after experience is gained, a study should be conducted that takes into consideration the results that might be achieved by hiring more IRS employees. *Id.* at 4.

230. 2003 Kelley testimony, *supra* note 3, *Privatization of Tax Collection Was Tried and It Failed*.

231. U.S. GEN. ACCOUNTING OFFICE, GAO-03-299, IRS LOCKBOX BANKS: MORE EFFECTIVE OVERSIGHT, STRONGER CONTROLS, AND FURTHER STUDY OF COSTS AND BENEFITS ARE NEEDED (Jan. 15, 2003), *available at* http://www.gao.gov/atext/d03299.txt.

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adequately safeguarded and properly processed."[232] There is no guarantee that similar mistakes would not arise in oversight of a PCA program.

No amount of deterrents provided by the law and IRS policy will dissuade all PCAs operating in a capitalistic society and ultimately motivated by the bottom line from engaging in taxpayer abuse. Additionally, penalties will not deter all low-paid PCA employees from engaging in inappropriate activities. IRS employees with secure government jobs have a much greater incentive to refrain from inappropriate activities. Additionally, oversight of the PCAs will be left up to an already overburdened IRS. For these reasons alone, irrespective of the fact that PCA usage would not produce the same yields as increased IRS funding, outsourcing taxes may just be a bad idea.[233]

The final policy consideration concerns government jobs. Outsourcing tax collection could be used in one of two ways. Either it could be used as a system designed to supplement IRS resources and contribute to more efficient collection activities, or it could be used as a system to replace well paid government employees with benefits and a strong union with low paid non-union PCA employees. To the extent that increasing IRS employees and resources would bring in more revenue than the use of PCAs for collection, the later approach does not constitute sound policy and should be rejected.

VI. CONCLUSION

Outsourcing tax collection is a policy that requires many serious considerations. Every American is potentially subject to PCA activities. Paying your taxes does not guarantee that a taxpayer will not be subject to PCA collection as the result of bureaucratic error. The recently passed legislation provides a loose framework for a future program that leaves numerous considerations with respect to implementation that must be addressed by the IRS in the structuring of contracts and

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232. *Id.*

233. "In January 2004, Congress approved the IRS's Fiscal Year 2004 budget, which would provide the funding to further develop the PCA program, but IRS delayed spending the funds until passage of the legislation appears to be more imminent." GAO Tax Debt Collection, *supra* note 220 at 3. The IRS officials recognize that major development work still remains and estimate that, upon passage of the authorizing legislation, it will take eighteen to twenty-four months to complete the remaining work on the PCA plan. *Id.* The IRS plan calls for PCA training courses on taxpayer issues, contract provisions that call for the following of federal law and prescribe the appropriate treatment of taxpayers and protection of taxpayer data, compliance checks that include for PCA call monitoring and taxpayer satisfaction surveys. *Id.* at 11-12.

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oversight of PCA activities. If such a program is implemented, the method of compensation for private collectors must provide incentives for the fair and equitable treatment of taxpayers. There must be adequate oversight by IRS employees to screen private collectors before granting contracts and to penalize collectors that violate taxpayers' rights and eliminate future use of those collectors with repeated transgressions. The program should not be used as a primary collection tool; it should only be used as a supplementary tool in the collection process. In order to maximize tax receipts, Congress must increase IRS funding and provide for more IRS employees instead of merely outsourcing the problem. There is no sound policy reason for not increasing the budget for a program that would bring in further revenue exponentially. A closely watched, well thought out plan for outsourcing tax collection activities could successfully supplement a corresponding increase in IRS in-house collection activities. Regardless of the course taken, a more efficient collection process is necessary not only to prevent the foregoing of current revenue but, also, to provide taxpayers an incentive to comply with tax laws in the future.

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DEFERENCE UNDER THE CLEAR REFLECTION OF INCOME REQUIREMENT: *SUI GENERIS*

W. Eugene Seago,[*] *and Edward J. Schnee*[**]

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I. INTRODUCTION

Much of administrative law is devoted to the questions of when and to what extent the court should defer to the decisions of an administrative agency.[1] Gaps in statutes often exist, and should the court decide that no deference is due the

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1. *See* Thomas W. Merrill, *The Mead Doctrine: Rules and Standards, Meta-Rules and Meta-Standards*, 54 ADMIN. L. REV. 807, 809 (2002). *See also, ABA Section of Taxation: Report of the Task Force on Judicial Deference, 57* Tax Law. 717 (2004).

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administrative branch, the judicial branch must fill the gaps in the manner the court deems most appropriate.[2] On the other hand, when deference to the administration is due, the court's task is one of determining whether the legislature has granted the agency the authority to fill the gaps, and if so, whether the agency has properly exercised its authority.[3] In the latter case, the issue for the court is not what is "the correct" interpretation or application of the statute, but whether the administrative rule clearly violates a legislative directive, and if not, whether the agency's answer is reasonable.[4]

In 1983, Henry P. Monagham explained the concept and significance of deference as follows:

> Deference, to be meaningful, imports agency displacement of what might have been the judicial view *res nova* – in short, administrative displacement of judicial judgment. Where there is meaningful deference, the agency, not the court, supplies at least part of the meaning of the law. Deference in this sense includes judicial decisions purporting to accept "reasonable" agency statutory construction, as well as judicial use of deference principles to resolve statutory "uncertainty" – a tie-breaker, so to speak – invoked when the court accepts the agency interpretation because it is satisfied that there is no one "correct" resolution of the statute's meaning.[5]

The Administrative Procedures Act[6] has some impact on how deference issues are decided, but in many instances the Supreme Court has been required to determine the precise roles of the judicial and administrative branches of government in filling gaps and resolving ambiguities created by the legislature.[7] As will be shown below, the courts have decided that it is appropriate for the administrative branch to have a much more influential role in resolving tax accounting issues than in other

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2. *See* Henry P. Monaghan, *Marbury and the Administrative State*, 83 COLUM. L. REV. 1, 6 (1983).

3. *Id.* at 5.

4. *Id.*

5. *Id.*

6. 5 U.S.C. §§ 551-706 (2001).

7. *See* Robert N. Anthony, *The Supreme Court and the AP: Sometimes They Just Don't Get It*, 10 ADMIN. L. J. AM. U. 1, 33 (1996).

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areas of the law.[8]

Tax accounting is concerned with the timing of income or deductions – when the income or deduction is recognized.[9] As a result of the time value of money, a deferral of taxable income is tantamount to an exclusion of the earnings on the deferred taxes, and the acceleration of income is equivalent to a double inclusion in income for the return that would have been earned on the deferred taxes.[10] Thus, the resolutions of tax accounting issues are extremely important to taxpayers and the government. Moreover, tax accounting issues typically present a number of defensible solutions; therefore, if the administrative branch chooses any one of these solutions and receives deference, the issue is decided in favor of the agency regardless of the existence of an even better solution.[11]

This article explores the general deference principles in Parts I and II. Part III considers the special case of deference as applied to the "clear reflection of income" requirements in Code section 446 and 471. Part IV discusses the taxpayer's defenses to the charge that the accounting method does not clearly reflect income. Part V presents examples of clear reflection of income cases were deference principles were correctly applied and where they were the principles were not recognized. Our conclusions are contained in Part VI.

II. WHY SHOULD THE COURTS DEFER TO THE ADMINISTRATION?

The legal principles supporting the grant of deference to administrative determinations has developed along an uncertain course, but is generally founded on the practice by Congress of delegating legislative powers to the administrative branch.[12] In

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8. *See infra* Part III.

9. *See* Daniel L. Halperin, *Interest in Disguise: Taxing the Time Value of Money*, 95 YALE L. J. 506, 508 (1986).

10. *See, e.g., id.* at 510; W. Eugene Seago, *A Modest Proposal Regarding the Matching Principle*, 90 TAX NOTES 1855, 1856 (2001).

11. *See* Chevron U.S.A. v. Nat'l Res. Def. Council, 467 U.S. 837, 843 n.11 (1984) (stating "[t]he court need not conclude that the agency construction was the only one it permissibly could have adopted to uphold the construction, or even the reading the court would have reached if the question initially had arisen in a judicial proceeding."); FEC v. Democratic Senatorial Campaign Comm., 454 U.S. 27, 39 (1981); Zenith Radio Corp. v. United States, 437 U.S. 443, 450, (1978); Train v. Natural Res. Def. Council, Inc., 421 U.S. 60, 75, (1975); Udall v. Tallman, 380 U.S. 1, 16, (1965); Unemployment Comp. Comm'n v. Aragon, 329 U.S. 143, 153, (1946); McLaren v. Fleischer, 256 U.S. 477, 480-81 (1921).

12. United States v. Mead, 533 U.S. 218, 226-27 (2001) (stating "[w]e hold that administrative implementation of a particular statutory provision qualifies for Chevron deference when it appears that Congress delegated authority to the agency generally to make rules carrying the force of law, and that the agency interpretation claiming

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1940 the Supreme Court explained why the administrative agencies are delegated law making powers:

> Delegation by Congress has long been recognized as necessary in order that the exertion of the legislative power does not become a futility. *Currin v. Wallace*, 306 U.S. 1, 15, and cases cited. But the effectiveness of both the legislative and administrative processes would become endangered if Congress were under the constitutional compulsion of filling in the detail beyond the liberal prescription here.[13]

Accordingly, the Court has limited its role as follows:

> We do not sit as a committee of revision to perfect the administration of the tax laws. Congress has delegated to the Commissioner, not to the courts, the task of prescribing 'all needful rules and regulations for the enforcement' of the Internal Revenue Code. 26 U.S.C. § 7805(a). In this area of limitless factual variations 'it is the province of Congress and the Commissioner, not the courts, to make the appropriate adjustments.'[14]

In a 1969 case the Supreme Court reasoned as follows:

> [I]t is fundamental . . . that as 'contemporaneous constructions by those charged with administration of' the Code, [Treasury] Regulations 'must be sustained unless unreasonable and plainly inconsistent with the revenue statutes, and 'should not be overruled except for weighty reasons.'[15]

Thus, Congress can enact a statute requiring that the administrative branch collect taxes on income even though

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deference was promulgated in the exercise of that authority.").

13. Sunshine Anthracite Coal Co., v. Adkins, 310 U.S. 381, 398 (1940); *see also* Monaghan, *supra* note 2, at 25 (stating "'legislation' is not a finished product when it leaves Congress.").

14. United States v. Correll, 389 U.S. 299, 306-07 (1967).

15. Bingler v. Johnson, 394 U.S. 741, 749-750 (1969) (citing Comm'r of Internal Revenue v. S. Tex. Lumber Co., 333 U.S. 496, 501 (1948)).

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Congress has not defined income. Congress can require that taxable income must be computed in such a manner that it is "clearly reflected" when Congress could not possibly know the meaning of these terms. When the administrative agencies attempt to fill the gaps, the court can determine whether the agency has exceeded the bounds of its authority using standards of deference, as will be further discussed below.[16]

In some instances the delegation is explicit, as in section 59(g) of the Internal Revenue Code.[17]

> Section 59(g) Tax Benefit Rule: The Secretary may prescribe regulations under which differently treated items shall be properly adjusted where the tax treatment giving rise to such items will not result in the reduction of the taxpayer's regular tax for the taxable year for which item is taken into account or for any other taxable year.[18]

Apparently, Congress recognized that the interplay between the alternative minimum tax and the tax benefit rule applicable to the "regular tax" can be extremely complicated, so much so that Congress, in section 59(g), explicitly delegated to the administration the authority to resolve these issues through regulations.[19] Thus, assume for a particular situation, persons technically proficient on the issue could devise two or more defensible methods to calculate the portion of a deduction that did not produce a tax benefit, but the regulations would accept only one of those methods. The regulation would be upheld because the Secretary was granted the authority to prescribe how taxable income is to be "properly adjusted."[20] That the court may have preferred a different method of calculating the portion of the deduction which produced a tax benefit is of no import because Congress has directed that the method to be followed is the Secretary's choosing.[21] To decide against the administration

16. *See infra* Part II.

17. For a judicial and legislative history of section 59(g), see I.R.S. F.S.A. 1995 WL 1770330 (July 27, 1995); U.S. v. Deckelbaum, 784 F. Supp. 1206, 1208 n.3 (D. Md. 1992). Section 59(g) is somewhat unusual in that it provides the Secretary "may", rather than "shall," prescribe regulations, but if the Commissioner does provide the regulations it would seem the regulations would have the force of law.

18. I.R.C. § 59(g) (2000).

19. *Id.*

20. *See* Ronald M. Levin, *Mead and the Prospective Exercise of Discretion*, 54 ADMIN L. REV. 771, 776 (2002).

21. *See id.* at 776-77.

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would be to reject the will of Congress.[22]

In some cases Congress has implicitly delegated law-making authority to the administration. For example, section 448(d)(5) provides that certain accrual basis service providers are not required to accrue income that "on the basis of experience" will not be collected.[23] Such language cries for clarification as to how the "basis of experience" is to be determined. It would be impossible to administer such a vague law fairly without the benefit of the Internal Revenue Service providing detailed guidance. This guidance – when accepted by the court – would create a single rule to be uniformly applied, resulting in a fair and consistent administration of the law.

