
January 2003

Checking the Beast: Why the Federal Circuit Court of Appeals Is Good for the Federal System of Tax Litigation

Christopher R. Egan

Recommended Citation

Christopher R. Egan, Comment, *Checking the Beast: Why the Federal Circuit Court of Appeals Is Good for the Federal System of Tax Litigation*, 56 SMU L. REV. 721 (2003)
<https://scholar.smu.edu/smulr/vol56/iss1/25>

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CHECKING THE BEAST: WHY THE FEDERAL CIRCUIT COURT OF APPEALS IS GOOD FOR THE FEDERAL SYSTEM OF TAX LITIGATION

*Christopher R. Egan**

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* J.D., 2002, Southern Methodist University School of Law; B.B.A., M.P.A., 1997, The University of Texas at Austin; Certified Public Accountant, Texas. The author currently works as a trial attorney for the U.S. Department of Justice, Tax Division in Dallas, Texas.

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IN 1990, a Congressional Federal Courts Committee concluded that the federal system of tax litigation was an "irrational," "crazy quilt."¹ The committee recommended that Congress beautify this quilt by removing tax jurisdiction from the Court of Federal Claims² and the Federal Circuit Court of Appeals.³ Congress has not yet adopted this change, and the debate between tax professionals continues.⁴ This paper argues that Congress should retain the "crazy quilt." The federal system of tax litigation may not be pretty, but it contains unique checks and balances that are needed to restrain a necessarily aggressive and powerful Internal

1. JUDICIAL CONFERENCE OF THE UNITED STATES, REPORT OF THE FEDERAL COURTS STUDY COMMITTEE 31 (Apr. 2, 1990), quoted in Martin D. Ginsburg, *The Federal Courts Study Committee on Claims Court Tax Jurisdiction*, 40 CATH. U. L. REV. 631 (1991).

2. At that time the Court of Federal Claims was known as the Court of Claims. Congress changed its name to the United States Court of Federal Claims on October 29, 1992. Federal Courts Administration Act, Pub. L. No. 102-572, 106 Stat. 4506.

3. JUDICIAL CONFERENCE OF THE UNITED STATES, REPORT OF THE FEDERAL COURTS STUDY COMMITTEE 31, 21, 69 (Apr. 2, 1990).

4. See, e.g., James P. Holden, *The Federal Courts Study Committee Has Not Made the Case for its Proposed Overhaul of the Tax Litigation Process*, 40 CATH. U. L. REV. 639 (1991); Ginsburg, *supra* note 1 (arguing that congress should adopt the study's recommendations); COMMISSION ON STRUCTURAL ALTERNATIVES FOR THE FEDERAL COURTS OF APPEALS, FINAL REPORT, pursuant to Pub. L. No. 105-119 (Dec. 18, 1998) (suggesting that all tax appeals could be centralized in the Federal Circuit Court of Appeals).

Revenue Service. The Federal Circuit Court of Appeals is a crucial part of these checks and balances because no court checks an aggressive and powerful federal agency better than the Federal Circuit.

The following five parts demonstrate this position. Part I diagrams the current system of federal tax litigation. Part II uses statistical analysis to argue that the Federal Circuit Court of Appeals is not biased against the government. Part III analyzes specific cases where the Federal Circuit has checked the IRS. Part IV explains why the Internal Revenue Service must be aggressive and powerful. Finally, Part V argues that no court checks the Internal Revenue Service better than the Federal Circuit.

I. FEDERAL TAX LITIGATION ORIGINATES IN THREE VENUES: DISTRICT COURTS, THE TAX COURT, AND THE COURT OF FEDERAL CLAIMS

In general, taxpayers can bring tax disputes in three venues: 1) the United States Tax Court; 2) the United States Court of Federal Claims; and 3) federal district court. These venues have different jurisdiction, location, and procedures.⁵

The jurisdiction of these courts is concurrent in some areas, but exclusive in others. The Tax Court has deficiency jurisdiction, but the district courts and the Court of Federal Claims have refund jurisdiction. In other words, to gain access to the Tax Court, taxpayers must refuse to pay a tax deficiency and file an action in the Tax Court.⁶ Otherwise, the taxpayer can pay the deficiency up front and file a refund action in either the taxpayer's home district court or in the Court of Federal Claims.⁷ District courts have exclusive jurisdiction over actions to quiet title in an estate or in real property,⁸ over criminal tax actions,⁹ and over tax disputes that arise during bankruptcy actions.¹⁰ District courts hear cases from one geographic jurisdiction, but the Court of Federal Claims and the Tax Court have national jurisdiction. Otherwise these three courts generally consider the same kinds of tax issues.

All of the Tax Court's cases are tax cases, but the district courts and the Court of Federal Claims hear a variety of cases. The Court of Federal Claims generally focuses on money claims against the United States. About 25% of the Court of Federal Claims' cases are tax refund cases, 33% involve government contracts, and 10% involve the Fifth Amend-

5. For a discussion on choosing which venue to litigate in, see GERALD A. KAFKA & RITA A. CAVANAUGH, *LITIGATION OF FEDERAL CIVIL TAX CONTROVERSIES* § 1.01 (2002).

6. 26 U.S.C. § 6213 (1988).

7. 28 U.S.C. § 1346 (1988).

8. 28 U.S.C. § 1346(f) (1988).

9. 28 U.S.C. § 1331 (2001) grants district courts general federal question jurisdiction: "The district courts shall have original jurisdiction of all civil actions arising under the Constitution, laws, or treaties of the United States."

10. *Id.*

ment's takings clause.¹¹ The court's other cases involve government payroll, Indian tribes, intellectual property, and various other statutory money claims.¹² The district courts hear the widest variety of cases, including civil and criminal cases. In the year 2000, less than 1% of civil cases filed in the district courts were tax cases.¹³

Location is another way these courts differ. The Tax Court is physically located in Washington, D.C., but its judges ride a circuit and conduct trials in designated cities across the nation.¹⁴ The Court of Federal Claims, on the other hand, occasionally conducts parts of its trials around the nation, but it is based in Washington, D.C. and conducts most trials in Washington.¹⁵ District courts are spread across the country.

Finally, these courts differ in procedure and appeal. The district courts offer jury trials, but the Tax Court and the Court of Federal Claims offer judge trials only. Other procedural rules of the district courts and the Court of Federal Claims mostly match, but Tax Court procedure is substantially unique.¹⁶ After trial, taxpayers appeal cases from the Tax Court and district courts to one of the regional circuit courts of appeals, according to the tax dispute's location. Taxpayers appeal Court of Federal Claims cases exclusively to the Federal Circuit Court of Appeals.

The following parts describe why the Federal Circuit Court of Appeals plays a crucial role in the above system by checking an aggressive and powerful Internal Revenue Service.

II. A STATISTICAL COMPARISON OF FEDERAL CIRCUIT TAX HOLDINGS WITH FIFTH CIRCUIT TAX HOLDINGS DEMONSTRATES THAT THE FEDERAL CIRCUIT IS NOT BIASED AGAINST THE GOVERNMENT

Opponents of Federal Circuit tax jurisdiction outwardly argue organization and uniformity as reasons to remove tax jurisdiction from the Federal Circuit,¹⁷ but their real motivation appears to be Federal Circuit

11. See U.S. CT. FED. CLAIMS, THE HISTORY OF THE UNITED STATES COURT OF FEDERAL CLAIMS, at <http://www.uscfc.uscourts.gov/uscfchistory.htm> (last modified June 4, 2001).

12. *Id.*

13. JUDICIAL BUSINESS OF THE UNITED STATES COURTS, 2000 ANNUAL REPORT OF THE DIRECTOR, TABLE C-2, U.S. DISTRICT COURTS—CIVIL CASES COMMENCED, BY BASIS OF JURISDICTION AND NATURE OF SUIT, DURING THE 12-MONTH PERIOD ENDING SEPTEMBER 30, 2000, available at <http://www.uscourts.gov/judbus2000/appendices/c02sep00.pdf> (last visited Jan. 30, 2003).

14. See Tax Court website, at <http://www.ustaxcourt.gov> (last updated Sept. 23, 2002).

15. See Court of Federal Claims website, at <http://www.uscfc.uscourts.gov> (last visited Jan. 30, 2002).

16. KAFKA & CAVANAUGH, *supra* note 5, § 1.01. Because of these different procedures Internal Revenue Service lawyers handle Tax Court cases, and Department of Justice lawyers handle district court and Court of Federal Claims cases.