The agency's "expertise" is frequently mentioned as a justification for the legislature deferring to the administrative branch.[24] The legislature, as well as the courts, may consider itself incompetent to decide the more technical questions such as the merits of an accounting method, but the courts are competent to decide issues framed in terms of deference;[25] that is, whether the administration's answer is reasonable, or not arbitrary.[26]

In *Chevron* the Supreme Court justified deference to the administration because of its political accountability for the policy choices Congress permits, and also because of the presumed expertise of the administrative agency.[27] In declaring valid an environmental regulation, the Court reasoned as follows:

> Congress intended to accommodate both [environmental and business] interests, but did not do so itself on the level of specificity presented by these cases. Perhaps that body consciously

22. *See id.* at 777.

23. *But see* FDA v. Brown & Williamson Tobacco Co., 529 U.S. 120, 123 (2000) (reasoning that extraordinary circumstances may counter this presumption of implicit authority).

24. *See, e.g.*, Ford Motor Credit Co. v. Milhollin, 444 U.S. 555, 566, 568-69 (1980) (reasoning "a court that tries to chart a true course to the Act's purpose embarks upon a voyage without a compass when it disregards the agency's views . . . [a]nd striking the appropriate balance is an empirical process that entails investigation into consumer psychology and that presupposes broad experience with credit practices. Administrative agencies are simply better suited than courts to engage in such a process.").

25. *See* Brown v. Helvering, 291 U.S. 193, 203 (1934); *see also* Cass R. Sunstein, *Law and Administration After Chevron*, 90 COLUM. L. REV. 2071, 2076 (1990) (making the point that while the court is competent to decide questions of law that the application of the law to facts call for a different standard, since the agency's specialized fact-finding capacity and accountability are highly relevant).

26. Sunstein, *supra* note 25, at 2105.

27. *See Chevron*, 467 U.S. at 865.

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desired the Administrator to strike the balance at this level, thinking that those with great expertise and charged with responsibility for administering the provision would be in a better position to do so; perhaps it simply did not consider the question at this level; and perhaps Congress was unable to forge a coalition on either side of the question, and those on each side decided to take their chances with the scheme devised by the agency. For judicial purposes, it matters not which of these things occurred. Judges are not experts in the field, and are not part of either political branch of the Government. Courts must, in some cases, reconcile competing political interests, but not on the basis of the judges' personal policy preferences. In contrast, an agency to which Congress has delegated policy-making responsibilities may, within the limits of that delegation, properly rely upon the incumbent administration's views of wise policy to inform its judgments. While agencies are not directly accountable to the people, the Chief Executive is, and it is entirely appropriate for this political branch of the Government to make such policy choices – resolving the competing interests which Congress itself either inadvertently did not resolve, or intentionally left to be resolved by the agency charged with the administration of the statute in light of everyday realities.

. . . When a challenge to an agency construction of a statutory provision, fairly conceptualized, really centers on the wisdom of the agency's policy, rather than whether it is a reasonable choice within a gap left open by Congress, the challenge must fail. In such a case, federal judges—who have no constituency – have a duty to respect legitimate policy choices made by those who do. The responsibilities for assessing the wisdom of such policy choices and resolving the struggle between competing views of the public interest are not judicial ones: 'Our Constitution vests such responsibilities in the political branches.'[28]

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28. *Id.* at 865-66.

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It should be noted that while section 706 of the Administrative Procedures Act (APA) provides that "the reviewing court shall decide all relevant questions of law . . . and determine the meaning and applicability of the terms of an agency action" the courts' deference to the administrative branch does not violate the APA.[29] This is true because the question of law in these cases becomes whether the agency's interpretation of a statute is reasonable.[30] Moreover, the APA must be applied in conjunction with the statutes pertinent to the case, and those statutes may enlarge the agency's law making powers.[31] According to one commentator: "Justice Marshall's exhortation in *Marbury v. Madison* that it is 'the province and duty of the judicial department to say what the law is' thus takes a back seat to an inquiry into the reasonableness of the agency's legal interpretation . . . ."[32]

That deference is not contrary to the APA requirement as evidenced by the history of the "Bumper's Amendment."[33] The amendment was a failed legislative proposal which would have amended section 706 of the Administrative Procedures Act to provide: "In making determinations on other questions of law, as distinguished from questions of facts or discretion under this section, the court shall not accord any presumption in favor of or against agency action."[34] However, the Bumpers amendment was not enacted, thus allowing the court to apply a presumption in favor of the agency; a form of deference.[35]

In summary, deference to the administrative branch is sometimes justified on the basis of Congressional intent, the balance of powers under the Constitution including the administrative branches authority to make policy in administering the law, and the expertise of the agencies.

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29. Administrative Procedure Act, Pub. L. No. 404, 60 Stat. 237, 243 (1946); 5 U.S.C. § 706 (2000).

30. *See* Monaghan, *supra* note 2, at 27 (stating "the judicial role is to specify what the statute cannot mean, and some of what it must mean, but not all that it means."); *see also* Colin S. Diver, *Statutory Interpretation in the Administrative State*, 133 U. PA. L. REV. 549, 570 (1985). In his dissent in *United States v. Mead*, Justice Scalia opined that the legal question becomes whether the agency's interpretation has gone beyond the scope of discretion that that the statutory ambiguity conferred. 533 U.S at 242 n.2.

31. *See* Robert N. Anthony, *supra* note 7, at 24; Merrill, *supra* note 1, at 833.

32. Jim Rossi, *Respecting Deference: Conceptualizing Skidmore Within the Architecture of Chevron*, 42 WM. & MARY L. REV. 1105, 1115 (2001).

33. *See* James T. O'Reilly, *Deference Makes a Difference: A Study of Impacts of the Bumpers Judicial Review Amendment*, 49 U. CIN. L. REV. 739, 739 (1980).

34. *See id.* at 741; David R. Woodward and Ronald M. Levin, *In Defense of Deference: Judicial Review of Agency Actions*, 31 ADMIN L. REV. 329, 329-30 (1979).

35. *See* Nat'l Labor Relations Bd. v. N. Ark. Elec. Coop., 446 F.2d 602, 607 (8th Cir. 1971).

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However, the justification for deferring to an agency in a particular situation may impact the degree of deference, as will be seen below.

III. THE VARIETIES OF DEFERENCE

In the above discussion, the term "deference" was used as though only one form of deference is applied by the courts in all situations. Actually, various types of deference have been applied, depending upon the particular statute in question, and the format in which the administrative position was presented.[36] The varieties of deference accorded to the various agencies have ranged from one in which the agency's position need only be not arbitrary or not unreasonable ("full *Chevron* deference"[37]) to another in which only "respectful consideration" (*Skidmore* deference)[38] is required. Generally, *Chevron* deference has been applied to regulations that were issued after the public was given notice and the opportunity to comment. *Skidmore* deference has been ascribed to a variety of agency pronouncements, as will be further discussed below.[39]

A. *Regulations*

In regard to the income tax, section 7805(a) requires the Secretary of the Treasury to "prescribe all needful rules and regulations for the enforcement of [the Internal Revenue Code]."[40] All tax regulations are subjected to public comments in accordance with the Administrative Procedures Act.[41] Regulations issued under the general authority of section 7805 are generally referred to as "interpretative regulations."[42] In addition, various sections of the Code direct the Secretary to issue regulations with varying charges (e.g., "such regulations as may be required";[43] "such regulations as he may deem

36. *See* Ellen P. Aprill, *Muffled Chevron: Judicial Review of Tax Regulations*, 3 FLA. TAX. REV. 51, 58 (1996).

37. Chevron U.S.A. v. Nat'l Res. Def. Council, 467 U.S. 837, 865 (1984).

38. Skidmore v. Swift & Co., 323 U.S. 134, 140 (1940).

39. *See infra* Part II B.

40. It should be noted that deference to a regulation can be a two edged sword for the Commissioner. See, Brookshire Holdings v. Comm'r, 320 F.3d 507, 511 (5th Cir. 2003); *see also* Woods Inv. Co. v. Comm'r, 85 T.C. 274, 282 (1985) (where the Commissioner was bound by his regulations that had not been amended in response to other changes in the law that affected the application of the regulations).

41. *See* Am. Standard, Inc. v. United States, 602 F.2d 256, 268 (Ct. Cl. 1979).

42. *See* Rowan Cos. v. United States, 452 U.S. 247, 253 (1981); Nat'l Muffler Dealers Ass'n v. United States, 440 U.S. 472, 476 (1979).

43. I.R.C. § 263A(i) (2000).

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necessary."[44]). Regulations issued in accordance with these specific charges are referred to as "legislative regulations."[45] Several of the accounting methods provisions in the Code (sections 446-483) direct the Secretary to prescribe regulations,[46] therefore creating the opportunity for the Service to issue legislative regulations.

It would seem that if Congress requires administrative agencies to issue regulations and other guidance, Congress would also explicitly say what authority those pronouncements would command. But Congress has left it to the Court to decide the weight of authority it should apply to agency rulings.[47] As previously discussed, some cases suggest that because of the "expertise" of the agency[48] it is better able to decide issues within its jurisdiction than are the courts; therefore, agency pronouncements generally should be upheld. While relative knowledge may be a practical way of deciding when the court should defer, the constitutionally correct justification for deference is that Congress has delegated authority to the agency to prescribe the rules to be followed.[49]

Before *Chevron* the Court sharply distinguished between interpretative regulations – agency interpretation of a statutory term as are issued under the general authority of section 7805 – and legislative regulations.[50] The legislative regulations were considered worthy of a higher level of deference than

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44. I.R.C. § 1502 (2000).

45. *See Rowan Cos.*, 452 U.S. at 253; *Nat'l Muffler Dealers Ass'n*, 440 U.S. at 476; *see also* Aprill, *supra* note 36, at 56-60.

46. *See, e.g.*, I.R.C. §§ 263A(i), 446(c)(1), 447(f)(3), 453(j), 453A(c)(6), 453A(e), 453B(h), 460(h), 467(h), 469(l), 472(a), 472(f), 475(g), 481(c), 483(f); *see also* I.R.C. § 471(a) (2002) (providing that "Whenever in the opinion of the Secretary the use of inventories is necessary in order to clearly reflect income. . . .").

47. In a sense, Congress is permitting the Court to decide whether it should defer to the administrative agency. *Chevron*, 467 U.S. at 844.

48. *See, e.g.*, Udall v. Tallman, 380 U.S. 1, 16 (1965); Fulman v. United States, 434 U.S. 528, 528-29 (1978); Ford Motor Credit Co. v. Milhollin, 444 U.S. 555, 556 (1980); Bragdon v. Abbott, 524 US 624, 642 (1998) (stating "[t]he well reasoned views of the agencies implementing a statute constitute a body of experience and informed judgment to which courts and litigants may properly resort for guidance" (citing Skidmore v. Swift & Co., 323 U.S. 134, 139-40 (1944))). In *Chevron*, the Court acknowledged "We have long recognized that considerable weight should be accorded to an executive department's construction of a statutory scheme it is entrusted to administer and the principle of deference to administrative interpretations has long been consistently followed by this Court whenever decision as to the meaning or reach of a statute has involved reconciling conflicting policies, and a full understanding of the force of the statutory policy in the given situation has depended upon more than ordinary knowledge respecting the matters subjected to agency regulations . . . ." *Chevron*, 467 U.S. at 844.

49. *Chevron*, 467 U.S. at 865.

50. *See* Hosp. Corp. of Am. v. Comm'r, 348 F.3d 136, 140 (6th Cir. 2003).

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interpretative regulations.[51] As previously mentioned, the regulations are "legislative" when Congress has delegated the Commissioner the authority to define a statutory term or prescribe a method of executing a statutory provision of the Internal Revenue Code[52] and regulations are accordingly issued. Interpretative regulations are thought to be those issued under the general authority in section 7805.[53] The distinction between legislative and interpretative regulations has been made without the benefit of precise definitions.[54] For example, the discussion of section 59(g) that was discussed above is a situation where the underlying regulations would be deemed "legislative" – a complex and vague statute that also includes a request or command that the administrative branch add clear rules to be applied to actual situations taxpayers will encounter.

Legislative regulations have always had the "force of law;" that is, the regulations are binding on taxpayers as well as IRS personnel.[55] But interpretative regulations were not afforded this deference in the past. Thus, in *Vogel Fertilizer* the Court invalidated the Commissioner's section 1563 interpretative regulations:

> The framework for analysis is refined by consideration of the source of the authority to promulgate the regulation at issue. The Commissioner has promulgated. Treasury Regulation section 1.1563-1(a)(3) interpreting this statute only under his general authority to 'prescribe all needful rules and regulations.' 26 U.S.C. § 7805(a). Accordingly, 'we owe the interpretation less deference than a regulation issued under a specific grant of authority to define a statutory term or prescribe a method of

51. *Id.* at 144.

52. Rowan v. United States, 452 U.S. 247, 253 (1981) (stating "[b]ecause we therefore can measure the Commissioner's interpretation against a specific provision in the Code, we owe the interpretation less deference than a regulation issued under a specific grant of authority to define a statutory term or prescribe a method of executing a statutory provision.").