17. Ginsburg, *supra* note 1.

bias.¹⁸ Some think that the Federal Circuit is so biased against the government, that it cannot be trusted with tax cases. The following statistics dispute this myth. The Federal Circuit is not generally biased against the government, but it has acquired a taxpayer-friendly reputation by checking the IRS's power in a few high profile cases.

The following tables demonstrate by comparing Federal Circuit tax holdings with Fifth Circuit tax holdings from 1997 through 2001. These tables compare substantive tax cases only. In other words, cases that turned on procedural and jurisdictional issues are not included. Also, the tables do not consider unpublished opinions; unpublished opinions generally involve routine cases that do not indicate a court's substantive position. Finally, the tables do not consider cases that turn on issues not heard by both courts. For example, criminal cases, bankruptcy cases, tort cases, and international trade cases are not considered.

A. AN ANALYSIS OF GENERAL WINS IN SUBSTANTIVE TAX CASES
INDICATES THAT THE FEDERAL CIRCUIT IS NOT GENERALLY
BIASED AGAINST THE GOVERNMENT

This first table analyzes all substantive tax cases and large corporate cases. The results show that the Federal Circuit generally holds for the government more often than does the Fifth Circuit.

FEDERAL CIRCUIT VERSUS FIFTH CIRCUIT
1997-2001 — GENERAL WINS IN SUBSTANTIVE TAX CASES

	Federal Circuit		Fifth Circuit	
	Taxpayer	Gov't	Taxpayer	Gov't
All Substantive Tax Holdings*	16	24	16	19
Corporate Cases over \$1 Million*	11	10	2	2
All Substantive by Estimated \$\$\$	232,930,627	311,684,422	38,479,794	18,694,567
Corp Over \$1 million by Estimated \$\$\$	230,026,646	257,572,664	12,257,626	10,586,776

*Mixed holdings are not included unless one party benefited significantly more than the other.

**Some dollar amounts are estimated from incomplete opinion information.

In all substantive cases, the Federal Circuit held for taxpayers only 40% of the time, while the Fifth Circuit held for taxpayers 46% of the time. In large corporate cases, the Federal Circuit held for taxpayers 52% of the time, but it makes sense that corporate taxpayers would succeed more than all taxpayers. A large corporation generally acts rationally, so it does not bring a case to trial unless it has a legitimate chance of winning. Other taxpayers may bring suit for emotional reasons.

Federal Circuit case value also stands out. Federal Circuit case value averages over \$13 million, while Fifth Circuit case value averages less

18. This is a commonly held sentiment among tax practitioners that the author confirmed by speaking with various professors, government lawyers, private lawyers, and Certified Public Accountants.

than \$2 million. This value comparison underscores the Federal Circuit's significant role in tax litigation.

**B. AN ANALYSIS OF TAX HOLDINGS INVOLVING THE MOST
LITIGATED ISSUES INDICATES THAT THE FEDERAL CIRCUIT
IS NOT BIASED AGAINST THE GOVERNMENT ON
ANY PARTICULAR ISSUE**

The next tables analyze the most litigated issues in both the Federal Circuit and the Fifth Circuit. Again, Federal Circuit bias against the government does not emerge.

**FEDERAL CIRCUIT SUBSTANTIVE TAX HOLDINGS
1997-2001 — WINS BY MOST LITIGATED ISSUES**

	By Number of Wins*		By Estimated \$ in Controversy**	
	Taxpayer	Gov't	Taxpayer	Gov't
Employee Compensation	—	6	—	89,770,007
Consolidated Taxation	1	1	6,641,022	1,328,788
Excise Taxes	2	1	3,243,096	415,889
General Income Definition	2	4	83,659,720	212,082,432

*Mixed holdings are not included unless one party benefited significantly more than the other.

**Some dollar amounts are estimated from incomplete opinion information.

The Federal Circuit's most litigated issue, employee compensation, does not demonstrate bias against the government. In fact, taxpayers

**FIFTH CIRCUIT SUBSTANTIVE TAX HOLDINGS
1997-2001 — WINS BY MOST LITIGATED ISSUES**

	By Number of Wins*		By Estimated \$ in Controversy**	
	Taxpayer	Gov't	Taxpayer	Gov't
Estate Tax	8	3	21,513,726	605,866
Personal Injury Damages	—	3	—	57,706
General Income Definition	3	1	4,511,816	1,725,000
Interest, Penalties, and Fees	2	2	853,236	2,613,776

*Mixed holdings are not included unless one party benefited significantly more than the other.

**Some dollar amounts are estimated from incomplete opinion information.

won none of those cases. In contrast, the Fifth Circuit's most litigated issue, estate tax, favors taxpayers. Taxpayers won almost 75% of estate tax cases in the Fifth Circuit.

**C. A JUDGE-BY-JUDGE ANALYSIS INDICATES THAT NO PARTICULAR
FEDERAL CIRCUIT JUDGE IS BIASED AGAINST
THE GOVERNMENT**

The next tables analyze tax holdings by Federal and Fifth Circuit judges that wrote at least three tax case opinions. Like the above tables, these

results do not indicate any particular Federal Circuit bias against the government.

**FEDERAL CIRCUIT SUBSTANTIVE TAX HOLDINGS
1997-2001 — WINS BY MOST ACTIVE JUDGES**

	By Number of Wins*		By Estimated \$ in Controversy**	
	Taxpayer	Gov't	Taxpayer	Gov't
Glenn Leroy Archer, Jr.	2	1	4,655,540	2,835,112
Daniel M. Friedman	2	2	34,981,630	1,996,151
Alan D. Lourie	2	1	63,920,016	60,000
Haldane Robert Mayer	1	3	6,641,022	15,602,658
Paul R. Michel	2	1	35,343,007	10,779
S. Jay Plager	3	1	2,663,341	652,424
Randall R. Rader	1	3	82,488,259	53,127,344
Alvin A. Schall	—	5	—	2,513,291

*Mixed Holdings are not included unless one party benefited significantly more than the other

**Some dollar amounts are estimated from incomplete opinion information

If any Federal Circuit judge is biased for or against the government, one may be biased for the government; Judge Schall has decided five cases for the government and zero against.

**FIFTH CIRCUIT SUBSTANTIVE TAX HOLDINGS
1997-2001 — WINS BY MOST ACTIVE JUDGES**

	By Number of Wins*		By Estimated \$ in Controversy**	
	Taxpayer	Gov't	Taxpayer	Gov't
Reynaldo G. Garza	—	2	—	448,585
Patrick E. Higginbotham	2	2	9,705,756	89,036
E. Grady Jolly	2	1	12,646,728	157,281
Edith H. Jones	4	—	8,397,596	—
Jerry E. Smith	2	1	1,769,946	33,343
Jacques L. Wiener, Jr.	2	2	3,419,399	1,726,710

*Mixed holdings are not included unless one party benefited significantly more than the other.

**Some dollar amounts are estimated from incomplete opinion information.

On the other hand, the Fifth Circuit may have one judge, if any, that is biased for taxpayers; Judge Jones decided four cases for taxpayers and zero for the government.

The above tables demonstrate that the Federal Circuit is not generally biased against the government. The next sections analyze why the Federal Circuit has acquired its taxpayer-friendly reputation, and why the Federal Circuit plays a crucial role in the federal tax system.

III. THE FEDERAL CIRCUIT'S TAXPAYER-FRIENDLY REPUTATION COMES FROM HIGH PROFILE CASES WHERE IT HAS CHECKED THE IRS

If the Federal Circuit is not generally biased against the government, how did it acquire its taxpayer-friendly reputation? Its reputation comes from high profile cases where it has restrained the Internal Revenue Service. This checking arises when the Federal Circuit decides how much deference to give IRS regulations and determinations. The Supreme Court has established general rules governing how much deference courts should give agency determinations, but the Federal Circuit does not apply these rules when their application would promote injustice. The next parts demonstrate by explaining when the Supreme Court defers to federal agencies, and by analyzing high profile cases where the Federal Circuit has checked the IRS.