53. *Id.* at 252-53.

54. *See* Batterton v. Francis, 432 U.S. 416, 424 (concerning a statute that permits the administrative agency to interpret "unemployed" for purpose of the Aid to Families with Dependent Children-Unemployed Fathers AFDC-UF program); *see also* Richard J. Pierce, *Distinguishing Legislative Rules from Interpretative Rules*, 52 ADMIN L. REV. 547, 556-57 (2000) (where Pierce describes a legislative regulation as one that in its absence there would not be an adequate legislative basis for enforcement action).

55. *See* United States v. Mead Corp., 533 U.S. 218 , 229 (2001).

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> executing a statutory provision.' . . .
>
> . . . We consider first whether the Regulation harmonizes with the statutory language. . . That language . . . while not completely unambiguous, is in closer harmony with the taxpayer's interpretation than with the Commissioner's Regulation.[56]

Assuming the Court's terms, "not completely unambiguous," means "ambiguous," the Court favored the taxpayer's interpretation of an ambiguous statute over that of the Commissioner and thus invalidated the regulation. It appears that no deference was afforded the administration. But this was before *Chevron*.

B. *The Chevron Two-step Analysis*

In *Chevron U.S.A. Inc. v. Natural Resources Defense Counsel, Inc.*, the Supreme Court was asked to determine the validity of an environmental protection agency regulation.[57] The regulation under scrutiny dealt with the boundaries of a zone used to measure the level of pollutants being emitted from a production facility.[58] The Court created a two-step analysis for determining the validity of regulations.[59]

Step one of the *Chevron* analysis requires the court to employ the "usual tools of statutory construction" to determine whether Congress has "directly spoken to the precise question at issue."[60] An affirmative answer in step one means that the analysis has been completed: the legislature's answer must be accepted.[61] Moreover, "the judiciary is the final authority on issues of statutory construction and must reject administrative constructions which are contrary to clear congressional intent."[62]

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56. *See also* Gen. Elec. Co. v. Gilbert, 429 U.S. 125, 143-45 (1976); Morton v. Ruiz, 415 U.S. 199, 231, 237 (1974).

57. 467 U.S. 837, 840 (1984).

58. *Id.* at 839-40.

59. It should be noted that the adoption of this two step analysis was made without any prodding from Congress and without any real evidence to suggest that the way the issues were being resolved was in desperate need of change. It is as though the Court stepped back and reviewed the situation and concluded "this is the way it should be done" without a compelling reason to justify its actions. *Id.* at 842-43.

60. *Id.*

61. *See, e.g.*, FDA v. Brown & Williamson Tobacco Co., 529 U.S. 120, 159 (2000); Gen. Dynamics Land Sys., Inc. v. Cline, 540 U.S. 581, 600 (2004).

62. *Chevron*, 467 U.S. at 843 n.9; *see also* Square D Co. v. Comm'r, 118 T.C. 299, 308-09 (2002) (where the Tax Court applied *Chevron* to reverse its position in Tate & Lyle, Inc. v. Comm., 103 T.C. 656, which had held the section 267(a) regulations invalid).

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A negative answer in step one means the analysis proceeds to step two, where the deference mode is invoked.[63]

Step one of *Chevron* should be contrasted with the approach outlined by the Supreme Court in *National Muffler Dealer's Ass'n v. United States*.[64] According to the *National Muffler* decision, the Court looks to see whether a regulation "harmonizes with the plain language of the statute its origin, and its purpose."[65] To complete this *National Muffler* analysis requires the Court to compare the regulation with the statute, whereas under *Chevron* the Court does not look to the regulations until step two - after it is determined the statute silent or ambiguous.[66] Given this comparison, *Chevron* seems to be the more logical approach. There is no need to consider a regulation unless the statute is ambiguous or silent, and with either ambiguity or silence on the issue, the regulation cannot "harmonize with the statute":[67] How could one draft a regulation that harmonizes with the plain meaning of a statute that is ambiguous or silent on the particular issue?

Proceeding to step two, the analysis slightly differs for legislative (an explicit delegation) or and interpretative regulations (an implicit delegation):

> If Congress has explicitly left a gap for the agency to fill, there is an express delegation of authority to the agency to elucidate a specific provision of the statute by regulation. Such legislative regulations are given controlling weight unless they are *arbitrary, capricious, or manifestly*

63. *See, e.g.*, Alfaro v. Comm'r, 349 F.3d 225, 228 (2003); *see also* Robinson v. Comm'r, 119 T.C. 44, 68 (2002) (where the Tax Court applied the Chevron two-step analysis to reverse it prior decision in Redlark v. Comm'r, 106 T.C. 31 (1996) that a regulation prohibiting the deduction for interest on a tax deficiency resulting from trade or business income was invalid).

64. 440 U.S. 472, 476-77 (1979).

65. *Id.* at 477. In *FDA v. Brown & Williamson Tobacco Co.*, the Court reasoned that it may be necessary to look to more than a specific statute to determine congressional intent: "In determining whether Congress has specifically addressed the question at issue, a reviewing court should not confine itself to examining a particular statutory provision in isolation. The meaning—or ambiguity—of certain words or phrases may only become evident when placed in context." 529 U.S. at 132.

66. *Nat'l Muffler*, 440 U.S. at 477.

67. *See* Aprill, *supra* note 36, at 89-91 (describing and advocating a fusion of *Chevron* and *Nat'l Muffler*); Paul L. Caron, *Tax Myopia Meets Tax Hyperopia: The Unproven Case of Increased Judicial Deference to Revenue Rulings*, 57 OHIO ST. L.J. 637, 668 (1996); Diver, *supra* note 30, at 562; Vogel Fertilizer v. United States, 455 U.S. 16, 25-26 (1982) (which can be interpreted to mean that the Court was rejecting the regulations based by applying *Nat'l Muffler* to reject the regulation under what would be an incorrect application of *Chevron's* step one).

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> *contrary to the statute*. .. Sometimes the legislative delegation to an agency on a particular question is implicit rather than explicit. In such a case, a court may not substitute its own construction of a statutory provision for a *reasonable interpretation* made by the administrator of an agency . . . .[68] [emphasis added]

Furthermore, "the Court need not conclude that the agency construction was the only one it permissibly could have adopted. . .or even the reading the Court would have reached if the question had arisen in a judicial proceeding."[69]

In *Chevron* the statute did not address the relevant issue and the delegation was implicit, but the Commissioner's position was clearly expressed in a regulation, which the Court found to be "reasonable."[70] However, as discussed above, the Court also noted that a legislative regulation (explicit delegation) will be treated as law unless it is "arbitrary, capricious, or manifestly contrary to the statute."[71] It is unknown how the two standards differ. Perhaps the "reasonable" standard requires stronger theoretical justification in terms of the specific issue the regulation addresses. For example, requiring taxpayers who use dollar-value LIFO to divide inventories into "pools" and then prohibiting the inclusion of manufactured and purchased goods in the same pool is not "arbitrary, capricious, or manifestly contrary to the statute" because of the differences in costs which can bias a LIFO index and therefore distort income.[72] However, prohibiting the purchaser of a manufacturing business from placing the items purchased and identical goods manufactured after the purchase in the same pool is "not reasonable," absent some explanation as to why this would distort income.[73]

While *Chevron* addressed the deference that should be applied to the interpretative regulations issued by an agency authorized to issue them, the discussion in the case does not explain the significance of the fact that the case was framed as a challenge to a regulation, rather than a ruling, or simply the agency's litigating position.[74] But other courts have concluded

68. *Chevron*, 467 U.S. at 842-44.

69. *Id*. at 843 n.11.

70. See Diver, *supra* note 30, at 597 for a discussion of the reasonableness standard.

71. *Chevron*, 467 U.S. at 844.

72. Tate & Lyle, Inc. v. Comm'r, 87 F.3d 99, 104 (1996).

73. UFE, Inc. v. Comm'r, 92 T.C. 1314 (1989).

74. Oris S. Kerr, *Shedding Light on Chevron: An Empirical Study of the Chevron Doctrine in the U.S. Courts of Appeals*, 15 YALE J. ON REG. 1, 19-20 (1998).

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that only regulations are deserving of *Chevron* deference because they are issued subject to notice and comment.[75] In regard to tax regulations – which are always subject to notice and comment – the Seventh Circuit reasoned as follows:

> General tax regulations [interpretative regulations] seem to carry the force of law, they are developed according to notice and comment, and they have the imprimatur of a congressional delegation of authority. In substance, general tax regulations fall short of being full legislative regulations only because the congressional delegation is general rather than specific. This distinction, however, may not have any effect at all on the standard of deference because *Chevron* itself dealt with a regulation promulgated under an arguably general grant of authority to the EPA under the Clean Air Act . . . . Furthermore, *Chevron* stated that its framework applied to implicit congressional delegations as well as to specific and explicit directives.[76]

Furthermore, in 2003 the Supreme Court opined in *Boeing Co. v. United States* that in regard to deference, legislative and interpretative regulations are not to be distinguished: "Even if we regard the challenged regulation as interpretive because it was promulgated under section 7805(a)'s general rulemaking grant rather than pursuant to a specific grant of authority, we must still treat the regulation with deference."[77] Thus, both legislative and interpretative regulations can receive *Chevron* deference.[78]

That the Court concluded the administrative agency can gain its authority though implicit delegation of authority – created by a statute that was vague or ambiguous on the issue before the Court - is probably the most significant conclusion in

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75. *See, e.g.*, Peoples Fed. Sav. & Loan Ass'n v. Comm'r, 948 F.2d 289, 300 (6th Cir. 1991); Bankers Life & Cas. Co. v. United States, 142 F.3d 973, 983-84 (7th Cir. 1998); Conn. Gen. Life Ins. Co. v. Comm'r, 177 F.3d 136, 144-45 (3d Cir. 1999); Harbor Bancorp & Subsidiaries v. Comm'r, 115 F.3d 722, 727 (9th Cir. 1997).

76. *Bankers Life & Cas. Co.*, 142 F.3d at 983-84 (citing *Chevron*, 467 U.S. at 844).

77. 537 U.S. 437, 448 (2003).

78. In proposed regulations under section 1363 (LIFO recapture following an S-election), the Service characterizes the regulations as pursuant to section 337(d)(1), which has legislative regulations language and is directed at assuring that corporate income will be taxed twice. *See* 69 Fed. Reg. 50109-10 (Aug. 13, 2004).

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Chevron.[79] This expanded finding of delegation was justified by the administrative agency's role in policy making as well as their superior knowledge regarding the effects of those policies,[80] as was discussed above.

C. *Skidmore Deference*

Generally, if the court determines that the administration's position is not worthy of *Chevron* deference, the court next refers to "*Skidmore* deference."[81] That is, *Skidmore* serves as a back-up to *Chevron* and would generally apply to agency rulings other than regulations.[82]

In *Skidmore v. Swift & Co.*, seven employees of Swift and Company sued for overtime pay under the Fair Labor Standards Act.[83] These employees, in addition to their normal daytime work, orally agreed to stay in or near the fire hall 3 to 4 nights a week.[84] On these nights the employees were responsible for answering calls but did not have to perform other duties.[85] The employees sued to receive compensation for the nights they remained at their duty station.[86]

The Fair Labor Standards Act did not create an agency to administer the act or determine the facts of individual cases.[87] It did create an administrator whose duties included bringing injunctions to restrain violations of the act.[88] The administrator issued an interpretive bulletin, an informal ruling concerning the application of the Act.[89] Basically the bulletin provided for a flexible solution based on facts and circumstances and illustrated the rules with examples, none of which directly apply to the facts in *Skidmore*.[90]

The Supreme Court was called upon to decide how much deference should be given to the bulletin and rulings of the administrator.[91] The Court began its analysis by acknowledging

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79. *Chevron*, 467 U.S. at 864.

80. *Id.* at 842-44.

81. In *United States v. Mead*, the Supreme Court remanded the case insofar as the tariff classifications applied *Skidmore* deference. 533 U.S. 218, 237 (2001).

82. *See id.* at 238-40; Christensen v. Harris County, 529 U.S. 576, 586-89 (2000).

83. Skidmore v. Swift & Co., 323 U.S. 134, 135 (1944).

84. *Id.* at 136.

85. *Id.*

86. *Id.* at 137.

87. *Id.*

88. *Id.*

89. *Skidmore*, 323 U.S. at 138.

90. *Id.*

91. *Id.* at 139.

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that the Act itself did not contain any provision that discusses deference to these rulings: "Instead, it put this responsibility on the courts."[92] However, it recognized that the administrator had more experience and knowledge about conditions in different industries than the courts had.[93] In addition, in previous cases the Court had given weight to rulings of the Treasury Department and other agencies charged with administering laws.[94]

The Court concluded that these rulings by the administrator were not binding on the courts but provided informed judgment to which the courts and litigants can turn for guidance.[95] The fact that the Court would look to the administrative agency for "guidance," while the Court would not look at the opposing counsel's opinion for guidance means that the agency opinion is receiving some deference.[96] The Court found support for deference based on the "Administrator's specialized experience and broader investigation and information than is likely to come to a judge in a particular case,"[97] and the Court then provided the following frequently applied guideline: "The weight of such a judgment [by the administrator] in a particular case will depend upon the thoroughness evident in its consideration, the validity of its reasoning, and all those factors which give it power to persuade, if lacking power to control."[98]

According to one commentator "*Skidmore*. . . makes clear that the weight given to the agency interpretation is always ultimately up to the court."[99] Justice Scalia has opined that "*Skidmore* deference gives the agency's current position some vague and certain amount of respect, but it does not, like *Chevron* leave the matter within the control of the Executive branch . . . ."[100] Nevertheless, when the Court found in *Mead* that

92. *Id.* at 137.

93. *Id.* at 139.

94. *Id.* at 140.

95. *See* Raymond B. Yates, M.D., P.C. Profit Sharing v. Hendon, 124 S.Ct. 1330, 1342 (2004).

96. *Skidmore*, 323 U.S. at 140.

97. *Id.* at 139.

98. *Id.* at 140; *see also* Pierce, Jr., *supra* note 54, at 547 n.163.

99. Thomas W. Merrill & Kristin E. Hickman, *Chevron's Domain*, 89 GEO. L.J. 833, 856 (2001).

100. United States v. Mead Corp., 533 U.S. 218, 247 (2001) (Scalia, J. dissenting) (noting that the *Skidmore* deference is "an empty truism and a trifling statement of the obvious" and "a recipe for uncertainty, unpredictability, and endless litigation"); Christensen v. Harris County, 529 U.S. 576, 589 (2000) (Scalia, J. concurring) (characterizing *Skidmore* as an "anachronism"); *see also* Equal Employment Opportunity Comm'n v. Arabian- Am. Oil Co., 499 U.S. 244, 258 (1991).

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the administrative agency's manual did not warrant *Chevron* deference, the Court remanded the case, directing the lower court to decide the case using *Skidmore* deference.[101] Thus, the Supreme Court believes that *Skidmore* deference can make a difference.[102] If nothing else, *Skidmore* deference could serve as a "tie breaker," when both parties in the suit have equally defensible positions. Thus, while the exact contours of *Skidmore* deference are not known,[103] it appears to fall between Chevron deference and de novo review.

It would seem that the weight given to the government's opposing counsel would also depend upon the *Skidmore* factors (thoroughness, validity of reasoning, and persuasive power),[104] with perhaps the administrative agency attaining a slight advantage in regard to the "thoroughness evident in the consideration." This is true because the administration can present evidence regarding its many experiences in administering the law that resulted in its position, much like an expert witness, whereas the opposing counsel is merely a "hired gun." Also, in reaching its position, the administrative agency must realize that it may be creating a two-edged sword that may be used to the advantage of another taxpayer.

D. *Revenue Rulings*

As discussed above, deference to regulations is generally based on the fact they are subject to public notice and comments, as is required by the APA.[105] Deference for other rulings is made a possibility by *Mead*,[106] as will be further discussed below. IRS revenue rulings are issued without notice and the opportunity for taxpayers to comment and therefore do not enjoy the automatic pass of regulations.[107] The IRS is certainly not pretentious in portraying the status of the authority of revenue rulings.

> A 'revenue ruling' is an official interpretation by the Service of the Internal Revenue laws and

101. *Mead*, 533 U.S. at 235-36, 238-239.

102. *Id.* at 259.

103. *See* Rossi, *supra* note 32, at 1109.

104. *See* Linda Galler, *Emerging Standards for Judicial Review of IRS Revenue Rulings*, 72 B.U. L. REV. 841, 892 n.126 (1992).

105. *See* United States v. Haggar Apparel Co., 526 U.S. 380, 389 (1999).

106. O'Shaughnessy v. Comm'r, 332 F.3d 1125, 1130 (8th Cir. 2003).

107. For an exhaustive discussion of the courts deference to Revenue Rulings through 1995 see Linda Galler, *Judicial Deference to Revenue Rulings: Reconciling Divergent Standards,* 56 OHIO L. J. 1037, 1095 n.90 (1995); *see also* Caron, *supra* note 67, at 670 n.16.

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> related statutes, treaties, and regulations, that has been published in the Bulletin. Revenue rulings are issued only by the National Office and are published for the information and guidance of taxpayers, Service officials and others concerned.[108]

It should be noted that, in a sense, revenue rulings have the "force of law" in that failure to follow rulings subjects taxpayers to penalties under IRC section 6662.[109]

In *O'Shaughnessy v. Commissioner*,[110] the IRS argued (based on *Mead)* that revenue rulings command *Skidmore* deference - commensurate with "the degree of the agency's care, its consistency, formality, and relative expertness . . . ."[111] However, the Tax Court has not accepted this position.[112]

The Tax Court has ruled that it is not bound by revenue rulings, although the court believes that taxpayers should be able to rely upon them.[113] On the other hand, the Sixth Circuit once extended *Chevron* deference to a revenue ruling,[114] although it has more recently concluded that revenue rulings may not be warranted *Chevron* deference but should carry "at least some added persuasive force."[115] The Federal Circuit Court leans toward the Tax Court position, although its position is not as strong.[116] The Supreme Court at first appeared to apply Chevron

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108. Rev. Proc. 89-14, 1989-1 C.B. 814; *see also* Rev. Proc. 2004-4, 2004-1 I.R.B. 125.

109. *O'Shaughnessy*, 332 F.3d at 1130.

110. *Id.*

111. *Mead*, 533 U.S. at 228.

112. *See, e.g.*, Lunsford v. Comm'r, 117 T.C. 159 (2001); Ind. Pub. Serv. Co. v. Comm'r, 105 T.C. 341, 350 (2001).

113. Baker v. Comm'r, 122 T.C. No. 8, at note 21 (2004), and cases cited therein. Nevertheless, the Tax Court will hold the Service to its prior rulings in cases where the Commissioner contradicts his long-standing and clearly articulated administrative position as set forth in prior rulings. *But see* Vons Cos., Inc. v. United States, 51 Fed. Cl. 1, 6 (2001).

114. Johnson City Med. Ctr. v. United States, 999 F.2d 973, 975 (6th Cir.1993).

115. Ammex, Inc. v. United States, 367 F.3d 530, 535 (6th Cir. 2004); *see also* Aeroquip-Vickers, Inc. v. Comm'r, 347 F.3d 173, 181 (6th Cir. 2003); *see also* Keller v. Comm'r, 725 F.2d 1173, 1182 (8th Cir.1984) (which ruled that Revenue Rulings are not "controlling authority"); Del Commercial Prop., Inc. v. Comm'r, 251 F.3d 210, 214 (D.C. Cir. 2001) (holding that Revenue Rulings should be accorded *Skidmore* deference); *Vons Cos, Inc.*, 51 Fed. Cl. at 8 n.5; *see also* Esden v. Bank of Boston, 229 F.3d 154, 169 n.19 (2d. Cir. 2000) (extending *Skidmore* deference to an IRS Notice).

116. *See Vons Cos, Inc.*, 51 Fed. Cl. at 15 (where the Federal Circuit provides an excellent summary of the status of deference for revenue rulings by the various courts). "The various decisions can be arrayed over a spectrum starting with those affording such rulings the least amount of deference and ending with those affording the most. If one end of the spectrum is reserved for courts according revenue rulings little or no weight then that position is undoubtedly occupied by the Tax Court (and those circuits following its lead), which has historically held that revenue rulings merely "represent the position

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to Revenue Rulings,[117] but later merely noted that the rulings do not have the force and effect of regulations.[118] Although the Revenue Ruling was not entitled to Chevron deference, the Court concluded in *Cleveland Indians Baseball Co. v. United States* that "the Rulings simply reflect the agency's longstanding interpretation of its own regulations. Because that interpretation is reasonable, it attracts substantial judicial deference,"[119] and in *Christensen v. Harris County*, the Supreme Court applied *Skidmore* to an administrative position expressed in a format similar to a revenue rulings.[120]

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of one of the parties" before the court. *Id.*; *see, e.g.,* Browne v. Comm'r, 73 T.C. 723, 731 (1980) (Hall, J., concurring); *see also* Estate of Kosow, 45 F.3d 1524, 1529 n.4 (11th Cir. 1995) (a revenue ruling "is merely an opinion of an IRS attorney"); Stubbs, Overbeck & Assoc., Inc. v. United States, 445 F.2d 1142, 1146-47 (5th Cir. 1971) ("A ruling is merely the opinion of a lawyer in the agency and must be accepted as such."). More toward the middle of the spectrum lies those courts which have held that revenue rulings, while not binding, are, nonetheless, entitled to consideration as a "body of experienced and informed judgment." Ricards v. United States, 683 F.2d 1219, 1224 n.12 (9th Cir. 1981); *see also* Foil v. Comm'r, 920 F.2d 1196, 1201 (5th Cir. 1990) (revenue rulings are "to be given weight as expressing the studied view of the agency whose duty it is to carry out the statute"). Then, at the polar opposite of the Tax Court are federal courts that have held, in terms analogous to those sometimes applied to interpretative Treasury regulations, that revenue rulings "have the force of legal precedents unless unreasonable or inconsistent with the provisions of the Internal Revenue Code. *See* Dunn v. United States, 468 F.Supp. 991, 993 (S.D.N.Y. 1979); *see also* In re Kaplan, 104 F.3d 589, 599 (3d Cir. 1997).

The Federal Circuit, whose precedents, of course, are binding on this court, appears to lie somewhere in the middle of this continuum, possibly with a slight cant towards the position of the Tax Court. Thus, in *Spang Indus., Inc. v. United States,* that court stated that "a revenue ruling is entitled to some weight as reflecting the Commissioner's interpretation of the regulation, but does not have the same force as a regulation." 791 F.2d 906, 913 (Fed. Cir.1986); *see also* Xerox Corp. v. United States, 228 Ct. Cl. 406, 656 F.2d 659, 671 n.20 (1981) ("[w]hile these rulings are not binding on the Secretary of Treasury or the courts, they may be helpful in interpreting a statute"). On another occasion, however, the Federal Circuit quoted, with approval, language from a 1934 Supreme Court decision which stated that revenue rulings cited by the Commissioner "have none of the force or effect of Treasury Decisions and do not commit the Department to any interpretation of law." Xerox Corp. v. United States, 41 F.3d 647, 657 (Fed. Cir.1994) (quoting Helvering v. N.Y. Trust Co., 292 U.S. 455, 468 (1934)). Following the Federal Circuit's lead, this court has mapped out a position that considers revenue rulings, but also does not afford them binding precedence. *See* Int'l Bus. Mach. Corp. v. United States, 38 Fed. Cl. 661, 675 (1997); Ridenour v. United States, 3 Cl. Ct. 128, 137 (1983) ("Although revenue rulings do not constitute 'binding precedent,' they provide some guidance as to the correct interpretation of the Internal Revenue Code.")

117. *See* Davis v. United States, 495 U.S. 472, 484 (1990), *criticized in* Galler, *supra* note 104, at 857-58.

118. Comm'r v. Schleier, 515 U.S. 323, 336 n.8 (1995); Cleveland Indians Baseball Co. v. United States, 532 U.S. 200, 219 (2001).

119. *Cleveland*, 532 U.S. at 220, but the Supreme Court saved for another day the issue of whether revenue rulings "themselves" should receive any deference.

120. Revenue Rulings are "entitled to respect" to the extent that they "have the power to persuade," Christenson v. Harris County, 529 U.S. 576, 587 (2000); *see* Travelers Ins. Co. v. United States, 303 F.3d 1373, 1382 n.12 (Fed. Cir. 2001) (where the court of

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Finally, the probability that a Revenue Ruling will receive any deference is greatly increased if the ruling is consistent with a longstanding, public position of the Service.[121] The converse of this is also true.[122]

E. *A Mere Litigating Position*

As discussed above, *Chevron* deference applies to regulations, but the Supreme Court has not applied *Chevron* to a revenue ruling, but in *Mead* the Court indicated that *Chevron* deference could possibly be extended to agency pronouncements other than regulations, which could possibly include a revenue ruling.[123] However, in *Bowen v. Georgetown University Hospital*, the Secretary of Health and Human Service attempted to apply regulations that had been issued without the opportunity for review and comment, which were therefore invalid, and argued that he was nevertheless entitled to deference, the Court ruled against the Secretary.[124] The Court ruled "we have never applied the principle of [*Chevron*] . . . to agency litigating positions that are wholly unsupported by regulations, rulings, or administrative practice."[125] The Court reasoned that to extend deference to agency counsel's interpretation of a statute when the agency itself has not articulated a position on the question would be extending to counsel the responsibility Congress delegated to the agency.[126] However, the Court has accorded deference, even to agency interpretations appearing for the first time in an *amicus* brief, where there was "simply no reason to suspect that the interpretation does not reflect the agency's fair and

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federal appeals deferred to the Commissioner when the taxpayer's method was inconsistent with the method prescribed in a revenue ruling).