A. THE SUPREME COURT GENERALLY GIVES AGENCY DETERMINATIONS CONTROLLING OR CONSIDERABLE WEIGHT, DEPENDING ON THE TYPE OF DETERMINATION

The Supreme Court has held that deference to regulations depends on whether the regulation is legislative or interpretive.¹⁹ Agencies issue legislative regulations under a specific grant of authority. In other words, Congress explicitly states in a particular statute that a federal agency shall make regulations necessary to implement the statute. The Supreme Court grants these regulations "controlling weight unless they are arbitrary, capricious, or manifestly contrary" to the governing statute.²⁰ Interpretive regulations, on the other hand, are issued under general interpretive authority. For example, I.R.C. § 7805 grants the IRS the general power to implement regulations that interpret the federal tax code. The Supreme Court grants these regulations "considerable weight," and has held that "a court may not substitute its own construction. . . for a reasonable interpretation made by the administrator of an agency."²¹

The weight given to other agency determinations varies. The Supreme Court considers a particular determination for "the thoroughness evident in its consideration, the validity of its reasoning, its consistency with earlier and later pronouncements, and all those factors which give it power to persuade. . . ."²² The Court has "long recognized that considerable weight should be accorded to an executive department's construction of a statutory scheme. . . ."²³

19. See *Chevron, U.S.A., Inc. v. Natural Res. Def. Council, Inc.*, 467 U.S. 837, 844 (1984).

20. *Id.*

21. *Id.*

22. *United States v. Mead Corp.*, 121 S. Ct. 2164, 2172 (2001) (quoting *Skidmore v. Swift & Co.*, 323 U.S. 134, 140 (1944)).

23. *Id.* at 2171 (quoting *Chevron*, 467 U.S. at 844).

The next three cases demonstrate that the Federal Circuit will not apply the above general rules if their application would bring injustice.

B. RITE AID CORP. v. UNITED STATES—The Federal Circuit Checks the IRS's Power to Govern Consolidated Taxation

In *Rite Aid Corp. v. United States*, the Federal Circuit refused to defer to a controversial consolidated return regulation.²⁴ The court invalidated the long-criticized loss disallowance rule in Treas. Reg. § 1.1502-20. That rule limits the loss that consolidated corporate parents can recognize from the sale of their subsidiary stock. Critics of the rule argue that it is invalid because it creates a new tax without Congressional approval. The Federal Circuit agreed with this criticism and concluded that loss disallowance rule is “manifestly contrary” to I.R.C. § 1502.²⁵ The following demonstrates that the Supreme Court’s general deference rules required the Federal Circuit to defer to the loss disallowance rule, but the Federal Circuit decided that those rules would not serve justice.

Rite Aid Corp. v. United States revolved around Rite Aid’s sale of its consolidated subsidiary Penn Encore. In 1984 and 1988, Rite Aid purchased all of Encore’s stock for \$4,659,730.²⁶ After this purchase, Encore was only marginally profitable, and in the final three years before 1994, Encore’s net income decreased from a \$1.7 million profit to a \$5.2 million loss.²⁷ Because of this loss, Rite Aid decided to sell Encore in 1994 to an unrelated company named CMI Holding Corporation for \$18 million in cash and additional CMI stock warrants.²⁸ Rite Aid wanted to treat the sale as an I.R.C. § 338(h)(10) asset sale, but it agreed to a stock sale after CMI insisted.²⁹ At the time of sale, Rite Aid’s basis in Encore stock had increased to \$38,644,400 because Rite Aid had contributed \$44,890,476 to Encore’s capital, and Encore had accumulated \$10,905,806 in negative earnings and profits.³⁰ In accordance with I.R.C. § 1001, Rite Aid subtracted this basis from the selling price and calculated a \$22,136,739 loss.³¹

The controversy arose because Treas. Reg. § 1.1502-20(c) disallowed this entire loss. The loss disallowance rule in Treas. Reg. § 1.1502-20(c) prohibits consolidated corporations from recognizing loss on the sale of their subsidiary stock to the extent of a duplicative loss factor.³² For this case’s purposes, the duplicative loss factor equals the subsidiary’s adjusted basis in its assets minus the fair market value of the subsidiary’s

24. *Rite Aid Corp. v. United States*, 255 F.3d 1357 (Fed. Cir. 2001).

25. *Id.* at 1360.

26. *Id.* at 1358.

27. *Id.*

28. *Id.*

29. *Rite Aid Corp.*, 255 F.3d at 1358.

30. *Id.*

31. *Id.*

32. Treas. Reg. § 1.1502-20 (1991).

stock at the time of sale.³³ Encore's factor equaled \$28,535,858, so all of Rite Aid's \$22,136,739 loss was disallowed.³⁴

Rite Aid paid its 1994 tax without recognizing the Encore loss and then filed a claim for refund. The Internal Revenue Service denied this claim, so Rite Aid filed a complaint with the United States Court of Federal Claims. The Court of Federal Claims granted the government's motion for summary judgment,³⁵ and Rite Aid appealed to the Federal Circuit.

On appeal, the Federal Circuit considered one issue: whether Treas. Reg. § 1.1502-20 validly implements the legislative authority granted in I.R.C. § 1502.³⁶ Section 1502 grants the Secretary of the Treasury the authority to "prescribe such regulations. . . in order that the tax liability of any affiliated group of corporations making a consolidated return and of each corporation in the group. . . may be [determined] in such manner as clearly to reflect the income-tax liability. . . and in order to prevent avoidance of such tax liability."³⁷ Rite Aid argued that the loss disallowance rule in Treas. Reg. § 1.1502-20 oversteps § 1502 because, instead of helping measure an already existing tax, the loss disallowance rule creates a new tax.³⁸

The Federal Circuit agreed with Rite Aid and invalidated the loss disallowance rule.³⁹ The court stated that I.R.C. § 1502 "does not authorize the Secretary to choose a method that imposes a tax on income that would not otherwise be taxed."⁴⁰ The loss disallowance rule imposes this new tax, concluded the court, because it unilaterally excepts I.R.C. § 165.⁴¹ Section 165 generally allows a parent corporation to deduct losses from the sale of subsidiary stock.⁴² But the loss disallowance rule excepts § 165 by taking these losses away from parents that file consolidated returns.⁴³ According to the court, this loss restriction might be valid if filing consolidated returns caused these losses, but these losses occur "regardless of whether corporations file separate or consolidated returns."⁴⁴ Because I.R.C. § 1502 allows the Treasury to address only problems that arise from consolidated taxation, the court concluded that the loss disallowance rule oversteps the authority granted in § 1502.⁴⁵

Before analyzing the court's argument, one must consider the broad power that Congress granted the IRS to implement consolidated return regulations. The Supreme Court generally grants these kinds of legisla-

33. See Treas. Reg. § 1.1502-20(c) (1991); *Rite Aid Corp. v. United States*, 46 Fed. Cl. 500, 503 (2000).

34. *Rite Aid Corp.*, 255 F.3d at 1358.

35. *Rite Aid Corp. v. United States*, 46 Fed. Cl. 500 (2000).

36. *Rite Aid Corp.*, 255 F.3d at 1358.

37. I.R.C. § 1502 (2001).

38. *Rite Aid Corp.*, 255 F.3d at 1360.

39. *Id.* at 1360.

40. *Id.* at 1359 (quoting *Am. Standard, Inc. v. United States*, 602 F.2d 256, 261 (1979)).

41. *Id.* at 1360.

42. I.R.C. § 165 (2001); *Rite Aid Corp.*, 255 F.3d at 1360.

43. *Rite Aid Corp.*, 255 F.3d at 1360.

44. *Id.* at 1360.

45. *Id.*

tive regulations “controlling weight unless they are arbitrary, capricious, or manifestly contrary to the statute [granting power].”⁴⁶ This grant of power increases the possibility of IRS abuse, but consolidated taxation is an extremely complicated concept that Congress is not equipped to handle. The IRS is the only government agency that can competently implement consolidated taxation, so Congress had no choice. Nevertheless, the Supreme Court’s general deference rules do not allow courts to check this broad authority. The next paragraphs demonstrate why Supreme Court rules generally require courts to defer to the loss disallowance rule by considering the inherent nature of consolidated taxation and the reasons why the IRS implemented the loss disallowance rule.

The IRS implemented the loss disallowance rule to solve a consolidated taxation problem that allows parent corporations to sell subsidiary built-in gain assets—assets with a higher fair market value than adjusted basis—without recognizing gain. For example,⁴⁷ suppose parent corporation *P* purchased the stock of subsidiary corporation *S* for \$400 and elected to file a consolidated return with *S*. *S* has two assets with \$100 of built-in gain each: Asset #1 with a \$100 basis and a \$200 market value, and Asset #2 with a \$100 basis and a \$200 market value. If *S* sells Asset #1, *P*’s consolidated group would recognize \$100 of gain. In addition, Treas. Reg. § 1.1502-32 allows *P* to increase its basis in *S* stock by \$100 to a total basis of \$500. Regulations allow this increase in stock basis, “so that income or loss previously included in a group’s consolidated taxable income is not reflected a second time on the sale of a subsidiary’s stock.”⁴⁸ But in the above situation, where *S*’s income relates to built-in gain, this basis increase allows *P*’s consolidated group to permanently avoid all taxation on the Asset #1 sale. For example, if *P* now sells all of its *S* stock, it recognizes an artificially created \$100 loss⁴⁹ that offsets the \$100 gain that *S* recognized on the Asset #1 sale. This result directly conflicts with I.R.C. § 336 and § 337, which require corporations to recognize gain when they distribute or sell corporate property.⁵⁰ To take advantage of this conflict, many corporations created abusive tax-shelter schemes with labels like “son of mirror.”⁵¹

To solve this problem, the IRS considered many complicated solutions.⁵² Theoretically, the most accurate solution is tracing. Tracing involves tracking a subsidiary’s built-in gain and not allowing the parent to

46. *Id.* at 1359 (citing *Chevron*, 467 U.S. at 844).

47. This example is based on example 2 in Consolidated Return Regulations, 55 Fed. Reg. 9426-01, 9427 (Temp. Reg. announced Mar. 14, 1990).

48. I.R.S. Notice 87-14, 1987-1 C.B. 445.

49. \$400 price minus \$500 basis equals \$100 loss.

50. See I.R.C. §§ 336, 337 (2001). These code sections repealed *Gen. Utils. & Operating Co. v. Helvering*, 296 U.S. 200 (1935).

51. For a detailed explanation of “son of mirror” transactions see BORIS I. BITTKER & JAMES S. EUSTICE, *FEDERAL TAXATION OF CORPORATIONS AND SHAREHOLDERS* § 13.42[5][c] (2001).

52. For a detailed analysis of all of these solutions and their drawbacks see Consolidated Return Regulations, 55 Fed. Reg. 9426-01, 9428-9429 (Temp. Reg. announced Mar. 14, 1990).

increase its subsidiary stock basis for any earnings or gain related to that built-in gain. Built-in gain changes as an asset's value changes, so tracing requires constant appraisal.⁵³ These appraisals are not only incredibly burdensome, they can be very imprecise and inconsistent.⁵⁴ The IRS concluded that "[t]racing becomes more subjective the deeper you go into it."⁵⁵ Accordingly, tracing was rejected.

After considering other combinations of tracing and presumption⁵⁶, the IRS decided on the loss disallowance rule.⁵⁷ The other options were as administratively burdensome and imprecise as tracing.⁵⁸ Treasury admitted that the loss disallowance rule was imperfect because it not only disallowed losses related to built-in gain, it disallowed economic losses.⁵⁹ Rite Aid's loss, for example, related to Encore's decline in economic value. Nevertheless, Treasury's other options, like tracing, had other problems and burdens. In the end, Treasury chose the loss disallowance rule because it saved IRS resources, and it produced a predictable result.⁶⁰

Taxpayers may disagree with Treasury's decision, but mere disagreement with a carefully-weighed solution to a complex problem does not usually overturn a legislative regulation. The Supreme Court has made it clear that if a "choice represents a reasonable accommodation of conflicting policies that were committed to the agency's care by the statute, [the Court] should not disturb it unless it appears from the statute or its legislative history that the accommodation is not one that Congress would have sanctioned."⁶¹ Congress has never objected to the loss disallowance rule since the IRS implemented it in 1990.⁶² In fact, Congress considered

53. Lee A. Sheppard, *Government Defends Loss Disallowance Rules*, 90 TAX NOTES TODAY 64-10 (1990). During discussions with the IRS, a taxpayer representative argued that financial accountants appraise assets only upon purchase. But the IRS responded "that financial accounting focused on the income of the purchaser, while the government was interested in implementing Notice 87-14, 1987-1 C.B. 445, which requires that fluctuations in asset value be addressed." *Id.*

54. *Id.*

55. *Id.*

56. For example, the Treasury considered disallowing all losses from subsidiary asset sales, but allowing taxpayers to prove otherwise through tracing. This method was rejected because "taxpayers, in order to take advantage of the rule, would be forced to resort to tracing, with all of its attendant complexity and administrative burdens for both taxpayers and the Service." Consolidated Return Regulations, 55 Fed. Reg. 9426-01, 9429 (Temp. Reg. announced Mar. 14, 1990).

57. See Consolidated Return Regulations, 55 Fed. Reg. 9426-01, 9428-9429 (Temp. Reg. announced Mar. 14, 1990).

58. *Id.*

59. At a Federal Bar Association meeting in 1990, IRS representatives admitted that the disallowance of economic loss was the "rough cut" under the loss disallowance model. Sheppard, *supra* note 53. But the IRS representatives reiterated that there are "different rough cuts under other models." *Id.*

60. See Consolidated Return Regulations, 55 Fed. Reg. 9426-01 (Temp. Reg. announced Mar. 14, 1990).

61. *Chevron*, 467 U.S. at 845 (quoting *United States v. Shimer*, 367 U.S. 374, 382 (1961)).

62. See Consolidated Return Regulations, 55 Fed. Reg. 9426-01, 9428-9429 (Temp. Reg. announced Mar. 14, 1990).

legislation that would repeal *Rite Aid*.⁶³ Congress delegated broad consolidated rule making authority to the IRS,⁶⁴ and the IRS's decision in favor of administrative convenience is generally within that authority.

In addition to the built-in gain problem, the inherent nature of consolidated taxation indicates that the loss disallowance rule is generally within the IRS's consolidated rulemaking authority. The Federal Circuit's opinion reasoned that the loss disallowance rule creates tax because it forbids *consolidated* parents from deducting a loss that I.R.C. § 165 allows *separate* parents to deduct.⁶⁵ This reasoning indicates a possible taxpayer injustice, but it does not indicate that the loss-disallowance rule exceeds the IRS's general consolidated rulemaking authority. The court's reasoning fails to recognize "that the consolidated return regulations adopt a comprehensive approach to gain and loss duplication that represents a fundamental departure from separate return treatment."⁶⁶ Unlike separate taxation, the IRS's scheme of consolidated taxation treats Rite Aid and Encore as one corporation for taxation purposes.⁶⁷ Accordingly, the loss disallowance rule furthers the clear measurement of the IRS's definition of consolidated income; it prohibits one corporation from recognizing the same loss twice—once when Rite Aid sells Encore and once when Encore later sells its assets.⁶⁸ I.R.C. § 165 allows both a separate parent and separate subsidiary to recognize this loss, but the IRS did not treat Encore and Rite Aid as separate corporations. In short, comparing the IRS's definition of consolidated taxation to separate taxation is like comparing apples to oranges.

Rite Aid's consent is a final reason that the loss disallowance rule is generally within the IRS's consolidated rule making authority. I.R.C. § 1501 states that consolidated treatment is a privilege that corporations may take advantage of only if they "consent to all the consolidated return regulations prescribed under section 1502."⁶⁹ Therefore, Rite Aid consented to the loss disallowance rule when it decided to file a consolidated return. Rite Aid obviously decided that consolidated taxation's advantages outweighed its disadvantages. As the government stated in its Federal Circuit brief, Rite Aid agreed to all of the consolidated return regulations and "must take the bitter with the sweet."⁷⁰

63. See Kenneth J. Kies, *Kies Opposes Overturning Rite Aid*, 2001 TAX NOTES TODAY 169-23 (2001). Granted, "the view of a later Congress cannot control the interpretation of an earlier enacted statute." *O'Gilvie v. United States*, 519 U.S. 79, 90 (1996). But it does give insight into what a prior Congress might have intended.

64. See I.R.C. § 1502 (2001).

65. *Rite Aid Corp.*, 255 F.3d at 1360.

66. Consolidated Return Regulations, 55 Fed. Reg. 9426-01, 9429 (Temp. Reg. announced Mar. 14, 1990).

67. *Textron, Inc. v. Comm'r*, 117 T.C. 7 (2001) ("The basic concept underlying . . . [the consolidated return] provisions is that the consolidated group is . . . a single taxable enterprise. . . ." (quoting 3 BITTKER & LOKKEN, FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS, ¶ 90.5 at 90-48 (2d ed. 1991))).

68. *Rite Aid Corp.*, 46 Fed. Cl. at 506.

69. I.R.C. § 1501 (2001).

70. *Rite Aid Corp.*, 255 F.3d at 1360.