121. Am. Bankers Ins. Group, Inc. v. United States, 308 F. Supp. 2d 1360, 1371 (S.D. Fla. 2004) (applying *Skidmore* deference to Revenue Ruling 79-404); *but see* Office Max, Inc. v. United States, 309 F. Supp. 2d 984, 994-95 (N.D. Ohio 2004) (rejecting the ruling).

122. CSI Hydrostatic Testers, Inc. v. Comm'r, 103 T.C. 398, 409 (1994). In short, unless an agency's interpretation of a statute or a regulation is a matter of public record and is an interpretation upon which the public is entitled to rely when planning their affairs, it will not be accorded any special deference. S. Pac. Transp. Co. v. Comm'r, 75 T.C. 497, 541-42 (1980).

123. United States v. Mead Corp., 533 U.S. 218, 230-31 (2001).

124. Bowen v. Georgetown Univ. Hosp., 488 U.S. 204, 212-13 (1988).

125. *Id.* at 212.

126. *Id.* There is no deference due to Commissioner's interpretation where it is neither longstanding nor a matter of public record upon which the public is entitled to rely when planning its affairs. CSI Hydrostatic, 103 T.C. at 409. "An agency interpretation . . . which conflicts with the agency's earlier interpretation is 'entitled to considerably less deference' than a consistently held agency view." INS v. Cardoza-Fonseca, 480 U.S. 421, 446 n.30 (1987).

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considered judgment on the matter in question."[127]

F. *Seminole Rock Deference*

Administrative agencies, just as the legislature, are constrained by the limitations on the use of language. Thus, the agency finds itself interpreting its own rules and regulation, creating a double entendre arising out of an ambiguous statute. Applying a *Chevron*-like analysis, one would first look to see if the regulation is ambiguous or contains gaps. If so, one would look to see whether the agency's interpretation is "reasonable." The issue is whether the agency should be granted deference in interpreting its rules and regulations.

In *Bowles v. Seminole Rock & Sand Co.* the Court was asked to interpret a regulation.[128] The Court concluded, without much analysis, that the administrative interpretation must be "controlling weight unless it is plainly erroneous or inconsistent with the regulation."[129] "Our only tools, therefore, are plain words of the regulation and any relevant interpretations of the Administrator."[130] More recently in *Auer v. Robbins* the Court again applied *Seminole Rock* deference to an interpretation of a regulation submitted by the Secretary of Labor in an amicus brief.[131] The petitioner in the case argued that the brief was tantamount to a mere litigating position.[132] Justice Scalia, in the majority opinion, found no reason to suspect the brief did not reflect the agency's "fair and considered judgment" on the issue.[133] In other circumstances, the Tax Court has not been so receptive, withholding deference except in cases where the interpretation is a matter of public record and is an interpretation upon which the public is entitled to rely.[134]

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127. Auer v. Robbins, 519 U.S. 452, 462 (1997); *see also* Marseilles Land and Water Co. v. Fed. Energy Comm'n, 345 F.3d 916, 920-21 (D.C. Cir. 2003); Udall v. Tallman, 380 U.S. 1, 16 (1965) (stating "[w]hen the construction of an administrative regulation rather than a statute is at issue, deference is even more clearly in order"); *see also* Am. Express Co. v. United States, 362 F.3d 1376, 1382 (Fed. Cir. 2001) (deferring to the Commissioner's interpretation of his own revenue procedure).

128. 325 U.S. 410, 411 (1945).

129. *Id.* at 414.

130. *Id.*

131. 519 U.S. 452, 461 (1997).

132. *Id.* at 462.

133. *Id.*

134. S. Pac. Transp. Co. v. Comm'r, 75 T.C. 497, 541- not satisfy the notice requirement. 92 T.C. 1165, 1170 (1989). 42 (1980); CSI Hydrostatic, 103 T.C. at 409. Moreover, in *Tandy Corp. v. Comm'r* the court held that issuing a revenue ruling when litigation proceedings have started will not satisfy the notice requirement. 92 T.C. 1165, 1170 (1989).

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However, Seminole Rock deference can only be applied after a finding that the regulation is ambiguous.[135] In *Christensen v. Harris County*, the Department of Labor administrator offered an opinion letter interpreting the regulations of the Wages and Hours Division.[136] The Court first concluded that the opinion letter lacked the force of law, but should be accorded respect under *Skidmore*.[137] Next the Government argued that the opinion letter should be granted *Seminole Rock* deference.[138] This was rejected because the underlying regulation was unambiguous.[139] The Court reasoned that "to defer to the agency's position would be to permit the agency, under the guise of interpreting a regulation, to create de facto a new regulation."[140]

The Seventh Circuit has expressed caution in granting deference to the interpretation of vague regulations:

> With full *Chevron* deference, agencies could pass broad or vague regulations through notice-and-comment procedures, and then proceed to create rules through *ad hoc* interpretations that were subject only to limited judicial review. All told, we think this is a clear case for the flexible approach *Mead* described, relying on the Supreme Court's earlier decision in *Skidmore v. Swift & Co.*, 323 U.S. 134 (1944), and we thus proceed on that basis.[141]

Nevertheless, the Supreme Court applied *Seminole Rock* deference as recently as 1994.[142] Thus it appears that *Seminole*

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135. Christensen v. Harris County, 529 U.S. 576, 588 (2000).

136. *Id.* at 580-81.

137. *Id.* at 587.

138. *Id.* at 588.

139. *Id.*

140. *Id.*

141. U.S. Freightways Corp. v. Comm'r, 270 F.3d 1137, 1139, 1142 (7th Cir. 2001); *see also* Schlumberger Tech. Corp. v. United States, 55 Fed. Cl. 203, 211 n.5 (2003) (considering a revenue ruling to be an interpretation of a regulation in that case, and thus accorded the ruling "some deference" even though *Seminole Rock* was not cited); *see also* John F. Coverdale, *Chevron's Reduced Domain: Judicial Review of Treasury Regulations and Revenue Rulings After Mead*, ADMIN. L. REV. 39, 90 (2003); Robert N. Anthony, *The Supreme Court and the AP: Sometimes They Just Don't Get It*, 10 AM. U. ADMIN. L. J. 1, 4 (1996) (criticizing the *Seminole Rock* doctrine).

142. Thomas Jefferson Univ. v. Shalala, 512 U.S. 504, 512 (1994) (stating "[i]n other words, we must defer to the Secretary's interpretation unless an "alternative reading is compelled by the regulation's plain language or by other indications of the Secretary's intent at the time of the regulation's promulgation"); *see also* United States v. Swank, 451

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Rock deference exists in cases in which *Chevron* is inapplicable. Specifically the courts are willing to defer to an agency's interpretation of its own pronouncements absent abuse by the agency.[143] *Chevron* does not apply to these situations because it is limited to agency interpretations of statutes.[144]

G. *Increasing Chevron's Octane Level*

The Court amplified *Chevron* in *United States v. Mead Corporation* [145] when it explained that regulations can attain *Chevron* deference under the following conditions: Congress granted the authority to the agency to make rules carrying the force of law, and the agency utilized the notice and public comment procedures as set forth in section 553 of the APA (that are generally applied to all income tax regulations.)[146] That the regulations attain the "force of law" means they are binding on all taxpayers as well as the IRS.[147]

The amplification made it clear that interpretative regulations as well as legislative regulations are worthy of *Chevron* deference, provided they are issued with appropriate notice and comment procedures.[148] Thus, the regulations in question in *United States v. Vogel Fertilizer Co.*,[149] (discussed above) which satisfied the notice and comment standard, probably would have been upheld under the *Chevron* analysis, if it had been applied. This is true because instead of applying *Chevron* the Court rejected the Treasury's regulation on the ground that the taxpayer's procedures more nearly harmonized with the ambiguous statute,[150] as though the Court's role was to choose the superior interpretation. That the taxpayer's method "more nearly harmonizes" with the statute implies that the regulation was not unreasonable, and thus it would have been upheld using the *Chevron* analysis.

In addition to clarifying the evaluation of interpretative

U.S. 571, 589 (1981); Ford Motor Credit Co. v. Milhollin, 444 U.S. 555, 566 (1980).

143. *Shalala*, 512 U.S. at 512.

144. *Id.* at 525.

145. 533 U.S. 218, 229-31 (2001).

146. *See, e.g.*, T.D. 8584, 1995-1 C.B. 20 (stating that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to general authority regulations under section 263A(f)).

147. *See* Merrill, *supra* note 1, at 809; 5 U.S.C. § 533(a) (1996).

148. United States v. Mead Corp., 533 U.S. 218, 230-31 (2001). As discussed above, legislative regulations are valid unless they are plainly inconsistent with the law, and interpretative regulations are valid if they are "reasonable." *See supra* Section D.

149. 455 U.S. 16, 17-18 (1982).

150. *Id.* at 25.

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regulations, *Mead* holds that *Chevron* deference is not limited to regulations issued subject to notice and comments.[151] Other statutory circumstances may indicate that the agency's pronouncements should be afforded *Chevron* deference.[152] While the Court did not indicate what other circumstances were required, the Court cited other cases in which the Court deferred to the administrator's opinion that was not presented in a regulation subject to notice and comment.[153] One of the cases cited in *Mead, Barnhart v. Walton*, involved a claim for disability benefits under the Social Security Act.[154] The Social Security Agency denied the claim on the basis that the Act's requirement of inability to engage in gainful employment included a 12-month absence requirement.[155] The Fourth Circuit Court of Appeals held that this interpretation of the act by the agency was incorrect.[156] The Supreme Court reversed the decision on the grounds that the interpretation was valid under *Chevron*.[157] As an explanation (or justification for) of its conclusion the Court stated in *Barnhart*:

> In this case, the interstitial nature of the legal question, the related expertise of the Agency, the importance of the question to administration of the statute, the complexity of the administration and the careful consideration the Agency has given the question over a long period of time all indicate that *Chevron* provides the appropriate legal lens through which to view the legality of the Agency interpretation. . . .[158]

In another case cited in *Mead*, *NationsBank of N.C. v. Variable Annuity Life Insurance Co.*,[159] *Chevron* deference was applied to a determination letter issued by the Controller of the Currency who was charged with enforcing the banking laws.[160] In effect, the bank was asking the Controller whether selling

151. *See also* Hosp. Corp. of Am. v. Comm'r, 348 F.3d 136, 140 (6th Cir. 2003) (granting deference to proposed regulations).

152. *Mead*, 533 U.S. at 229.

153. *Id.* at 230-31.

154. 535 U.S. 212, 214-15 (2002).

155. *Id.* at 215.

156. *Id.* at 216.

157. *Id.* at 221-22.

158. *Id.* at 222.

159. 513 U.S. 251 (1995).

160. *Id.* at 254, 257, 260.

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annuities would violate the banking laws that the Controller was in charge of enforcing.[161] The Controller interpreted the statute as permitting the bank to sell annuity contracts, and thus authorized the bank to enter into that business.[162] The Court concluded as follows:

> The Controller of the Currency is charged with the enforcement of banking laws to an extent that warrants the invocation of [the rule of deference] with respect to his deliberative conclusions as to the meaning of these laws.[163]

As will be discussed below, *Mead* and *Barnhart* may provide a justification for the courts deferring to the administration's positions on tax accounting matters that are not included in regulations.[164]

In a pre-*Chevron* case that is analogous to *NationsBank, Ford Motor Credit Co. v. Milhollin*, the Supreme Court deferred to the statutory interpretation of the Truth in Lending Act in an opinion letter issued by the staff of the Federal Reserve Board, the agency charged with administering the law.[165] The Court found deference appropriate in these circumstances by the fact that the statutes provided creditors with a defense against liability arising out of good faith reliance on staff interpretations.[166] Moreover, language in the legislative history indicated "a preference for resolving interpretative issues by uniform administrative decisions, rather than piecemeal legislation."[167]

Barnhart and *NationsBank* are just two examples of the Court's willingness to defer to reasonable administrative actions that were not necessarily supported by regulations directly on point. Justice Scalia, dissenting in *Mead*, notes many other examples of deference to administrative positions that are not supported by regulations.[168] In 1985 Colin S. Diver compiled a list

161. *Id.* at 254-55.

162. *Id.* at 255.

163. *Id.* at 256-57.

164. *See* Auer v. Robbins, 519 U.S. 452, 462 (1997) (affording *Chevron* deference to the Secretary of Labor's interpretation of the Fair Labor Standards Act in its amicus brief because it was not a *post hoc* rationalization and reflected the agency's fair and considered judgment).

165. 444 U.S. 555, 566, 568 (1980).

166. *Id.* at 566-67.

167. *Id.* at 568.

168. *Mead*, 533 U.S. at 253-54.