Despite the IRS's broad power to govern consolidated taxation, the Federal Circuit decided not to defer. The IRS's legislative power to govern consolidated taxation is unusually broad, so the Supreme Court's general deference rules are not appropriate. Congress gave the IRS the complete power to determine and collect consolidated taxes on only one condition: the IRS's rules must be determined and applied "in such manner as clearly to reflect" consolidated income.⁷¹ This is a massive amount of power to give an unelected group that aggressively collects taxes, but Congress had no choice; the IRS is the only government entity with the expertise needed to implement consolidated taxation. Furthermore, Congress does not have enough time to implement such a complicated system. But this grant of power is dangerous because the IRS is also designed to aggressively collect taxes. This combination of power and aggression could lead to abuse if it is not carefully checked. The Federal Circuit decided that this extraordinary grant of power should not receive the Supreme Court's general deference.

After deciding that the consolidated loss disallowance rule should receive a lower amount of deference, the Federal Circuit determined that the loss disallowance rule promotes injustice. The loss disallowance rule drastically changed the definition of income. Billions of dollars ride on the ability of corporate parents to recognize economic loss on the sale of subsidiary stock. A rule that hurts taxpayers so drastically should be determined by Congress, not the IRS.

One could argue that Congress approves of the loss disallowance rule because it considered legislation that would repeal *Rite Aid*.⁷² But Congress's approval does not mean that the IRS should make such drastic decisions. Congress may not agree with the next IRS decision. If Congress was not currently faced with budget deficits, it may not have approved of the loss disallowance rule; Rite Aid could cost the Treasury as much as \$10 billion in tax revenue after other corporations file for refund.⁷³ In short, the Federal Circuit decided that taxpayers should not be charged billions of dollars without Congressional approval.

C. LOCKHEED MARTIN CORP. v. UNITED STATES: THE FEDERAL
CIRCUIT REFUSES TO DEFER TO THE IRS'S NARROW
DEFINITION OF FUNDED RESEARCH

In *Lockheed Martin Corp. v. United States*, the Federal Circuit restrained the IRS from interpreting tax statutes too narrowly.⁷⁴ The IRS's interpretation was not unreasonable, but it was very aggressive, and the Federal Circuit decided that deferring to the IRS's judgment would not serve justice.

71. I.R.C. § 1502 (2001).

72. See Kies, *supra* note 63.

73. *Id.*

74. *Lockheed Martin Corp. v. United States*, 210 F.3d 1366 (Fed. Cir. 2000).

Lockheed revolved around over 300 contracts that Lockheed entered into with government and private entities. Lockheed and the United States agreed to limit the trial's contract interpretation to four major projects: LANTIRN; SICBM; SLAT; and Titan IV.⁷⁵ The LANTIRN project developed technology that would permit precision bomb delivery and nighttime aircraft operation.⁷⁶ SICBM attempted to develop a small, mobile, and inexpensive unit designed to launch nuclear warheads, but the government terminated SICBM before completion.⁷⁷ SLAT attempted to develop a reusable ship-to-ship missile that reached supersonic speeds at low altitude.⁷⁸ The Navy intended to use these missiles to practice anti-missile defense, but the government decided not to buy production units.⁷⁹ Titan IV developed a space launch vehicle for placing satellites into orbit.⁸⁰

Because it incurred research expenses while performing these contracts, Lockheed claimed \$63,745,727 in qualified research expenditure (QRE) tax credits. The Internal Revenue Service denied this claim because it concluded that the government funded Lockheed's research.⁸¹ Lockheed then filed suit in the United States Court of Federal Claims. The Court of Federal Claims agreed with the IRS, and granted the government's motion for summary judgment.⁸² Lockheed then appealed to the Federal Circuit. The Federal Circuit held that Lockheed's research was not fully funded, and Lockheed was entitled to deduct research credits.

Two statutes governed Lockheed's claimed QRE credits—I.R.C. § 44F for credits earned before 1988, and I.R.C. § 41 for credits earned during and after 1988⁸³—but the relevant language in each section matches. Both of these sections allowed QRE credits for expenses related to “qualified research” only,⁸⁴ and each explicitly excluded from qualified research any research “funded by any grant, contract, or otherwise by any other person (or any governmental entity).”⁸⁵ Lockheed's ability to claim QRE credits turned on the definition of “funded.”

The code sections cited by Lockheed did not define “funded,” but Treas. Reg. § 1.41-5(d) did. This regulation focuses on whether the taxpayer retains substantial rights in its research results. Research is fully funded if the taxpayer “retains no substantial rights in research under the

75. Sixty-five percent of the expenses claimed by Lockheed were incurred in these four contracts. *Lockheed Martin Corp. v. United States*, 42 Fed. Cl. 485, 487 (1998).

76. *Lockheed*, 42 Fed. Cl. at 487.

77. *Id.* at 488.

78. *Id.*

79. *Id.*

80. *Id.*

81. *Id.* at 487.

82. *Id.* at 500.

83. All references to § 44F are to the 1982 I.R.C.; all references to § 41 are to the 1988 I.R.C.

84. I.R.C. § 44F(a) (1982); I.R.C. § 41(a) (1988).

85. I.R.C. § 44F(d) (1982); I.R.C. § 41(d) (1988).

agreement providing for the research.”⁸⁶ For example, the regulation states that a taxpayer does not retain substantial rights if the taxpayer “must pay for the right to use the results of the research,”⁸⁷ or if the taxpayer “confers on another person the exclusive right to exploit the results of the research.”⁸⁸

Accordingly, the regulations completely disqualify research credits if the taxpayer does not retain substantial rights in its research, but they only partially disqualify if the taxpayer does retain substantial rights.⁸⁹ If the taxpayer retains substantial rights, it may claim the partially qualified expenditures to the extent another party does not pay them. In other words, a taxpayer that performs research to satisfy a contract may claim research expenditures to the extent they exceed the contract price.

Lockheed and the government agreed that Lockheed’s contracts give Lockheed some rights to its research, but they disagreed about the substantiality of Lockheed’s rights. Lockheed’s contracts all have substantially similar provisions. These provisions generally gave the government unlimited rights to the technical data and computer software generated from the contract’s performance. The government could, without Lockheed’s consent, “use, duplicate, or disclose technical data or computer software in whole or in part, in any manner and for any purpose whatsoever, and to have or permit others to do so.”⁹⁰ Lockheed, on the other hand, was generally required to reimburse the government if Lockheed sold any “products, technology, material, services, and/or development or production techniques” created through contract performance.⁹¹ Lockheed had to “reimburse the U.S. Government for a fair share of U.S. Government expenditures for nonrecurring costs applicable to the items to be sold.”⁹² In addition, the International Traffic in Arms Regulations required Lockheed to seek State Department approval before entering into “any kind of licensing agreement, technology transfer, or technical assistance agreement; before exporting any hardware to a foreign entity; or before it could even discuss any technical information not in the public domain.”⁹³

Lockheed claimed that, regardless of the above limitations, it had substantial rights to its research because it “retained the right to use the research results in its business.” The Federal Circuit agreed.⁹⁴ The court stressed that the right “to use the research results, even without the exclusive right, is a substantial right.”⁹⁵

86. Treas. Reg. § 1.41-5(d).

87. Treas. Reg. § 1.41-5(d)(3).

88. Treas. Reg. § 1.41-5(d)(2).

89. Treas. Reg. § 1.41-5(d)(3).

90. *Lockheed*, 42 Fed. Cl. at 490.

91. *Id.* at 492-93.

92. *Id.*

93. *Id.* at 492 (citing Int’l Traffic in Arms Regulations, 22 C.F.R. §§ 120-30).

94. *Lockheed*, 210 F.3d at 1372.

95. *Id.* at 1375.

The Federal Circuit's opinion does not specifically criticize the research credit regulations, but the Court implicitly seems to disapprove of their hyper-technical definitions. These regulations attached technical meanings to common statutory terms. The research credit statutes allow a credit for research expenses that are not "funded."⁹⁶ The statute does not define "funded," but a common sense reading indicates that a taxpayer cannot claim a credit for expenses that another entity pays. Lockheed admitted that the government contract paid for some of its research, but the contract did not pay for it all. Lockheed merely tried to claim a credit for the research expenses it had to pay above and beyond the contract price. Nevertheless, the IRS developed technical regulations that severely restricted the meaning of "funded." According to these regulations, being funded had more to do with "substantial rights" than funding.⁹⁷

But even under the IRS's hyper-technical definition, Lockheed still appeared to qualify for research credits. These regulations required the taxpayer to retain "substantial rights" in the research results.⁹⁸ Under the plain meaning of substantial, the right to use research without permission qualifies as substantial. But the IRS decided to attach a hyper-technical meaning to substantial and determined that the right to use was not substantial.

D. HATTER v. UNITED STATES: THE FEDERAL CIRCUIT PROTECTS THE JUDICIARY'S INDEPENDENCE

*Hatter v. United States*⁹⁹ demonstrates the Federal Circuit's vigorous defense of constitutional principals. When taxation affects constitutional principals, the Federal Circuit tends to show even less deference toward the IRS than it usually does.

Hatter revolved around Congress's ability to withhold Social Security tax from the salaries of Article III judges. Until 1983, Article III judges did not participate in Social Security.¹⁰⁰ But in 1983, Congress ordered federal courts to start withholding Social Security tax from Article III judges' salaries.¹⁰¹ Sixteen federal judges that were appointed before 1983 challenged this withholding as violating the Compensation Clause in

96. I.R.C. § 44F(d) (1982); I.R.C. § 41(d) (1988).

97. Treas. Reg. § 1.41-5(d).

98. *Id.*

99. *Hatter v. United States*, 64 F.3d 647 (Fed. Cir. 1995).

100. *Hatter*, 64 F.3d at 648. Most federal employees, including Article III judges, participated in the Civil Service Retirement System and did not need social security. *Id.*

101. *Id.* Hospital insurance withholding began on January 1, 1983. Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, § 278(a), 96 Stat. 324, 559, 562 (codified as amended at 26 U.S.C. § 3121(u) (1988)). Old Age and Survivors Disability insurance withholdings began on January 1, 1984. Social Security Amendments of 1983, Pub. L. No. 98-21, § 101(a)(1), (b)(1), (d), 97 Stat. 65, 67-70 (codified as amended at 26 U.S.C. § 3121(b)(5)(E) (1988 & Supp. V 1993) and 42 U.S.C. § 410(a)(5)(E) (1988 & Supp. V 1993)).

Article III.¹⁰² This clause states that an Article III judge's compensation "shall not be diminished during their Continuance in Office."¹⁰³ The sixteen federal judges argued that withholding social security violated the Compensation Clause because it "diminished" their salaries.

These judges brought a refund suit in the Court of Claims,¹⁰⁴ but the court dismissed.¹⁰⁵ The judges appealed to the Federal Circuit, and the Federal Circuit reversed and remanded.¹⁰⁶ On remand, the Court of Federal Claims granted the government's motion for summary judgment,¹⁰⁷ and the judges again appealed to the Federal Circuit. The Federal Circuit reversed the Court of Federal Claims and held that withholding social security from the judges' salaries violated the Compensation Clause.

The Federal Circuit began its discussion by quoting the Supreme Court's endorsement of an independent judiciary: "A Judiciary free from control by the Executive and Legislature is essential if there is a right to have claims decided by judges who are free from potential domination by other branches of government."¹⁰⁸ Compensation, the Federal Circuit argued, greatly affects that independence, so "the Constitution's language broadly prohibits any diminution in judicial compensation during a judge's continuance in office."¹⁰⁹

Next, the court explained that the Supreme Court had already held that the Compensation Clause prohibits using taxation to diminish an Article III judge's salary.¹¹⁰ In *Evans v. Gore*, the Supreme Court held that the Compensation Clause's broad words prohibited all diminution of an Article III judge's salary:

The prohibition is general, contains no excepting words and appears to be directed against all diminution, whether for one purpose or another; and the reasons for its adoption . . . make with impelling force for the conclusion that the fathers of the Constitution intended to prohibit diminution by taxation as well as otherwise,—that they regarded the independence of the judges as of far greater importance than any revenue that could come from taxing their salaries.¹¹¹

Accordingly, the Federal Circuit concluded that the Social Security tax violated the Compensation Clause.¹¹²

The Federal Circuit further supported its analysis by quoting the Constitution's framers. Alexander Hamilton stated that the term "diminished" prohibits any action that changes the "condition of the individual

102. *Hatter*, 64 F.3d at 649.

103. U.S. CONST. art. III, § 1.

104. At that time the United States Court of Federal Claims was named the Court of Claims.

105. *United States v. Hatter*, 21 Cl. Ct. 786 (1990).

106. *Hatter v. United States*, 953 F.2d 626 (1992).

107. *Hatter v. United States*, 31 Fed. Cl. 786 (1994).

108. *Hatter*, 64 F.3d at 649 (quoting *United States v. Will*, 449 U.S. 200, 217-18 (1980)).

109. *Id.* at 649.

110. *Id.*

111. *Evans v. Gore*, 253 U.S. 245, 255 (1920).

112. *Hatter*, 64 F.3d at 650.

[judge] for the worse.”¹¹³ James Madison determined that the term “compensation” applied to all “emoluments” of the judicial office.¹¹⁴

The government argued that *O’Malley v. Woodrough*¹¹⁵ overruled *Evans*, but the Federal Circuit disagreed. *O’Malley* held that newly appointed Article III judges must continue to pay income taxes after appointment:

To subject them to a general tax is merely to recognize that judges are also citizens, and that their particular function in government does not generate an immunity from sharing with their fellow citizens the material burden of the government whose Constitution and laws they are charged with administering.¹¹⁶

Nevertheless, the Federal Circuit pointed out that the judges in *O’Malley* took office after Congress had applied income tax to judicial salaries.¹¹⁷ Thus, the judges in that case “suffered no diminishment in compensation after taking office.”¹¹⁸ But the judges in *Hatter* did because they were “already judges when the Social Security taxes took effect.”¹¹⁹

The Federal Circuit finally held that Social Security benefits were speculative and did not offset the social security tax.¹²⁰ If Social Security taxes were vested in an account for each judge, then Social Security’s benefits would offset the Social Security tax.¹²¹ But social security taxes were not “vested in any manner,” so any benefits from Social Security were “entirely speculative”¹²²—recent raiding of the Social Security trust fund supports this position. The Federal Circuit refused to offset Social Security’s “concrete present reduction” with a “speculative, incalculable future benefit.”¹²³ The court therefore refunded the entire amount of Social Security tax withheld from the judges’ salaries.¹²⁴

One can argue against the Federal Circuit’s *Hatter* decision.¹²⁵ It seems reasonable to assume that Social Security’s benefits equal Social Security’s costs, so the Social Security tax did not diminish the judges’ compensation. But *Hatter* demonstrates the Federal Circuit’s aggressive defense

113. THE FEDERALIST NO. 79, 473 (Alexander Hamilton) (Clinton Rossiter ed., 1961) as quoted in *Hatter*, 64 F.3d at 651.

114. THE FEDERALIST NO. 51, 321 (James Madison) (Clinton Rossiter ed., 1961).

115. *O’Malley v. Woodrough*, 307 U.S. 277 (1939).

116. *Id.* at 282.

117. *Hatter*, 64 F.3d at 650.

118. *Id.* at 650.

119. *Id.*

120. *Id.* at 652.

121. *Id.*

122. *Hatter*, 64 F.3d at 652.

123. *Id.* at 652.

124. *Id.* at 653.

125. The Supreme Court affirmed the Federal Circuit’s holding regarding Social Security, but on different grounds. *Hatter v. United States*, 532 U.S. 557 (2001). The Court overruled *Evans v. Gore*, 253 U.S. 245 (1920) “insofar as it holds that the Compensation Clause forbids Congress to apply a generally applicable, nondiscriminatory tax to the salaries of federal judges.” *Hatter*, 253 U.S. at 567. But the 1983 Social Security statute discriminated against then-sitting judges, so the Court held that it violated the Compensation Clause. *Id.* at 572-78.

of constitutional ideals. It would rather err for the Constitution than against it.

The next section explains why the Federal Circuit sometimes feels compelled to restrain the IRS.

IV. THE IRS IS AN AGGRESSIVE AND POWERFUL BEAST THAT MUST BE CHECKED

The Internal Revenue Service is a beast by necessity and design. The federal tax system is the largest and most complicated debt collection system in the world, and administering it requires expertise and an aggressive nature. Congress does not have the expertise, and it does not want to antagonize the people that elect it, so it gives the IRS an unusually large amount of power.

Part A explains the IRS's aggression, Part B explains the IRS's power, and Part C explains why the IRS must be checked.