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of factors that are weighted heavily toward accepting the administration's interpretations and this list is still valid:

> (1) whether the agency construction was rendered contemporaneously with the statute's passage, see, e.g., Norwegian Nitrogen Prods. Co. v. United States, 288 U.S. 294, 315 (1933); (2) whether the agency's construction is of longstanding application, see, e.g., NLRB v. Bell Aerospace Co., 416 U.S. 267, 275 (1974); (3) whether the agency has maintained its position consistently (even if infrequently), see, e.g., Haig v. Agee, 453 U.S. 280, 293 (1981); (4) whether the public has relied on the agency's interpretation, see, e.g., Udall v. Tallman, 380 U.S. 1, 18 (1965); (5) whether the interpretation involves a matter of 'public controversy,' see, e.g., United States v. Rutherford, 442 U.S. 544, 545 (1979); (6) whether the interpretation is based on 'expertise' or involves a 'technical and complex' subject, see, e.g., Aluminum Co. of Am. v. Central Lincoln People's Util. Dist., 52 U.S.L.W. 4716, 4719 (U.S. June 5, 1984) (No. 82-1071); (7) whether the agency has rulemaking authority, see, e.g., FCC v. National Citizens Comm. for Broadcasting, 436 U.S. 775, 793 (1978); (8) whether agency action is necessary to set the statute in motion, see, e.g., Ford Motor Credit Co. v. Milhollin, 444 U.S. 555, 565-66 (1980); (9) whether Congress was aware of the agency interpretation and failed to repudiate it, see, e.g., Zemel v. Rusk, 381 U.S. 1, 11 (1965); and (10) whether the agency has expressly addressed the application of the statute to its proposed action, see, e.g., Investment Co. Inst. v. Camp, 401 U.S. 617, 627-28 (1971).[169]

IV. THE SPECIAL CASE OF INCOME TAX ACCOUNTING

John F. Coverdale has examined the deference issue and its post-*Chevron* developments through *Christensen* and *Mead* as applied to tax regulations and rulings.[170] Early in his discussion he summarizes as follows:

169. Diver, *supra* note 30, at 599 n.95.
170. Coverdale, *supra* note 141, at 41.

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> *Mead*, like *Christensen*, continues to leave open the possibility of granting Chevron deference to agency positions reached outside of notice-and-comment rulemaking, because it treats notice-and-comment rulemaking and adjudication only as indicators that Congress has granted the agency the authority to speak with the force of law and that the agency has done so.[171]

Mead also instructs "different statutes present different reasons for considering respect for the exercise of administrative authority or deference to it."[172] It is clear that in all cases the courts should defer to a regulation and be afforded *Chevron* deference if the regulation is (1) issued by an agency that Congress has charged with the duty of enforcing a particular set of laws, and (2) subjected to notice-and-comment.[173] But the deference received, if any, by positions expressed in other formats depend upon Congressional intent as determined on a case by case basis.[174]

The starting point on this case-by-case approach in the situations not involving a regulation, but requiring a determination of congressional intent, must be the relevant statutes. Consider the general requirement the taxpayer's accounting method must satisfy as provided in section 446(b):

> 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.[175]

The ambiguity in "clearly reflects income" is apparent,[176] and

171. *Id.* at 54; Coverdale, as well as Justice Scalia in his dissent, find problems with the Court's emphasis on finding that Congress intends the agency to have rule making power. However, this is not an issue on tax issues because of the general authority granted the Secretary of Treasury in section 7805. *Id.* at 81-82; *Mead*, 533 U.S. at 239.

172. *Mead*, 533 U.S. at 238.

173. *Id.* at 226-27.

174. *See id.* at 243 (Scalia, J. dissenting).

175. I.R.C. § 446(b) (2000).

176. Professor Boris Bittker notes the circularity of the statute:

> The statutory phrase [clear reflection of income] is not only hopelessly vague but circular to boot, because the 'income' that must be clearly

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determinations as to whether the requirement has been satisfied must be made on a case by case basis.[177] It is equally apparent that Congress intentionally enacted an ambiguous statute. Thus, the issue is: Who did the Congress intend to resolve this ambiguity- the courts or the Internal Revenue Service? Given the Treasury's general powers to issue regulations under section 7805, then to the extent that regulations can be written to cover the myriad of situations that can arise about the timing of income and expenses, *Chevron* deference would apply to the regulations.[178] In addition, if *Seminole Rock* deference is applied to ambiguities in the regulations, the boundaries would be clear: The regulations and all reasonable agency interpretations of the regulations would receive deference.[179]

However, it is not feasible for the Service to issue regulations that would address a substantial portion of the issues that can arise, and Congress is undoubtedly aware of the limitations on the Services' capacity to subject the numerous clear reflection of income issues to notice and comment procedures. Moreover, assuming the case is made that the taxpayer's method does not clearly reflect income, and thus the Secretary requires the taxpayer to change to a method that, "in the opinion of the Secretary, does clearly reflect income," it seems unlikely that Congress intended to limit the Secretary's choice of a method to those prescribed in existing regulations.[180] If Congress had intended a limit on this power, beyond a "reasonableness" requirement, Congress would not have referred to the Secretary's opinion without appropriate limitations or explanation.

The Commissioner has filled a void in the statute by adding to the regulations that "no method of accounting is acceptable,

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> reflected by the taxpayer's accounting method is taxable income, not financial, economic, or any other variety of income. In short, income is clearly reflected by an accounting method if the ultimate result of using the method is taxable income.

Boris I. Bittker & Lawrence Lokken, Federal Taxation of Income, Estates and Gifts, § 105.1.7 (2d ed. 1989).

177. Ford Motor Co. v. Comm'r, 102 T.C. 87, 91-92 (1994), *affd*, 71 F.3d 209 (6th Cir.1995).

178. Coverdale, *supra* note 141, at 92.

179. *Id.* at 61.

180. *See* Mulholland v. United States, 28 Fed. Cl. 320, 334 (1993) (reasoning that the Commissioner's discretion to determine whether a method does not clearly reflect income is more narrow than his authority to prescribe another method for the taxpayer); *but see* Dana Corp. v. United States, 38 Fed. Cl. 356, 353 (1997) (noting that *Mulholland* is incorrect in extending a *de novo* standard of review to whether or not a taxpayer's method of accounting clearly reflects income and instead examining *de novo* the Commissioner's exercise of discretion in making the determination).

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unless in the opinion of the Commissioner, it clearly reflects income."[181] That regulation has been in existence for almost 50 years,[182] and was subject of notice and comment and therefore has the force of law.

Long before *Chevron*, the Supreme Court deferred to the administration on tax accounting issues when it declared "it is not the province of the court to weigh and determine the relative merits of systems of accounting."[183] In another early tax accounting case, the Supreme Court deferred to the Service in determining whether the taxpayer's method of accounting clearly reflected income:

> Much latitude for discretion is thus given to the administrative board charged with the duty of enforcing the Act. "Its interpretation of the statute and the practice adopted by it should not be interfered with unless clearly unlawful."[184]

More recently, in Thor Power Tool v. Commissioner, the Court concluded:

> The Code and Regulations give the Commissioner "wide discretion in determining whether a particular method of inventory accounting should be disallowed as not clearly reflective of income.[185]

Moreover, in another case the Court held that it is proper to first look to the intent of Congress as expressed by "longstanding committees expertly grounded in tax problems."[186] In the particular case Congress had not addressed the issue, and the Court deferred to the administration's position as not having abused his discretion.[187]

Based on the Supreme Court's early decisions regarding the Commissioner's authority under section 446(b) and a long history of lower court decisions, a court addressing a tax accounting decision will often begin its opinion as follows:

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181. I.R.C. § 1.446-1(a)(2) (2004).

182. T.D. 6282, 1958-1 C.B. 59.

183. Brown v. Helvering, 291 U.S. 193, 204-05 (1934) (citing Lucas v. Am. Code Co., Inc., 280 U.S. 445, 449 (1930)); *see also* United States v. Catto, 384 U.S. 102, 114 (1966).

184. Lucas v. Am. Code Co., Inc., 280 U.S. 445, 449 (1930).

185. 439 U.S. 522, 532 (1979).

186. Am. Auto. Ass'n v. United States, 367 U.S. 687, 698 (1961).

187. *Id.*

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> In *Thor Power Tool Co. v. Commissioner,* the Supreme Court explained: It is obvious that on their face, secs. 446 and 471, with their accompanying Regulations, vest the Commissioner with wide discretion in determining whether a particular method of inventory accounting should be disallowed as not clearly reflective of income. 439 U.S. 522, 540 (1979). This Court's cases confirm the breadth of this discretion. In construing Sec. 446 and its predecessors, the Court has held that "[t]he Commissioner has broad powers in determining whether accounting methods used by a taxpayer clearly reflect income." *Hansen v. Commissioner*, 360 U.S. 446, 467 (1959). Since the Commissioner has "[m]uch latitude for discretion," his interpretation of the statute's clear-reflection standard "should not be interfered with unless clearly unlawful." *Lucas v. Am. Code Co.*, 280 U.S. 445, 449 (1930). * * * In construing * * * a predecessor of Sec. 471, the Court held that the taxpayer bears a "heavy burden of [proof]," and that the Commissioner's disallowance of an inventory accounting method is not to be set aside unless shown to be "plainly arbitrary." *Lucas v. Structural Steel Co.,* 281 U.S. 264, 271 (1930).[188]

> The Commissioner's determination with respect to clear reflection of income is entitled to more than the usual presumption of correctness, and the taxpayer bears a heavy burden of overcoming a determination that a method of accounting does not clearly reflect income.[189]

> The respondent's determination pursuant to his authority under Section 446(b) is presumptively correct and must be upheld unless the petitioner has proved it clearly erroneous or arbitrary.[190]

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188. *See, e.g.*, Honeywell Inc. v. Comm'r, 64 T.C.M. 1992-453 (CCH) 437 (1992) (citing Lucas v. Kan. City Structural Steel Co., 281 U.S. 264, 271 (1930)).

189. Rotolo v. Comm'r, 88 T.C. 1500, 1513-14 (1987); *see also, e.g.*, Peninsula Steel Prod. & Equip. Co. v. Comm'r, 78 T.C. 1029, 1044-45 (1982); RCA Corp. v. United States, 664 F.2d 881, 886 (2d Cir. 1981); Dana Corp. v. United States, 174 F.3d 1344, 1347-48 (Fed. Cir. 1999); Am. Express Co. v. United States, 262 F.3d 1376, 1379 (Fed. Cir. 2001).

190. Brooks-Massey Dodge, Inc. v. Comm'r, 60 T.C. 884, 891 (1973).

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Therefore, it appears that the courts have concluded that the Commissioner is comparable to the Controller of Currency in *NationsBank* and the staff of the Federal Reserve Board in *Ford Motor Credit*.[191] That is, Congress has implicitly expressed its intent that the Commissioner commands *Chevron* deference on tax accounting issues when his authority is expressed in a manner other than regulations.[192] It follows from *Mead* that the Secretary's opinion regarding the clear reflection of income, regardless of the format in which it is presented, should be accorded the same deference as a regulation issued with notice and comments.[193] The only modification to this conclusion is that the interpretation should be that of the agency, and not merely the opinion of a litigating attorney or some other employee who does not have the authority to speak for the agency. These qualifications will be revisited below.

While our conclusion may sound like the writers have simply adopted Justice Scalia's dissenting opinion in *Mead,* [194] our conclusion is based on the specific language of section 446(b).[195] Thus, the agency opinions about whether an accounting method clearly reflects income may not be in a class entirely by themselves in regard to deference; rather, those opinions should be in the same class as regulations that were subjected to notice and comment.

As discussed above, the courts should defer to the agency's position on a determination regarding tax accounting unless that position is "clearly unlawful" or "plainly arbitrary."[196] *Chevron* uses the terms "arbitrary, capricious, or manifestly contrary to the statute" in regard to legislative regulations.[197] In the case of interpretative regulation "a court may not substitute its own construction of a statutory provision for a reasonable interpretation made by the administrator of an agency."[198]

The Court does not elaborate on the distinction between the

191. *See* NationsBank of N.C. v. Variable Annuity Life Ins. Co., 513 U.S. 251, 256-57 (1995); *see also* Ford Motor Credit Co. v. Milhollin, 444 U.S. 55, 565-66 (1980).

192. *Mead*, 533 U.S. at 219.

193. *Id.* at 226-27 (holding that "administrative implementation of a particular statutory provision qualifies for *Chevron* deference when it appears that Congress delegated authority to the agency generally to make rules carrying the force of law, and that the agency interpretation claiming deference was promulgated in the exercise of that authority").

194. *Id.* at 239-40 (Scalia, J., dissenting).

195. I.R.C. § 446(b) (2000).

196. *Honeywell*, 64 T.C.M. (CCH) 437 (1992).