A. ADMINISTERING THE WORLD'S LARGEST DEBT COLLECTION SYSTEM REQUIRES AGGRESSION

Aggressiveness is inherent in any effective debt collection system. Because of this aggression, businesses usually outsource debt collection. Businesses fear that debt collection could hurt their public image. Debt collectors must irritate debtors with frequent letters and phone calls, they must threaten to inform credit agencies, and they must threaten to seize collateral.¹²⁶ If this non-judicial leveraging does not work, then the collector must bring suit, seize property, and garnish wages.¹²⁷ These activities are unpleasant, and they could harm customer relations. Congress recognized this phenomenon in the Consumer Credit Protection Act.¹²⁸ That act protects consumers from overly aggressive debt collectors, but its debt collection provisions do not apply to businesses that collect their own debts.¹²⁹

As hard as collecting is for businesses, it is even harder for the IRS. In the year 2000, the IRS collected over \$2 trillion.¹³⁰ The most recent figures indicate that the gap between taxes owed and taxes collected is

126. For an excellent discussion of non-judicial collection methods, see ELIZABETH WARREN & JAY LAWRENCE WESTBROOK, *THE LAW OF DEBTORS AND CREDITORS* 45-157 (4th ed. 2001).

127. For an excellent discussion of state law debt collection methods, see *id.* at 45-157.

128. 15 U.S.C. §§ 1601-1693r (2001).

129. 15 U.S.C. § 1692a(6) (2001) (defining "debt collector" as "any person who uses any instrumentality of interstate commerce or the mails in any business the principal purpose of which is the collection of any debts, or who regularly collects or attempts to collect, directly or indirectly, debts owed or due or asserted to be owed or due *another*" (emphasis added)).

130. INTERNAL REVENUE SERVICE ANNUAL REPORT, STATEMENT OF CUSTODIAL ACTIVITY FOR THE FISCAL YEAR ENDED SEPTEMBER 30, 2000, available at <http://www.irs.gov> (Forms and Publications, Publication 3385) (last visited Jan. 30, 2003).

\$125 billion and growing.¹³¹ Fighting that gap and collecting that tax is a large job that the IRS has to perform with comparatively small resources. To make things harder, the IRS depends on self reporting. The tax code requires taxpayers to honestly determine their tax bill and voluntarily pay it. A kind and gentle IRS cannot police this system.

Recent tax reform legislation highlights aggression's necessity. In 1998, alleged victims of IRS abuse paraded in front of Congressional hearings.¹³² These people told horrendous stories, while taxpayer privacy laws prevented the IRS from telling its side.¹³³ Recent investigations have proven most of these stories false,¹³⁴ but Congress used these stories to justify new laws that severely restricted the IRS's ability to collect tax.¹³⁵ Congress decided to make the IRS a kinder, gentler debt collector.¹³⁶

As good as Congress's intentions may have been, their IRS Reform Act caused tax evasion to skyrocket and IRS moral to plummet. For example, national property seizures plummeted nearly 80% in 1999.¹³⁷ North Texas property seizures plummeted from 286 in 1996 to 3 in 1999.¹³⁸ The number of North Texans that owe uncollected taxes increased from 51,600 in 1997 to 71,100 in 1999.¹³⁹ The number of North Texas businesses with federal tax debt increased from 9,900 in 1997 to 16,100 in 1999.¹⁴⁰ In addition, the IRS audit rate dropped from 1.7% in 1995 to less than 1% in 2000.¹⁴¹ Tax collections plummeted and Congress

131. Karen Hube, *Return to Sender: The IRS is Auditing Fewer People These Days but Trying to Guess the Red Flags Isn't Easy*, WALL ST. J., Feb. 28, 2000, at R19 (citing figures from the Government Accounting Office). That represents almost 1% of the federal government's 1992 budget. See EXECUTIVE OFFICE OF THE PRESIDENT OF THE UNITED STATES, BUDGET OF THE UNITED STATES GOVERNMENT FISCAL YEAR 2001, HISTORICAL TABLES, available at <http://w3.access.gpo.gov/usbudget/fy2001/maindown.html> (last visited Jan. 30, 2003).

132. See John D. McKinnon, *Some IRS Abuse Charges are Discredited*, WALL ST. J., Apr. 25, 2000, at A2 [hereinafter McKinnon I]; John D. McKinnon, *Highly Publicized Horror Story that Led to Curb on IRS Quietly Unravels in Virginia Civil Court*, WALL ST. J., Dec. 9, 1999, at A28 [hereinafter McKinnon II].

133. For example, one taxpayer accused the IRS of knocking his son to the floor at gun point and watching his naked daughter dress at gun point. McKinnon II, *supra* note 132. Congress refused to waive the disclosure laws that prohibited the IRS from telling its side of the story.

134. See McKinnon I, *supra* note 132; McKinnon II, *supra* note 132.

135. See Internal Revenue Service Restructuring and Reform Act of 1998, H.R. 2676, 105th Cong. (1998). Among other things, this act threatens IRS Agents with termination and greatly restricts the IRS's ability to seize property.

136. See Todd Bensman, *IRS Struggling to Recreate Itself as a Gentle Giant: Collections, Enforcement Slow to a Near Halt in N. Texas District*, DALLAS MORNING NEWS, Apr. 1, 2000, at 1A.

137. John D. McKinnon, *Highly Publicized Horror Story that Led to Curb on IRS Quietly Unravels in Virginia Civil Court*, WALL ST. J., Dec. 9, 1999, at A28.

138. See Todd Bensman, *IRS Struggling to Recreate Itself as a Gentle Giant: Collections, Enforcement Slow to a Near Halt in N. Texas District*, DALLAS MORNING NEWS, Apr. 1, 2000, at 1A.

139. *Id.*

140. *Id.*

141. Karen Hube, *Return to Sender: The IRS is Auditing Fewer People These Days but Trying to Guess the Red Flags Isn't Easy*, WALL ST. J., Feb. 28, 2000, at R19.

rethought its kinder IRS.¹⁴²

B. CONGRESS DOES NOT HAVE THE TIME OR EXPERTISE TO EFFECTIVELY GOVERN FEDERAL TAXATION

In addition to aggression, an effective IRS must be powerful. Congress does not possess the expertise or time to effectively determine income taxation's details. These details are incredibly and necessarily complex. This complexity is driven by the high dollar amounts riding on effective tax planning. Consider the millions of dollars that companies like Enron and General Electric have saved through tax planning.¹⁴³ A minor label here or a third party there can produce millions in tax savings. Consequently, tax professionals dedicate their careers to learning taxation's rules, and developing procedures for getting around them. Two types of taxation demonstrate: partnership taxation and consolidated corporate taxation.

Partnership regulations contain complex standards and prohibitions designed to distinguish economic-motivated allocations from tax-motivated allocations.¹⁴⁴ Only seasoned tax professionals that specialize in partnership taxation can adequately maneuver the regulations' many twists and turns. On the surface, this complexity may seem unnecessary, but a deeper look reveals its necessity. Partnership taxation's greatest advantage is the freedom it gives partners to allocate income, loss, and deductions as they see fit. But this advantage also offers a large opportunity for abuse. In the past, creative tax professionals have used partnership taxation's allocation freedom to lower tax liability. They would allocate tax items one way and economic items another. The partners' economic gains increased, while the IRS's tax collection decreased.

To stop this abuse without diluting partnership taxation's legitimate advantages, the IRS developed complex regulations that help distinguish economic allocations from phantom tax allocations. This distinction requires tracking how tax allocations affect partner equity. A tracking system like that combines complex accounting standards with statutory requirements.¹⁴⁵ One cannot expect this system to be effectively developed by a time-strapped Congress that has to legislate everything from airline safety to consumer credit.

142. See Bensman, *supra* note 138; Hube, *supra* note 141.

143. See John D. McKinnon, *Enron Strategy Opposed by Clinton Draws Scrutiny of Government Officials*, WALL ST. J., January 15, 2002, at A18 [hereinafter McKinnon III]. Enron used a financial "trust-preferred" securities to reduce taxes and hide debt. *Id.*

144. See Treas. Reg. § 1.704-1. This regulation contains over 70 subsections and almost 80 pages of prohibitions and accounting standards that track partnership equity. For an in depth analysis of partnership taxation, see WILLIAM S. MCKEE ET AL., *FEDERAL TAXATION OF PARTNERSHIPS AND PARTNERS* (2002).

145. For example, Treas. Reg. § 1.704-1(b)(2)(ii)(b) requires partnerships to maintain capital accounts in accordance with the general accounting principals in Treas. Reg. § 1.704-1(b)(2)(iv). These capital accounts are used to determine proper distributions upon partnership liquidation. Treas. Reg. § 1.704-1(b)(2)(ii)(b) (requiring partnerships to liquidate in accordance with the positive capital accounts). For a more detailed discussion, see MCKEE ET AL., *supra* note 144.

Another tax complication involves consolidation. Consolidated taxation allows a financial entity to share tax items while also operating as separate legal entities. This is a fantastic advantage for corporations, but it opens avenues for abuse. Without close controls, corporations could implement schemes that allow them to apply tax credits they did not earn or deduct tax losses that they did not suffer.¹⁴⁶ To combat this abuse, the IRS has established regulations that track everything from asset basis to corporate tax credit.¹⁴⁷ Again, this is a complex set of accounting and legal principles that one cannot expect Congress to maintain.

Only one government entity has the expertise and resources to develop and manage taxation's complexity: the Internal Revenue Service. The Internal Revenue Service employs more tax lawyers than any firm in the United States. It has tax experts across the nation that can implement the complicated systems described above. Congress has no choice but to give the IRS an unusually large amount of power to determine and collect tax.

C. THE IRS'S COMBINATION OF POWER AND AGGRESSION CAN LEAD TO ABUSE

As necessary as an aggressive and powerful IRS is, this combination can lead to abuse. On one hand, Congress designed the IRS to aggressively collect tax. On the other hand, Congress gives the IRS an unusually large amount of power to determine tax. This combination encourages the IRS to aggressively determine tax liabilities. If not carefully checked, this aggression can lead to exaggerated tax debts. It can lead to the IRS imposing tax bills that Congress never intended taxpayers to pay.

Congress does not have the time or exposure to adequately restrain the IRS, so courts must fill the gap. The following explains why the Federal Circuit fills this gap so well.

V. NO COURT CHECKS THE BEAST BETTER THAN THE FEDERAL CIRCUIT

No tax venue restrains the IRS's aggression and power better than the Federal Circuit Court of Appeals. Other tax venues lack the Federal Cir-

146. For example, Enron used "trust-preferred" securities to reduce taxes and hide debt. McKinnon III, *supra* note 143. Enron would borrow money from a subsidiary, treat the transaction as debt for tax purposes, but as equity for financial accounting purposes. *Id.* Enron's latest financial statements show at least \$900 million dollars of these trust-preferred securities. *Id.* The Internal Revenue Service initially challenged these securities, so Enron filed suit in the Tax Court. *Id.* Many observers thought that the IRS would lose that case, so the IRS eventually settled, and issued Technical Advice that allowed some kinds of trust-preferred securities. *Id.* See also BITTKER & EUSTICE, *supra* note 51, § 5.10 (describing corporate tax shelters in general) and § 13.42[5][c] (2001) (describing "son of mirror" transactions that allowed taxpayer to deduct phantom losses).

147. For example, I.R.C. § 382 restricts a parent's ability to purchase a subsidiary and immediately apply that subsidiary's loss carryovers to the consolidated tax return. The subsidiary loss carryover is treated like an investment that the parent must apply over time. For a detailed explanation, see BITTKER & EUSTICE, *supra* note 51, § 14.44.

cuit's history and monetary-claim expertise. The Federal Circuit specializes in bringing uniform justice to disputes between the United States and its citizens. The next parts explain. Part A describes the Federal Circuit's history, and Part B explains why other tax venues do not bring justice as effectively as the Federal Circuit.

A. CONGRESS CREATED THE COURT OF FEDERAL CLAIMS AND THE
FEDERAL CIRCUIT COURT OF APPEALS TO FAIRLY SETTLE
MONETARY DISPUTES BETWEEN THE UNITED
STATES AND ITS CITIZENS

The Federal Circuit and the Court of Federal Claims evolved from the original Court of Claims.¹⁴⁸ Congress specifically created these courts to bring prompt justice to citizens with monetary claims against the United States.

Congress created the Court of Claims on February 25, 1855.¹⁴⁹ This court originally had jurisdiction to hear monetary claims based on a congressional statute, executive regulation, or contract with the United States.¹⁵⁰ Before then, citizens submitted these claims directly to Congress.¹⁵¹ But as Congress's workload increased, it decided to create a separate tribunal named the Court of Claims. Pleased by the Court of Claims's performance, Congress further expanded its jurisdiction in 1887; the Court of Claims became the primary forum for all monetary claims against the government.¹⁵²

As the Court of Claims's work load increased, it split into a trial and appeals division. The Court of Claims relied on commissioners to hear evidence and determine facts.¹⁵³ The court's judges then acted as an appeals division for parties that did not agree with the commissioners' findings. Congress formalized this arrangement in 1982 by splitting the Court of Claims into a formal Article III trial court and Article III appeals court.¹⁵⁴ The trial court is named the United States Court of Federal Claims and the Appeals Court is named the Federal Circuit Court of Appeals.

These courts both continue the tradition stated in Abraham Lincoln's 1861 message to Congress: "It is as much the duty of government to render prompt justice against itself, in favor of citizens, as it is to adminis-

148. At that time the Court of Federal Claims was known as the Court of Claims. Congress changed its name to the United States Court of Federal Claims on October 29, 1992. Federal Courts Administration Act, Pub. L. No. 102-572, 106 Stat. 4506.

149. Federal Judiciary Center History on the Court of Claims, *available at* http://air.fjc.gov/history/oc_frm.html.

150. *Id.*

151. *Id.*

152. *Id.*

153. *Id.*

154. *Id.* The original Court of Claims judges became Federal Circuit appeals judges, and additional judges were appointed for the new Court of Federal Claims. *Id.*

ter the same between private individuals.”¹⁵⁵

B. THE FEDERAL CIRCUIT’S HISTORY AND EXPERTISE HELP IT CHECK THE IRS BETTER THAN ANY OTHER TAX VENUE

The Federal Circuit’s tradition and expertise has helped it restrain the IRS more effectively than any other Court. The Tax Court lacks the Federal Circuit’s history and perspective, and the regional circuit courts of appeal lack the Federal Circuit’s expertise.

The United States Tax Court began as executive agency, and it has always specialized in tax. The Revenue Act of 1924 established the Tax Court’s predecessor named the Board of Tax Appeals.¹⁵⁶ This Board was an independent executive agency created to provide taxpayers a forum for disputing tax deficiencies before payment.¹⁵⁷ Before then, taxpayers had to pay a disputed tax deficiency before they could seek judicial relief. In 1969, Congress changed this tribunal’s name to the United States Tax Court, and changed it from an executive agency to an Article I court.¹⁵⁸ The President appoints Tax Court judges to 15-year terms.

The Tax Court’s IRS focused history prevents it from appreciating the IRS’s unusual power and aggressiveness. The Tax Court has never settled disputes involving other federal agencies, so it does not completely appreciate how the IRS compares to other agencies. The Court of Federal Claims and the Federal Circuit, on the other hand, regularly settle disputes with many different federal agencies. Thus, the Tax Court is more limited in its ability to determine how much courts should defer to the IRS.

The federal district courts and the regional courts of appeals have a wider exposure to federal agencies than the Tax Court, but these courts lack the Federal Circuit’s expertise and uniformity. The Federal Circuit specializes in refund suits against federal agencies. It specializes in the issues that a court must consider when determining how much deference to give the IRS. Also, the Federal Circuit has national jurisdiction, instead of regional jurisdiction. Its understanding of deference issues is not limited to one geographic area, and it can apply deference standards uniformly.

VI. SUMMARY: THE FEDERAL CIRCUIT COURT OF APPEALS IS GOOD FOR THE FEDERAL SYSTEM OF TAX LITIGATION

The Federal Circuit Court of Appeals has a long history of fairly settling monetary disputes between the United States and its citizens. Its tax jurisprudence is no exception. The Federal Circuit has a keen eye for the

155. See United States Court of Federal Claims website, at <http://www.uscfc.uscourts.gov> (last visited Jan. 30, 2002).

156. KAFKA & CAVANAUGH, *supra* note 5, § 2.01[2].

157. *Id.*

158. *Id.*

IRS's power and aggressiveness, and it has checked the IRS whenever justice has required. Since the Federal Circuit performs this duty better than all other tax venues, Congress should retain the crazy quilt of tax litigation and continue to let the Federal Circuit promote justice.

Casenote