197. Chevron U.S.A. v. Natural Res. Def. Council, 467 U.S. 837, 844 (1984).

198. *Id.*

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"arbitrary, capricious, or manifestly contrary" standard and the reasonableness test.[199] Thus, it is not clear when an agency determination would satisfy the former test but not the latter. However, because the statute and regulations give the Commissioner the power to determine whether the taxpayer's method clearly reflects income,[200] the present authors submit that the agency determination is tantamount to a legislative regulation. Therefore, the IRS's determination on the accounting methods issue should be subjected to the "arbitrary, capricious, or manifestly contrary" standard. Indeed, in the Supreme Court decisions discussed above, the Court used the terms "plainly arbitrary" and "clearly unlawful."[201]

The Supreme Court has ruled that an agency's action is "arbitrary and capricious" if the agency (1) relied on factors which Congress has not intended to be considered, (2) entirely failed to consider an important aspect of the problem, (3) offered an explanation for its decision that runs counter to the evidence before the agency, or (4) is so implausible that it could not be ascribed to a different view or be the product of the agency expertise.[202] In *United States v. U.S. Gypsum Co.*, the Supreme Court explained that "a finding is 'clearly erroneous' when although there is evidence to support it, the reviewing court on the entire evidence is left with the definite and firm conviction that a mistake has been committed."[203] This standard has generally been applied by appellate courts to determine when to defer to the trial court on a finding of facts or law.[204]

V. THE TAXPAYER'S ANSWER

In the tax accounting cases, the Commissioner charges that the taxpayer's method does not clearly reflect income, and the taxpayer must explain how the Commissioner's position is

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199. *Id.*

200. Treas. Reg. § 1.446-1(a)(2) (2004).

201. *See* Jennifer C. Root, *The Commissioner's Clear Reflection of Income Power Under § 446(b) and the Abuse of Discretion Standard of Review: Where has the Rule of Law Gone and Can We Get it Back?*, 15 AKRON TAX J. 69, 99-100 (2000) (discussing the distinction between the abuse of discretion and clearly erroneous standards); *see also* Francis M. Allegra, *Section 482: Mapping the Contours of the Abuse of Discretion Standard of Judicial Review*, 13 VA. TAX. REV. 423, 480 (1994).

202. Motor Vehicle Mfr. Ass'n v. State Farm Ins. Co., 463 U.S. 29, 43 (1983).

203. 333 U.S. 364, 395 (1948).

204. *But see* Florida Progress Corp. v. Comm'r, 348 F.3d 954 (11th Cir. 2003) (concluding the Tax Court's characterization of events as a "rate adjustment" rather than a refund for purposes of section 1341); *see also* Consolidated Mfg., Inc. v. Comm'r, 249 F.3d 1231, 1239 (10th Cir. 2001).

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arbitrary or unreasonable.[205] The Commissioner cannot reject a method authorized by the Internal Revenue Code, nor, generally, can the Commissioner reject a method authorized by the regulations.[206] Moreover, the fact that the taxpayer's method of accounting is in accordance with generally accepted accounting principles is a consideration in the taxpayer's favor,[207] as will be further discussed below.

The taxpayer will often defend its method as matching expenses with revenues. That is, the method of accounting results in the expense to earn the income being deducted in the same year as the revenues are reported, whereas, the Commissioner's method would result in a mismatching of revenues and expenses. While this is not a complete defense, it is often persuasive.[208]

Finally, if the taxpayer can demonstrate that the Commissioner has been inconsistent in his treatment among taxpayers, and thus violated the principle of horizontal equity, the Commissioner is more likely to be deemed arbitrary.[209] However, that is not to say that the Commissioner cannot change positions over time after more experience has been gained.

VI. EXAMPLES OF THE COURTS' APPLICATIONS AND FAILURES TO APPLY PRINCIPLES OF DEFERENCE

As indicated above, in an accounting method case the taxpayer must demonstrate to the court that the taxpayer's method of accounting "clearly reflects income."[210] The IRS or the Government must then present its reasons for rejecting the

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205. Ford Motor Co. v. Comm'r, 102 T.C. 87, 92 (1994).

206. *See, e.g.*, Fidelity Assoc. v. Comm'r, T.C.M. (CCH) 2327 (1992); *but see Ford Motor Co.*, 102 T.C. at 93-94, *aff'd.* 71 F.3d 209 (6th Cir. 1995) (noting that the taxpayer's application of the regulation produced a ridiculous result (in favor of the taxpayer) under the facts of the case and the Commissioner was permitted to set aside his regulations).

207. Treas. Reg. § 1.446-1(a)(2).

208. *See, e.g.*, Lincoln Elec. Co. v. Comm'r, 54 T.C. 926, 932 (1970) (considering the matching principle as the heart of the clear reflection of income requirement); *see also* Seago, *supra* note 10, at 1858-59; *but see* Alan Gunn, *Matching of Costs and Revenues as a Goal of Tax Accounting*, 4 VA. TAX. REV. 1, 14-17, 19, 35 (1984).

209. *See, e.g.*, RLC Gas Co., v. Comm'r, 98 T.C. 457, 491-92 (1992); Bay State Gas Co. v. Comm'r, 75 T.C. 410, 422-24 (1981); U.S. Freightways Corp. v. Comm'r, 270 F.3d 1137, 1145 (7th Cir. 2001).

210. For an exhaustive discussion of the "rule of law" versus "rule of men" aspect of the clear reflection of income requirement see Edward A Morris, *Reflections on the Rule of Law and "Clear Reflection of Income": What Constrains Discretion?*, 8 CORNELL J. OF L. & PUB. POL'Y, 445, 446-51 (1999).

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taxpayer's method.[211] Given that the Government can decide which cases to litigate, and because of the deference granted the Commissioner, it is rare that the taxpayer will prevail in court.[212] Nevertheless, some taxpayers have succeeded, especially in the Tax Court.[213] In many of these cases, the reason for success is that the deference rules are not rigorously applied.

One consideration presented by the regulations that can run in the taxpayer's favor is the use of an accounting method that is in accordance with generally accepted accounting principles (GAAP).[214] This is true because Treasury Regulation 1.446-1(a)(2) provides that "ordinarily" the consistent application of a method that is in accordance with GAAP will clearly reflect income.[215] However, according to the Supreme Court in *Thor Power Tool Company*, the regulations provide two prongs to the clear reflection of income test. First, the method must be consistent with GAAP. But second, "*no* method of accounting is acceptable unless, in the opinion of the Commissioner, it clearly reflects income."[216] The regulations were characterized as providing a two-pronged test to refute the taxpayer's argument that when the method used satisfies GAAP a presumption is created that the taxpayer's method clearly reflects income.[217] The Court ruled that no such presumption could be created, but in the process created the impression that GAAP was irrelevant because there is only one test: Whether "in the opinion of the Commissioner" the taxpayer's method clearly reflects income.[218] However, with a two pronged test where one prong is "paramount," it logically follows that failing that test but passing the GAAP test does nothing for the taxpayer. It seems clear that satisfying GAAP is a consideration that runs in favor of the taxpayer but is not the determining factor, as subsequent cases have illustrated.[219] Thus, when a tax accounting method is challenged and the taxpayer presents expert testimony that the method is in accordance with GAAP, the chances the taxpayer will prevail are improved, but not guaranteed.[220]

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211. *Id.* at 496-97, 499-501.
212. *Id.* at 499-501.
213. *Id.*
214. *See generally* Harold Dubroff, M. Connie Cahill and Michael D. Norris, *Tax Accounting: The Relationship of Clear Reflection of Income To Generally Accepted Accounting Principles*, 47 ALB. L. REV. 354, 360-61, 389, 396-97 (1983).
215. Treas. Reg. § 1.446-1(a)(2).
216. Thor Power Tool Co. v. Comm'r, 539 U.S. 522, 540 (1979).
217. *Id.* at 538-40.
218. *Id.* at 540.
219. *Id.*
220. *See, e.g.*, LaCrosse Footwear Inc., v. United States, 191 F.3d 1372, 1379-80 (Fed.

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American Automobile Ass'n v. United States, a pre-*Chevron* case, is the high water mark in regard to the Court's deference to the Commissioner.[221] In *AAA*, the taxpayer's accounting method was in accordance with GAAP, but the Supreme Court held that the method could be rejected by the Commissioner as not clearly reflecting income.[222] The association sold three-year service contracts and attempted to spread the income over the life of the contracts, which was required by GAAP.[223] The taxpayer argued that in addition to satisfying GAAP, spreading the income resulted in matching expenses incurred under the contracts with their revenues, and thus clearly reflected income.[224] The Supreme Court rejected the taxpayer's method.[225] The Court justified its holding by stating that the taxpayer could not relate the recognition of revenues from individual contracts with the costs of servicing the contracts.[226] This would be a "lame" argument, but for the fact that the Court was applying deference. That is, nothing in the code, regulations, or prior court decisions mentioned that the clear reflection of income could not be based on the overall performance of the accounting method as applied to all customers. The argument was accepted because it was adopted by the IRS and was not unreasonable, given the void in the statutory language in regard to when income must be recognized.[227] Indeed, in inventory accounting, it is not necessary to relate the actual cost of goods transferred to the revenue from the goods that physically flow to the customers.[228] Aside from the validity of deference, the decision is indefensible.

In *Peninsula Steel Products v. Commissioner*, the Tax Court reached a conclusion applying analysis that was consistent with *Chevron*.[229] The manufacturer of pollution control equipment in *Peninsula Steel* convinced the Tax Court that a LIFO inventory approach to assigning the cost of materials to specific contracts whose income was determined under the completed contract

Cir. 1999); Dayton Hudson Corp., v. Comm'r, 153 F.3d 660, 665-66 (8th Cir. 1998); Apollo Computer, Inc. v. United States 32 Fed. Cl. 334, 349-50 (1994).

221. 367 U.S. 687, 697-98 (1961); *see also* Schlude v. Comm'r, 372 U.S. 128, 135 (1963).

222. *AAA*, 367 U.S. at 690, 697-98.

223. *Id.* at 690.

224. *Id.* at 690-93.

225. *Id.* at 689, 692-93.

226. *Id.* at 693-94.

227. *Id.* at 695-98.

228. Treas. Reg. § 1.471-2(d) (2004).

229. 78 T.C. 1029, 1053-56 (1982); *see also* Spang Indus., Inc. v. United States, 791 F.2d 906, 908, 912 (Fed. Cir. 1986); Reco Indus., Inc. v. Comm'r, 83 T.C. 912, 917-18 (1984).

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method satisfied the clear reflection of income requirement.[230] Peninsula's experts presented testimony that the method was in accordance with GAAP, and the Service did not challenge the expert's opinion.[231] Rather, the Service argued that the use of an inventory approach to materials cost was incompatible with the completed contract method.[232] The Tax Court found that the regulations addressed the time at which the materials cost should be added to the contract but did not address the manner in which the cost of the materials was to be determined.[233] In the process of rejecting the Service's argument that LIFO could not be used to determine the cost of materials, the Service summarily dismissed a revenue ruling on point.[234] *Skidmore* was not cited in the case, although one could argue that silence on the cost assignment issue did not create ambiguity in the regulations.[235] The Tax Court did recite the usual shibboleth about the heavy burden the taxpayer must bear when the Service challenges an accounting method, but then the court recognized a congressional intent that the LIFO method should be available to all taxpayers who use purchase goods and materials for use in their products.[236] Moreover, the Commissioner failed to present any policy arguments in the context of this case for rejecting Congress's intent that LIFO should be generally available to taxpayers.[237] Thus, although the Tax Court did not acknowledge the *Chevron* analysis, the Court essentially decided the case on the basis of *Chevron* step one: Using the usual tools of statutory interpretation, the court concluded that LIFO applies to all materials used in production.[238] Because the taxpayer was producing goods for customer, the taxpayer should be allowed to use LIFO to account for the materials cost.

On the other hand, *Honeywell Inc., v. Commissioner*[239]

230. *Peninsula Steel*, 78 T.C. at 1053.

231. *Id.* at 1048.

232. *Id.* at 1050.

233. *See* Steve R. Looney, *Using LIFO to Value Costs Under the Completed Contract Method: A Tale of Two Accounting Methods*, 39 TAX LAW. 235, 253 (1986).

234. Rev. Rul. 59-329, 1959-2 C.B. 138; *Peninsula Steel*, 78 T.C. at 1052 (stating a lack of belief "that respondent has authority to promulgate by a revenue ruling the absolute rule of law . . . he seeks to apply in the instant case").

235. *Skidmore* was also conspicuous by its absence in *RLC Indus. v. Comm'r*, where the Tax Court did not grant the Commissioner any latitude in applying the regulations. Skidmore v. Swift & Co., 323 U.S. 134, 139-40 (1944); RLC Indus., 98 T.C. 457, 489-91, 497-99, 500-03 (1992).

236. *Peninsula Steel*, 78 T.C. at 1058-59.

237. *Id.* at 1059.

238. *Id.* at 1058-59.

239. 64 T.C.M. (CCH) 437 (1992).

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represents the low-water mark in deference, in the present authors' opinion. The issue was whether the taxpayer was required to account for parts used on service contracts as inventory.[240] The outcome of the case depended upon the interpretation of Regulations section 1.471-1.[241] That regulation requires the taxpayer to use an inventory system to account for the cost of goods "in every case in which the production, purchase, or sale of merchandise is an income-producing factor."[242] The taxpayer argued that the parts were not "merchandise" because they were not "held for sale."[243] Instead of treating the case as one of determining whether the Commissioner was making a reasonable interpretation of the regulations and apply *Seminole Rock* deference, the Tax Court viewed the case as one of determining "the correct treatment" of the parts.[244] Although Judge Cohen recited the usual language regarding the deference due the Commissioner, she proceeded to consider how the customers viewed the transaction (i.e., the purchase of a service contract rather than the purchase of parts), and the fact that customers paid a fixed price regardless of the cost of the parts used, to conclude that the transactions were not sales of merchandise.[245] While this was not the classic transfer of property for cash, the taxpayer did transfer property for consideration and thus, a little deference was all that was required to reach a decision in favor of the Commissioner; but no deference was granted.[246]

As another example of the Tax Court's failure to grant the administration deference when the court should have, consider the case of *Osteopathic Medical Oncology & Hematology, P.C v. Commissioner*.[247] The professional services corporation used substantial amounts of chemicals and drugs in treating cancer patients.[248] The Service argued that the drugs and chemicals were inventories and therefore, the inventory accounting rules should be applied.[249] Section 471 clearly gave the Commissioner

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240. *Id.*

241. *Id.*

242. *Id.*

243. *Id.*

244. *Honeywell*, 64 T.C.M. (CCH) 437.

245. *Id.*

246. *See also* Hewlett-Packard Co. v. United States 71 F.3d 398, 402-03 (Fed. Cir. 1996), *reversing* Apollo Computer, Inc. v. United States, 32 Fed. Cl. 334 (1994).

247. 113 T.C. 376, 392-93 (1999); *see also* Note, *Cash Method of Accounting for Professional Health Services Corporations: Osteopathic Medical and Hematology, P.C. v. Commissioner*, 54 TAX LAW 223, 231 (2000).

248. *Osteopathic Med.*, 113 T.C. at 377.

249. *Id.* at 379-80.

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the power to invoke the inventory rules.[250] The Code does not define inventories but Treasury Regulation 1.471-1 provides that inventory accounting is required whenever the "production, purchase, or sale of merchandise is an income-producing factor."[251]

Because the Code did not provide the answer by leaving the term "inventory" undefined, it would have been appropriate for the court to proceed to *Chevron* step two. Under step two, looking to the regulations was of little help because it did not define "merchandise." The court then proceeded to look to other areas of law for the meaning of merchandise, a search that also proved fruitless.[252] Most importantly, the majority of the Tax Court judges believed that doctors are the "quintessential" service providers,"[253] and accordingly, that drugs were "subordinate to the medical services."[254]

The Service directed its arguments to the effects of inventory accounting on the clear reflection of income by emphasizing the fact that drugs are a significant factor (twenty-six percent of gross receipts from operations) in measuring income. This is contrary to the common view of the nature of medical practice.[255] In the present writers' opinion, the arguments were compelling and the Commissioner should have won the case, without being granted any deference. With the benefit of deference, based on the Commissioner's knowledge of income measurement (relative to a Tax Court judge), it should have been a slam-dunk for the Commissioner.

Contractors have played a major role in a series of cases in which little regard has been given to the deference issue and mixed results have been attained on the inventory issue.[256] In *Ansley-Sheppard-Burgess Co. v. Commissioner*, an electrical contractor was permitted to use the cash method of accounting – the method clearly reflected income - even though materials costs were substantial.[257] However, the IRS failed to argue that the

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250. I.R.C. § 471(a) (2000).

251. Treas. Reg. § 1.471-1 (2004).

252. *Osteopathic Med.*, 113 T.C. at 382-83.

253. *Id.* at 384.

254. *Id.* at 385; *see also* Hosp. Corp. of Am. v. Comm'r, 107 T.C. 116, 144 (1996).

255. *Osteopathic Med.*, 113 T.C. at 390; *see* Wilkenson-Beane v. Comm'r, 420 F.2d 352, 355 (1st Cir. 1970) (concluding that a funeral director was selling merchandise).

256. *See* Jim Turin & Sons, Inc. v. Comm'r, 75 T.C.M. (CCH) 2534 (1998) (citing Galedrige Constr., Inc. v. Comm'r, 73 T.C.M. (CCH) 2838 (1997) (finding that asphalt is not merchandise)).

257. 104 T.C. 367, 377 (1995).

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materials were subject to the inventory rules.[258] Having learned from *Ansley-Sheppard*, the service argued that a paving company's asphalt was inventory,[259] but the Tax Court concluded that the asphalt was not inventory because of its "ephemeral" quality, as though that had anything to do with the clear reflection of income.[260] These cases were decided after a case in which a roofing contractor's materials were deemed to be inventory.[261]

The Tax Court's complete disregard for the deference due the Commissionerwas evident in one of the contractor cases, *Osteopathic Medical Oncology & Hematology, P.C v. Commissioner*. This decision caused the Service to give up the quest to make small businesses with significant materials cost use the accrual method.[262] In 2001, the Service issued Revenue Procedure 2001-10, permitting these businesses to use the cash method without regard to whether the materials used might be classified as inventory.[263] While this may have been a laudable change in terms of simplifying the law, the law would not have been so complex as to require the change in policy, if the courts had regard for deference principles so that the businesses would have known their tax accounting requirements.

VII. LIFO POOLS AND ITEMS

The dollar-value LIFO regulations contain many rules regarding pooling and pricing inventory items without expressing the rationale for the rules, and often provide only skeletal definitions.[264] When the IRS is challenged on the application of the regulations, the Tax Court has been receptive to the Service's "at trial" offering of a rationale for the rules, as support for finding the regulations to be "reasonable."[265]

The LIFO inventory method has produced some cases where the courts have paid more regard for the deference the Commissioner should enjoy. In *Amity Leather Products v. Commissioner* the domestic parent corporation and its foreign

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258. *See id.* at 368.

259. Galedrige Constr., Inc. v. Comm'r, 73 T.C.M. (CCH) 2838 (1997).

260. *Id.*; *see also* RACMP Enters. v. Comm'r, 114 T.C. 211 (2000) (holding that a cement contractor was not employing inventories because of the "ephemeral" qualities of cement).

261. J.P. Sheahan Assocs., Inc. v. Comm'r, T.C.M. (CCH) 2842 (1992).

262. *Osteopathic Med.*, 113 T.C. at 382-83.

263. Rev. Proc. 2001-10, 2001-1 C.B. 272.

264. Treas. Reg. § 1.472-8 (2004).

265. *See* Amity Leather Prods. v. Comm'r, 82 T.C. 726, 736 (1984).

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subsidiary produced identical products.[266] The foreign subsidiary sold its goods to the domestic parent.[267] One of the issues in the case was whether the foreign and domestically produced goods could be combined into one dollar-value LIFO pool.[268] The regulations in question provided that a taxpayer who produces goods for resale and who also purchases goods for resale must maintain separate pools for the produced goods and purchased goods.[269] It is not apparent why separate pools would be required, and the regulation offers no explanation.[270] But in enforcing the regulation, the Tax Court accepted the Service's explanation that "a narrow definition of an item within a pool will generally lead to a more accurate measure of inflation . . . and thereby lead to a clearer reflection of income."[271] While this justification for maintaining separate pools seems to confuse the concept of inventory items and inventory pools, it was good enough to satisfy the "reasonableness" requirement of the second *Chevron* step.[272]

On the other hand, in *UFE, Inc. v. Commissioner*, the taxpayer purchased the assets of a manufacturing business, which included an inventory of finished goods and goods in process.[273] The bargain purchase price was allocated among the assets in a manner that resulted in a low valuation of the inventory.[274] UFE elected the dollar-value LIFO inventory method, treating the purchased goods as the base period LIFO inventory.[275] After the purchase the taxpayer continued producing the same goods.[276] Relying on the regulations as interpreted in *Amity Leather,* the Service argued that the beginning inventory was purchased goods that must be included in a dollar-value LIFO pool, separate from the goods produced after the acquisition.[277] That is, according to the Service, UFE operated a wholesale business in regard to the purchased goods, and a manufacturing business in regard to the post-acquisition production. However, the mere recitation of the regulations and

266. *Id.* at 728-29.
267. *Id.* at 729.
268. *Id.* at 734.
269. *Id.* at 735 (citing Treas. Reg. § 1.472-8 (2004)).
270. Treas. Reg. § 1.472-8 (2004).
271. *Amity Leather*, 82 T.C. at 734, 736.
272. *Id.* at 734, 736.
273. 92 T.C. 1314, 1318-19 (1989).
274. *Id.* at 1319.
275. *Id.*
276. *Id.* at 1322.
277. *Id.* at 1319-21.

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a citation to *Amity Leather* was not convincing - the Tax Court dug deeper. *Amity Leather* was distinguished because it involved a continuing process of purchasing goods, selling them and replacing them with other purchased goods, whereas UFE made a one-time purchase of the beginning inventory that would be sold and replaced with identical goods it produced.[278] The Tax Court further reasoned that:

> It would, in our view, distort income to remove the small amount of finished inventory from the business' ongoing flow of inventory accounting. We conclude that petitioner properly included the finished inventory in a single pool. This accounting treatment serves the overriding purpose of the LIFO regulations which is to match current costs against current income.[279]

Thus, the Tax Court required a plausible explanation for finding the opaque regulation reasonable in the context of the taxpayer's situation, and absent that explanation by the Service, the Service's position was rejected, as would be done under Chevron step two.

The Service found a plausible theory to address the same bargain purchase issue in *Hamilton Indus. v. Commissioner*.[280] Instead of arguing that the purchased and produced goods should be included in separate pools, the Service argued that the purchased and produced goods were different dollar-value LIFO inventory items, and treating them as the same item would distort income.[281] That is, to clearly reflect income using dollar-value LIFO, inflation should be eliminated from the ending inventory valuation. But if the goods produced are price according to the prices of the purchased goods, the proper inflation adjustments will not be made. However, the Service appears to have prevailed because it had the better argument, rather than as a result of receiving any deference.[282]

Finally, a taxpayer who has computed taxable income in accordance with the regulations generally satisfies the clear reflection of income requirement.[283] However, in one case, *Ford*

278. UFE, Inc. v. Comm'r, 92 T.C. 1314, 1321-22 (1989).
279. *Id.* at 1322.
280. 97 T.C. 120, 127 (1991).
281. *Id.*
282. *Id.* at 147-50.
283. Ford Motor Co. v. Comm'r, 102 T.C. 87, 97 (1994).

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Motor Company v. Commissioner, the result attained under the regulation produced results that were so "outrageous" under the facts that the Tax Court – agreeing with the Commissioner – set aside the regulation.[284] This rejection of a regulation that has been subjected to notice and comments, but on the request of the administration, appears to be the ultimate form of deference.

VIII. CONCLUSIONS

In the above discussion we have concluded that the Commissioner has not received his deference due in tax accounting cases. Moreover, *Chevron* deference should be afforded the Commissioner when the issue is whether the taxpayer's accounting method clearly reflects income, regardless of the format in which the Commissioner's position is expressed. In applying this principle it becomes important to distinguish the Commissioner's position, as opposed to a mere employee of the Internal Revenue Service.

In *Bowen v. Georgetown University Hospital*, the Court ruled, "We have declined to give deference to an agency counsel's interpretation of a statute where the agency itself has articulated no position on the question."[285] Preceding the quote, the Court commented, "We have never applied the principle of those cases [deference under *Chevron*] to agency litigating positions that are wholly unsupported by regulations, rulings, or administrative practice."[286]

When the litigating position is supported by "rulings" or "administrative practice," however, deference is consistent with legislative intent in regard to the clear reflection of income. An agency position that has not undergone the rigors of notice and comment should attain *Chevron* deference when the authorities express the official position of the Internal Revenue Service and the taxpayers have been provided adequate notice of the agency's position. In *Mead*, the Court did not think that the thousands of customs agents making interpretations of rulings could speak for the entire Customs Agency and in *Georgetown Hospital*, the Court reasoned that "Congress has delegated to the administrative official and not to appellate counsel the responsibility for elaborating and enforcing statutory commands."[287] However, in *Martin v. Occupational Safety and*

284. *Id.* at 94, 104.
285. 488 U.S. 204, 212 (1988).
286. *Id.*
287. United States v. Mead Corp., 533 U.S. 218, 258 n.6 (2001); *Bowen*, 488 U.S. at 212 (quoting Inv. Co. Inst. v. Camp, 401 U.S. 617, 628 (1971)).

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Health Review Commission, the Court reasoned that the Secretary of Labor's decision to enforce an employee's citation of violation was "an agency action," and not a *post hoc* rationalization and was worthy of *Chevron* deference.[288] Moreover, in *Hospital Corp. of America v. Commissioner*, the appellate court concluded that temporary regulations that had not been subject to notice and comment were "arrived at centrally by the Treasury Department, after careful consideration" and therefore deserved *Chevron* deference.[289]

Thus, it follows from the specific delegation of authority to the Commissioner under IRC sections 446 and 471 and from the Supreme Court decisions discussed in this paper that the Commissioner's actions in enforcing the clear reflection of income are worthy of *Chevron* deference. The deference should be applied to the litigation positions on tax accounting issues taken by the Commissioner in litigation, as well as in revenue rulings and other forms of public notice. This will require the Internal Revenue Service to be very deliberate in choosing litigating positions and issuing revenue rulings, but will result in a reduced burden on the courts.

The downside to deference is that it will reduce experimentation. That is, once the Service has decided its position on a tax accounting matter, the taxpayer will have no incentive to develop a superior method that can be easily trumped by the Commissioner's choice.

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288. 499 U.S. 144, 145 (1991); *but see* Anthony, *supra* note 141, at 10.

289. 348 F.3d 136, 144-45 (6th Cir. 2003).